

# Creating a Community Investment Fund

## A Local Food Approach

A Grassroots Guide — Version 1.0  
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A Project of Cutting Edge Capital

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## **Acknowledgments**

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This guide describes the process by which a small group of local food advocates began creating an investment fund in the Pioneer Valley of Western Massachusetts. The fund is yet to be formally named, but we call it, in these pages, the Community Capital Fund. It is a work still in progress.

That said, we have learned much thus far. So much that we decided to prepare this guide so that others could take advantage — more quickly and inexpensively — of our experience. We hope to inspire others to experiment with local investment funds, learn new lessons, share their insights, and join us in building a field together. Our ultimate aim is to launch community capital funds across the country.

We designed this guide not to convert beliefs, but to help individuals who already believe in just, local, sustainable food systems to be able to invest in just that.

Many thanks to Jeff Rosen of the Solidago Foundation and Tom Willits of the Lydia B. Stokes Foundation for commissioning this work. Jenny Kassan, founder and CEO of Cutting Edge Capital, wrote a series of memos for this project which provided the legal analysis. And very helpful comments on various drafts came from the members of the PVGrows Finance Committee: Rick Chandler, Judy Gillan, Phil Korman, Margaret Christie, Mary Hoyer, Jim Oldham, Michael Abbate, Chris Sikes, John Waite and Alan Singer. Thanks as well to a team of advisors including Grant Abert, Eric Becker, Michael Brownlee, Jess Cook, Paul DiLeo, Anders Ferguson, Alex Linkow, and Dan Pullman. Special thanks to Sam Stegeman, the PVGrows coordinator, who has kept this process moving forward.

We anticipate revising this guide periodically, so if you use it, please let us know your recommendations on how to improve it for others.

**Michael H. Shuman**  
**Silver Spring, May 2013**

# Introduction

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**This guide aims to help communities across the United States create their own investment funds to grow local food businesses.**<sup>1</sup> It grows out of the efforts of a network called PVGrows in which local food advocates are working together in the Pioneer Valley of Western Massachusetts to revitalize the local economy, support the agricultural community, and increase residents' access to healthier food. From the beginning, PVGrows has given high priority to raising capital.

**More and more U.S. communities are interested in promoting local food, and appreciate that a critical obstacle is mobilizing capital for new or expanded local food businesses.** Starting in 2008, this movement also has seen a dramatic growth of interest in local investment. That year marked the "GFC" — the global financial crisis — when millions of U.S. investors saw a significant percentage of their wealth disappear as the stock market and housing market sank. Americans are now seriously asking whether they can continue to entrust their retirement and their kids' education to such a rickety financial system. They want to put their money to work in the enterprises they know and care about, and an increasing number have expressed interest in investing in local farms and food enterprises.

**What stands in the way are obsolete institutions and laws that make local investment extremely difficult and expensive.** Securities laws enacted during the Great Depression effectively created a system of economic apartheid, with "accredited investors" being able to invest in any business they wish and unaccredited investors being essentially told to get lost. Accredited investors comprise the richest one percent of Americans — those who earn more than \$200,000 (or \$300,000 with a spouse) or have more than \$1 million in assets, excluding one's primary residence.<sup>2</sup> As long as entrepreneurs don't lie about their business plans, governance, and numbers, they can easily approach any "accredited" investor for an investment.

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<sup>1</sup> Practically speaking, "local" has two prongs: proximity and ownership. Proximity refers to the distance from producer to consumer. Thus, many locavores want their food to travel a short distance "from farm to table," because proximity fosters relationships of trust between consumers and farmers, maximizes the level of economic activity within a community, and minimizes the carbon footprint of shipping. From a local investment perspective, an equally critical factor is ownership. Local ownership of a business means that a majority of the shareholders of a company live close to its operations. What matters is *control* of a business by people who live in the place where it operates, because local control increases the chances of a business hiring locally, spending money locally, pumping up the local economic multiplier, contributing to local charities and civic society, and behaving responsibly to local stakeholders.

<sup>2</sup> The threshold for an accredited individual is \$200,000, which is earned by fewer than 1% of Americans. See <http://politicalcalculations.blogspot.com/2011/09/distribution-of-income-for-2010.html>. The threshold for an accredited couple is \$300,000. Under 2% of American households earn this much income. See <http://www.decisionsonevidence.com/2012/02/want-to-know-your-household-income-percentile-ranking/>. Since households can have more than a couple as earners — grandparents' pensions and children's work also might contribute to household income — probably the percentage of *couples* earning over \$300,000 is closer to 1%. Institutions, such as churches or foundations, can achieve accredited status if their assets exceed \$5 million.

The other 99% are “unaccredited” and presumed too gullible to invest in a company without massive legal paperwork. In many states, before a business can make an investment “offering” to even a single unaccredited investor, it must pay an attorney to produce a private placement memorandum and various regulatory filings and documents that can cost \$25-50,000 in legal, accounting, and government fees. If a company wants many unaccredited investors, it must create a public offering for which many lawyers might charge another \$50,000 or more.

**Here’s the stunning bottom line: Even though roughly half the jobs and the output in the economy comes from local small business, almost all our investment dollars go into big corporations on Wall Street.** The overall wealth of the country is over \$150 trillion.<sup>3</sup> Some of this wealth is held as land, buildings, and machinery, and considered “illiquid”— not very easy to convert into dollars. The most liquid assets held by household and nonprofits are stocks, bonds, mutual funds, pension funds, and life insurance funds, and at the end of 2010 these totaled about \$30 trillion. Not even 1% of these savings touches local small business.

Were local businesses uncompetitive, unprofitable, and obsolete for the U.S. economy, this gap would be understandable. But local businesses are highly competitive (their share of jobs in the United States is growing), and at least as profitable as larger corporations (sole proprietorships are three times as profitable as C-corporations).<sup>4</sup> Our investment gap actually represents a huge capital market failure. It means that Americans are systematically overinvesting in Wall Street and underinvesting in Main Street. Were this \$30 trillion allocated efficiently, at least \$15 trillion would shift into locally owned small businesses.

**In recent years, millions of American have pioneered some intriguing ways to invest in local business. Here are just a few of the highlights:**

- An estimated two million Americans have embraced “Move Your Money” and relocated their day-to-day financial activities, including their checking accounts, loans, credit cards, and mortgages, to a local bank or credit union.
- Communities have used existing tools to facilitate local investment, such as bank CDs in targeted local businesses, a new generation of investment-minded co-ops, sponsorship web sites like Kickstarter and IndieGogo, peer-to-peer lending sites like Kiva and Prosper, investors networks like LION (the Local Investment Opportunities Network of Port Townsend, Washington), and Community Development Financial Institutions (CDFIs).
- The JOBS Act, signed into law by President Obama in April 2012, will soon provide a new “crowdfunding” exemption for companies seeking up to \$1 million in capital, permitting all Americans to invest at least \$2,000 per company per year.

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<sup>3</sup> Federal Reserve, “Flow of Funds Accounts of the United States,” 4th Quarter 2010, 10 March 2011.

<sup>4</sup> Michael H. Shuman, “The Competitiveness of Local Living Economies,” in Richard Heinberg and Daniel Lerch, eds, *The Post Carbon Reader: Managing the 21st Century’s Sustainability Crises* (Healdsburg, CA: Watershed Media, 2010).

**Yet in one respect, the local investment revolution remains incomplete.** “One off” investments in local companies, like “one off” investments in any company, are inherently risky. Smart local investors prefer to pool their money, diversify their risk, and hedge their bets. The problem is that securities laws governing such funds, starting with Investment Company Act of 1940, place onerous obstacles in the way of unaccredited investors — and the JOBS Act reforms do not change these laws at all.

You’re probably thinking — well, I could perhaps ask my mutual fund to invest some of my money in my community. Think again. There are 7,500 mutual funds in the United States, and not a single one invests a penny in local business. This is not because it’s legally impossible — mutual funds could invest in municipal bonds and direct public offerings — but because mainstream financial institutions thus far have lacked the interest in shaping themselves to focus on local investments. So why not create a local mutual fund? Eventually, someone will. But the legal expenses for doing so today could be hundreds of thousands of dollars.

Mutual funds, however, are not the only pools of money in which unaccredited investors can participate. The Investment Company Act has more than a dozen exemptions.<sup>5</sup> This handbook explores just one of these — the use of a nonprofit fund to support small businesses.

To be clear: There are hundreds of funds across the United States, primarily revolving loan funds, that do support local business. Many are run by states, cities, economic development organizations, or foundations, and they are undeniably important tools for helping small entrepreneurs. But nearly all of them only tap investment dollars from accredited investors. This guide is about also tapping dollars from the other 99%.

### **There are precedents out there, but remarkably few of them:**

- ***RSF Social Finance***, starting in 1984, encouraged followers of Rudolf Steiner across the United States to place their money in a nonprofit fund that would support Waldorf Schools. Over the years, loan recipients have expanded to include businesses linked to food and agriculture, education and the arts, and ecological stewardship. Consistent with the participatory philosophy of Steiner, the fund accepts unaccredited investors from nearly 40 states.

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<sup>5</sup> Some of the most common exemptions (with section numbers from the Act) relevant for our discussion are these:

- (3)(b)(1) Any issuer primarily engaged, directly or through a wholly owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities.
- (3)(b)(2) Any issuer which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities . .
- (3)(c)(1) Any issuer whose outstanding securities (other than short-term paper) are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities. .
- (3)(c)(10)(A) Any company organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes.

Private funds most commonly use the 3(c)(1) and 3(c)(7) exemptions. Under Section 3(c)(1), private funds with no more than 100 investors are exempt from coverage under the Investment Company Act. If a fund wants to have more than 100 investors, it generally uses the 3(c)(7) exemption which requires that investors be “qualified purchasers” (high net worth individuals and institutional investors).

- ***The New Hampshire Community Loan Fund*** has provided \$150 million to in-state businesses and individuals since it was established in 1983. Unaccredited investors may place \$1,000 or more into the fund, and receive 1-5% per year depending on how long they commit to leaving their money on deposit.
- ***The Cooperative Fund of New England*** takes money from all kinds of investors, including unaccredited ones, and lends it, in the form of convertible debt, to promising cooperatives throughout the region.
- ***The Calvert Foundation***, a nonprofit arm of the Calvert Fund (itself a pioneer in socially responsible investing), sells Community Investment Notes and uses the proceeds to invest in community development financial institutions (CDFIs) and other community friendly programs like community development corporations. Investors in 49 states, including many unaccredited investors who can buy \$25 notes on MicroPlace, have placed \$180 million into this program.
- ***The Economic and Community Development Institute***, based in Columbus, Ohio, has 14 revolving loan funds to support small businesses in the region. The most recently established fund allows unaccredited investors to participate.
- ***MountainBizWorks***, in Asheville, North Carolina, provides small businesses loans ranging from \$500 to \$150,000, and unaccredited investors can participate.
- ***Common Capital of Holyoke***, Massachusetts, just launched a community capital fund that aims to take money from all kinds of investors, including unaccredited ones, and invest in all kinds of local businesses in Western Massachusetts.
- ***The Equity Trust***, based in Western Massachusetts, provides loans to farms, land trusts, and housing projects across the United States. Unaccredited investors willing to commit at least \$1,000 for a year or more may join.

There is an urgent need to create more of these funds all across the country, to move more capital into local businesses in a way that brings down the risk of investing in a single company. And there's a need to make these funds simple to understand, easy to invest in, and efficient to run by professionals, so that investors feel confident that their dollars are being stewarded to optimal community outcomes.

### **The Approach of This Guide**

For several years, the members of PVGrows have been trying to expand the financial resources available for local food businesses in Western Massachusetts. They knew there was a growing community of consumer activists enthusiastic about food. They also knew that many residents supported the growth of the local food economy as investor activists. And they knew that farm and food system businesses needed a more patient form of investment capital at certain stages



of their business. Given the alignment of these interests, they set to work to create a local investment fund.

**This guide documents PVGrows' early thinking process. It is organized to provide a roadmap for other groups interested in creating their own local investment funds.**

We hope that our experience spurs other funds in other communities, and helps local investment practitioners across the country connect with one another. As our body of experience grows, we will put out future editions, perhaps through a Wiki page, with more case studies and cities, more models to consider, and a more detailed list of do's and don'ts.

We begin by briefly telling the backstory of PVGrows. In the chapters after that, we lead you through the basic questions you'll need to answer to set up your own fund. The five big questions are these:

- *What are your objectives?*
- *What types of finance will best support your highest priority businesses?*
- *What legal structure makes the most sense?*
- *How can you mobilize the right investors for your fund?*
- *How can you fine-tune your fund's business plan?*

The guide leads you through these five big questions, and the many issues beneath them, in the form of a decision tree, summarized in Chart 1. Throughout each section we weave bits and pieces of our story. But the big decisions concerning our Community Capital Fund — at least our preliminary decisions — are laid out in the Epilogue. You'll see that PVGrows is now creating a pilot fund of \$2.5 million. Most of our story, however, is yet unwritten — as is yours!

## Chart # 1. A Decision Tree

<b>Set Your Funds Objectives</b>
<ul style="list-style-type: none"><li>• <i>Geographic Focus</i></li><li>• <i>Economic Mission</i></li><li>• <i>Risk vs. Reward</i></li><li>• <i>Priority Businesses</i></li><li>• <i>Targeted Business Stage (Startup vs. Early Stage vs. Mature)</i></li><li>• <i>Capital Needs of Businesses</i></li><li>• <i>Business Plan for Fund (Costs, Revenues, Losses, Returns)</i></li><li>• <i>Size of Fund</i></li><li>• <i>Mission Statement</i></li></ul>
<b>Determine the Fund's Top Investment Targets</b>
<ul style="list-style-type: none"><li>• <i>Type of Investment (Debt, Royalty, Equity, etc.)</i></li><li>• <i>Size of Average Investment</i></li><li>• <i>Technical Support</i></li></ul>
<b>Pick the Right Legal Structure for Your Fund</b>
<ul style="list-style-type: none"><li>• <i>Exemptions from Investment Company Act</i></li><li>• <i>Potential Alternatives to an Investment Fund</i></li><li>• <i>Piggybacking on Another Fund</i></li></ul>
<b>Recruit the Right Investors in the Fund</b>
<ul style="list-style-type: none"><li>• <i>Investor Motivations</i></li><li>• <i>Traditional Sources of Community Capital</i></li><li>• <i>Unaccredited Investors</i></li><li>• <i>Voice of Investors within the Fund</i></li></ul>
<b>Fine-Tune Your Fund's Business Plan</b>
<ul style="list-style-type: none"><li>• <i>Open vs. Closed Fund</i></li><li>• <i>Anticipated Lifetime of Fund</i></li><li>• <i>Plan for Ongoing Operations</i></li><li>• <i>Anticipated Failures</i></li><li>• <i>Indicators of Success</i></li></ul>

# I. The Pioneer Valley Story

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The Pioneer Valley in Western Massachusetts is a rich agricultural center in New England. It is made up of three counties — Franklin, Hampden, and Hampshire — with 697,458 residents spread over 1,850 square miles. Unlike many other rural regions of the United States, which lack vital infrastructure, this one has benefitted from the proximity of cities like Boston, Hartford, and Albany, as well as the presence of some of the most prestigious universities in the country. But its farmers, most of whom own relatively small landholdings, have steadily lost competitive ground to large-scale, industrial, and increasingly global agriculture.

The region is diverse, both geographically and socioeconomically. It contains seemingly idyllic New England towns, hamlets, and small urban centers that face contemporary challenges associated with the collapse of their traditional industrial base. The cities of Greenfield, Holyoke, and Springfield, where huge tracts of former industrial complexes lay abandoned, are struggling with the decline of municipal budgets, and their services are stretched to the breaking point. Within just a few miles of some of the finest soils in the world, residents of these cities live in food deserts, suffering the effects of low-nutrition diets.

Over the past generation the Pioneer Valley has given birth to a robust local food movement. One reason is that the region has excellent farmland and a variety of agricultural microclimates, include fertile bottomland, sloping orchard sites, and upland pastures that support a wide diversity of agricultural products. It has enjoyed a steady, if small, influx of new farmers, often with good experience and training from local farms, colleges, and incubator or training programs.<sup>6</sup> With the support of a number of influential nonprofits, such as Community Involved in Sustaining Agriculture (CISA), public interest in local farms, local farm products, and other local food businesses has grown substantially. And there has been a proliferation of kitchen incubators, community gardens, youth leadership programs focused on local food, and strong farm-to-school programs.

In 2008, as the leaders of the local food movement in the Pioneer Valley puzzled over how to scale it up, they came to two conclusions: First, they needed access to flexible capital and related business services that could nurture mission-focused food entrepreneurs in the Pioneer Valley. Second, they needed to collaborate and network better — but without forming a new organization that would compete with the existing groups for scant resources. The solution was to form the PVGrows network.

The official mission statement of PVGrows proclaimed it be “a collaborative network dedicated to enhancing the ecological and economic sustainability and vitality of the Pioneer Valley food system.” It’s worth underscoring that PVGrows was foremost about bringing together people already working on the local food system —not about raising capital. It was and still is a membership organization without dues. It convenes its members twice a year as well as in

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<sup>6</sup> These opportunities include Hampshire College, the Stockbridge School at UMass, CRAFT, the New England Small Farm Institute, The Farm School, and numerous formal or informal apprentice or employee training opportunities on local farms.

smaller working groups, where participants can connect with others doing similar work. The network began with over thirty members, and over four years has grown to 600.

The Finance Working Group (FWG) of PVGrows was composed of members expert in what was happening in New England in the area of “food finance.” Besides their own experience as investors, they were inspired by Slow Money, an organization dedicated to mobilizing 1% of investment into local farms and food businesses. Slow Money had fast-growing chapters in Boston and Portland, Maine. Maine was also home to the nationally respected Coastal Enterprises, a Community Development Financial Institution that invests in local food systems. The New Hampshire Community Loan Fund was developing a number of innovative financing instruments, including royalty-based finance, around a variety of local businesses. The Vermont Sustainable Jobs Fund was creating a Flex Capital Fund to help underwrite a statewide food economy.

Despite these many initiatives, the Finance Working Group concluded that huge local financing gaps remained, particularly for viable food enterprises that were not fully “bankable.” So it decided to launch a loan fund overseen by nine members.<sup>7</sup> FWG members called the fund a pilot, because the primary purpose was to learn about local investing by doing it. Though some members had already been making loans to farm and food enterprises, none had yet done so collaboratively. Nor had they deliberately sought to work with other community groups, philanthropic organizations, and state and federal agricultural programs. The group raised \$750,000 for its loan pool, from both mission-oriented and institutional investors, and then collectively made decisions where to invest based on a mission matrix.

Day-to-day administration of the pilot fund was placed in the hands of an existing local fund in Holyoke called Common Capital. If the applicant met the mission objectives and seemed viable, it was passed on to Common Capital to undertake the due diligence. If Common Capital came to a favorable ruling on the loan application, the applicant was funded, with Common Capital administering the loan.

The PVGrows pilot loan fund would end up making only two direct investments totaling \$300,000. But it also indirectly catalyzed other deals for businesses that didn’t quite fit its own lending criteria. For example, Real Pickles, doing much of its own legwork but also relying on the assistance of Cutting Edge Capital and PVGrows, raised \$500,000 in a direct public offering to assist its transition to a worker-owned cooperative. Common Capital was also motivated to pre-finance a farm-to-city CSA model, which then allowed its participants to use U.S. Supplemental Nutrition Assistance Program (SNAP) debit cards to pay for the fresh, organic produce.

Listening to its members’ own experience and the wisdom of peers such as Coastal Enterprises and the Vermont Sustainable Jobs Fund, the group recognized the need to support its

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<sup>7</sup> The Finance Committee members were: Community Involved in Sustaining Agriculture (CISA), New England Small Farm Institute (NESFI), Mass Department of Agricultural Resources (MDAR), Common Capital, Franklin County CDC (FCCDC), Cooperative Fund of New England (CFNE), Equity Trust, Inc., Lydia B. Stokes Foundation, and Solidago/Frances Fund Foundation.

borrowers with business assistance. Recently, PVGrows partnered with the Fair Food Fund to create a \$75,000 Technical Assistance Fund, offering up to \$15,000 in direct business services to help established food businesses expand their operations. Tapping these and other technical assistance resources from the Working Group partners, nearly a dozen applicants to the loan fund — including poultry processors, dairy processors, greenhouse growers, beekeepers, and local distributors — have used these services to move their business plans forward.

In two respects, PVGrows has unquestionably succeeded. A number of important local food businesses, unable to secure debt capital from banks or other financial institutions, have been able to stabilize and grow. And the Working Group has learned how to finance many more local food businesses in the future.

Learning, of course, has meant surmounting challenges too. One of the biggest has been finding qualified entrepreneurs to finance. As Jeff Rosen summarizes, “We don’t know why we are not seeing this entrepreneur class coming to us. It’s possible that people do not know about the fund. It’s possible that in its pilot phase, the fund does not offer flexible enough capital. It is also possible that there are too few firms in the space defined by viable but not fully bankable. Possibly, as some have suggested, in the current economy, people generally and potential entrepreneurs specifically do not want to take on any debt or risk. Or, as some would suggest, we need to do more to train, motivate, and attract the right kind of management to the local food economy. As one would suspect, the truth is probably an amalgamation of all theories. But some are easier to fix than others. It is much easier to change the terms of the loan fund, or to improve our outreach. It is much more daunting to think about the body of work and resources it will take to build the entrepreneur pipeline.”

**The charge to Cutting Edge Capital was to explore these questions more deeply and help the Finance Committee come up with an appropriate next stage for its work.** The presumption was that another fund was needed, but that it would need a model with the following four characteristics:

- Involve all kinds of local investors, including unaccredited investors, flexibly in the Pioneer Valley food economy.
- Provide more patient capital to a variety of businesses, in different stages, in partnership with other financial institutions where necessary.
- Aggregate the risks in a fund managed properly by investment professionals.
- Support this investment activity with other forms of community engagement that could grow a critical mass of local investors committed to growing the local food economy.

The following chapters summarize our exploration. The questions we review, and to which we provide at least provisional answers, are the same questions that any investment fund must answer before it is launched.

## II. Clarifying Your Objectives

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So you want to start a local investment fund? The very first step in any journey is to know where your destination is: What geographic region do you consider “local”? What’s the mission of the fund? What kinds of businesses are you trying to support? At what stage — startup or mature? How does your business plan pencil out cash flow if everything goes well? What kind of risk are you prepared to take on? What size will your financial packages be? How will you present your mission to the outside world?

### **GEOGRAPHIC FOCUS**

*How do you define your community?*

Your first task is to choose how local you want your local fund to be. The tricky part is to frame a definition that coincides with a critical mass of investors. Investing in just your town may not be at a large enough scale to facilitate the fund’s financial success.

PVGrows was formed to serve the Pioneer Valley, but the difficulty that the initial loan fund experienced in locating enough deals raised the question of whether a successor fund might need to serve a larger area. Perhaps the area should be Western Massachusetts? Or the entire state? Or New England?

Expanding the geographic range, however, carries risks and challenges too. You begin to enter into geographic focal points of other funds. You are less capable of intimately knowing the businesses you are serving.

PVGrows also considered other issues linked to its choice of geographic scope. For example, might it make sense to invest exclusively or primarily in low-income neighborhoods (or zip codes) within the Pioneer Valley? This could make it easier for the fund to attract investment from institutions with a federal designation as a Community Development Financial Institution (CDFI). Or might the fund want to invest some of its funds in local investment funds outside the Pioneer Valley? One plausible rationale would be to diversify the portfolio geographically — to insulate itself from the ups and downs of inevitable local business cycles — but in a way that still supports locally owned food businesses.

### **ECONOMIC MISSION**

*Which social or economic problems are you trying to solve? Exactly what kinds of local businesses do you wish to support?*

Answering these questions inevitably requires an analysis of your local economy. PVGrows already knew a great deal about its local food system, but it still was not sure how to take that system to scale.

**As Jeff Rosen reflects:**

*Given all the recent interest, people from all aspects of the food system wonder, “What will it take to scale up a vibrant, resilient, local food economy?” Is it reasonable to assume that we could increase our access to healthy foods, preserve farmlands, generate decent jobs, retain local spending dollars and decrease our dependence on the fossil-fuel driven global food system by strategic investments in a revitalized local food economy? If the answer is yes, as many of us believe, what kind of investments do we need, and where are we going to get those investments from? <sup>8</sup>*

We decided to study what it might take to expand the Pioneer Valley’s local food system by 25%. What we meant by a “25% shift” was that the localization gap in every food-business sector — that is, the gap between the level of business that exists today and the level needed to achieve total self-reliance in that sector — would be closed a quarter of the way. The 25% goal was chosen to be big enough to inspire regional mobilization of the business, policymaking, and grassroots communities, but not so big to be dismissed as utopian.

Our study reviewed the rationales for food localization, the emerging competitiveness of local food businesses, and the existing contours of the Pioneer Valley food system. To analyze the impact of a 25% shift, we undertook a “leakage analysis,” which meant examining each sector of food buying, whether fresh food, processed food, or restaurant food, and determining the degree to which residents were buying local.

A variety of tools are available to measure leakage in a given community. We used IMPLAN, the Minnesota Input-Output Model deployed extensively by economic development agencies nationwide. IMPLAN shows, sector by sector, the existing supply and demand, as well as the changes that occur from “shocks” to this system — like the shift of consumer spending 25% toward local food.

We found that a 25% shift toward food localization would create 4,030 new jobs (including direct, indirect, and induced effects), enough in principle to put one out of every six unemployed workers in the region back to work. From a media standpoint, this was perhaps the most compelling finding. It underscored that local food could deliver the one economic item everyone seems to care about — jobs. It also set a highly motivating target for a local investment fund. Additionally, we found that a 25% shift would generate \$128 million in new annual wages and \$259 million in additional value-added.

Was food too narrow a focus? It’s worth returning to the problem that PVGrows had with finding enough deal flow for its first fund. The Finance Working Group overseeing the fund considered the possibility that it might want to expand its focus to other kinds of business, like renewable energy or light manufacturing. Some of its members, like Common Capital and the Coop Fund of New England, were already focusing on multiple sectors. The challenge, however, is that building expertise and quality control becomes more difficult as a fund moves into more business sectors. The decision was made to stick with farm and food businesses.

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<sup>8</sup> Jeff Rosen, *Can Investors Help to Bring the Local food Movement to Scale? Lessons from the Pioneer Valley*, The Natural Farmer (NOFA, Fall 2012).

What were the unique capital challenges of these businesses in the Pioneer Valley? Our experience with the PVGrows loan fund suggested that the region had more than enough lending resources. However, there was no coordinated effort to provide farming and food entrepreneurs with a layer of capital that was more patient and risk-tolerant. This was the kind of capital needed to seriously scale up the local food economy. We also knew that a growing number of local residents wanted to put some portion of their investment resources into these kinds of business. We needed to consider, as a core question for our mission, what was the right balance of risk and reward that could bring these businesses and investors together.

## **RISK AND REWARD**

*How much risk is the fund prepared to tolerate? How much desire does the fund have-and really its investors-for potential rewards? How willing are these investors to lose money?*

Most investment funds are for-profit companies that aim to maximize returns, and even funds run by nonprofits like PVGrows have no desire to lose money. In principle, then, an investment fund wants to take on enough risk to serve those who cannot access more mainstream sources of capital, but not so much risk that business failures wipe out the fund. Balancing investor risk with the community virtues of filling a gap in the capital system is the most fundamental design challenge facing a local investment fund

The entire discourse about the “riskiness” of companies sounds more scientific than it really is. No one knows for sure how likely it is that any company, or any portfolio of companies, or any fund managing that portfolio, will fail. Even the best research can’t predict the future. The success of any company may depend on unknowable factors about the market, the products, the management, the consumer base, etc. While it is generally true that investors demand a higher rate of return for more risk, that doesn’t mean that the tools for measuring risk are very good. Three factors underscore why projections about rates of return and related risk should be treated skeptically.

First, consider what constitutes a market rate of return for the tens of thousands of companies that are publicly traded. There’s probably no area of finance in which we have more data, so we should have no trouble discerning a “market rate of return,” right? Investment advisers often imply that if you leave your money in a diversified stock-market portfolio for many years, for the “long-term,” you can expect an annual return of 8%, 12%, even 20%. In fact, over 140 years of the Standard & Poors (S&P) Index, the typical annual return of the entire market (adding dividends but removing the effects of inflation) is 2.6%.<sup>9</sup> What’s obvious, then, is that finance is an area where hype trumps data.

Second, while a scientific approach to finance would lead us to believe that smart fund managers, after studying specific publicly traded companies, can assemble portfolios that beat the market, this rarely turns out to be the case. We know, for example, that the vast majority of

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<sup>9</sup> Michael H. Shuman, *Local Dollars, Local Sense: How To Shift Your Money from Wall Street to Main Street and Achieve Real Prosperity* (White River Junction, VT: Chelsea Green, 2012). The raw data come from economist Robert Shiller of Yale.



mutual funds, each managed with supposedly scientific precision, underperform the market. It was this revelation that led to the speedy spread and use of low-fee index funds two decades ago.

Third, as one leaves the world of publicly traded stocks and publicly regulated mutual funds, where the reporting follows legally dictated rules, the hype and unreliability of the data increase. While there is no question that some unregulated hedge funds spectacularly outperform the market, we have learned that widely publicized good years are often followed by underpublicized poor ones. Scholars who have studied hedge and venture funds have found that their overall performance is no better and perhaps even worse than the market.

The bottom line is to appreciate that the best that a local fund can do is dig deep into one particular sector, learn as much as it can about applicant companies and entrepreneurs, specialize in one or two styles of local investing, and focus on first-rate execution. That's why PVGrows decided to focus on the food sector and learn the craft of investing before it considered scaling up with a more ambitious fund. Focusing on a small geographic community like the Pioneer Valley made it easier to mitigate risk by understanding local market conditions and getting to know the local entrepreneurs.

PVGrows was also very clear that, unlike many for-profit funds, it was seeking to achieve "blended returns." This term originates from Jed Emerson, a pioneer in the field of impact investing, who argues that some social investments, even if their financial return is low or negative, might nevertheless be worth making because of their positive social returns to the local economy, to the labor force, and to the environment. While there are no uniform standards by which to measure these "triple-bottom-line" (TBL) returns, the concept is a powerful one and accurately captures the motives of many local investors. This is another reason to open the fund to unaccredited investors who may have lower expectation for financial returns than sophisticated professional investors. (We'll return to the topic of investor expectations later.)

### **Jeff Rosen suggests how this calculus influenced the participants of PVGrows:**

*Consider some distinctions between a traditional, sector-specific equity fund (typically, equity funds have a sector focus, such as a fund that invests in Biotech or Clean Technology firms, allowing them to hire specific expertise to guide investment decisions and shepherd the investment portfolio) and a proposed local food fund. Private equity funds typically invest in a management-led value proposition. If they are early stage funds (investing in startups, companies that have yet to market a product or are very early in their market penetration), they expect a number of failures, and the way the fund (attempts to provide) investors with a high return is by betting on some huge wins (home runs in investor parlance). Everyone wants to invest in the next Apple, Google, or Starbucks, and these high-yield companies provide returns because they explode onto the national or global stage and reach huge numbers of customers; they show astronomical growth rates. Private equity funds will control risk by deep engagement: often they seek to have a seat on the board of directors when the investment stake is high enough. This leads to a potentially undesirable outcome, where the venture fund*

*pressures a business to pursue profits in a way that maximizes the short term interests of the investors, but not necessarily the long term interests of the original entrepreneurs. We have all heard that story.*

*Many aspects of this model do not fit in the local food fund. Local food investors do not want the entrepreneur to scale up in a big way, and/or exit to a multinational. They are invested in the fund to create lasting value in the community. Just like the case of the individual TBL business, you could have a fund with a number of successful ventures, generating lasting food system impact, yet the fund will not have the 'home runs' in the portfolio to carry the expected losses. This issue is exacerbated by the fact that the fund will have within its core mission the preference to provide critical or innovative capital. By definition, the investments will be risky. The risk is exacerbated by the sector specifics, the mission requirements, and the geographic focus. Remember, any time you limit the pool of potential investments, you are increasing the risk.*

Rosen argues that ultimately the investors in PVGrows should be prepared for a relatively low financial return, coupled with a high TBL return. But, again, what is a “low financial return?” If a typical market return on a publicly traded security is 2.6% per year and we know that funds rarely outperform the market, then a fund like PVGrows probably needs to set investor expectations at perhaps 1-2% per year, *plus the TBL returns.*

The question remains: How much risk is PVGrows willing to tolerate? Is the PVGrows fund more or less risky than an investment in the public markets? The premise of the fund is that it will fill a gap, rather than compete with existing capital resources, and it will likely take on companies that banks have already turned down or would not even consider. So these loans and companies, by definition, are riskier than bank loans. On the other hand, the public markets are quite volatile, and increasingly so, thanks to high-frequency, computer-driven trading. It could be argued that investing in the local food economy, with deep local knowledge, is less risky than investing securities in the stock market, with almost no personal knowledge. In any event, investors need to understand that a broad range of returns is plausible.

One of the reasons the PVGrows network decided to focus on all aspects of the food system was to maximize community engagement and thereby mitigate some of the risk. While a business may not have enough collateral to be bankable, it may nevertheless have ample community collateral embedded in the relationships of people who know the businesses. PVGrows members also can boost the businesses as consumers and word-of-mouth marketers.

**In any event, it's essential that the fund take affirmative steps — more than a bank would — to minimize the risks of failure.** Here are some of the recommendations PVGrows found helpful:

- Know your sector well to maximize your ability to judge the future performance of your portfolio businesses.
- Screen out exceptionally high risks, like startups, or allocate only a small portion of assets to high-risk investments.
- Invest only in entrepreneurs and companies you know reasonably well.

- Place clear, demanding performance standards on all clients, and develop clear plans for what happens when clients fall short.
- Provide technical assistance to client businesses to address potential weak points.
- Consider creating a portfolio of local businesses that are buying and selling to one another, so that the success of each generates multipliers that propel the others.
- Encourage your investors to buy from the supported businesses, as a way of increasing their chances of success.

## PRIORITY BUSINESSES

*Exactly which local businesses are your highest priorities for finance by your fund? How should you decide?*

Prior to Cutting Edge Capital being hired, various members of PVGrows had analyzed the local food system to evaluate what businesses were missing. In 2011, for example, the Community Involved in Sustaining Agriculture (CISA) issued a report, *Scaling Up Local Food: Investing in Farm and Food Systems Infrastructure in the Pioneer Valley*.<sup>10</sup> The report identified some of the key new businesses required for a more diversified, local food economy, including: meat and poultry slaughter and processing facilities; dairy processing facilities; temperature and humidity-controlled storage facilities (root cellars, refrigeration, freezers); improved or expanded facilities for aggregation, basic processing, freezing, and co-packing; distribution and delivery serving a variety of types of markets and farms; logistics that coordinate ordering, delivery, and invoicing; and grain processing facilities and equipment. This was a great list, but it was hard to know how to rank these priorities.

Using IMPLAN, we were able to analyze which businesses, if expanded to meet local demand by 25%, would create the most jobs and the best wages. Here's what we found:

- **Meat and Poultry** — If land and training are available, there is great potential for new jobs from: raising animals like pigs, sheep, and goats (327 jobs); raising beef cattle (162 jobs); and slaughtering these animals locally (139 jobs). Additional jobs are possible from raising poultry and eggs (23 jobs), and slaughtering them locally (16 jobs).
- **Farming** — There is significant potential for new jobs from: growing fruit (160 jobs); nursery trees and plants (157 jobs); tree nuts (75 jobs); vegetables (47 jobs); grains (45 jobs); and other crops (18 jobs). Another 26 jobs could come from agricultural support activities.
- **Value-Adding Manufacturing** — The directly grown items above could be fed into various well-paying manufacturing enterprises, including: local bakeries (117 jobs); frozen food (40 jobs); soft drinks and ice (36 jobs); confectionary products (32 jobs); canned fruits and vegetables (31 jobs); wineries (31 jobs); cookies, crackers, and pasta

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<sup>10</sup> See <http://buylocalfood.org/upload/resource/ScalingUp10-17-11lrwithLinks.pdf>.

(27 jobs); snack foods (23 jobs); seasonings and dressings (17 jobs); and breweries (13 jobs).

- **Dairy** — There are large job opportunities for raising more dairy cows (291 jobs), along with value-adding local manufacturing of milk and butter (34 jobs) and ice cream and frozen desserts (20 jobs).
- **Food Service** — Even though the Pioneer Valley is rich in food service, the local demand is so large that another 76 jobs in this sector are possible.

These categories corresponded with the initial analysis of CISA — but also enabled us to identify some very specific business opportunities within each category. These business opportunities pointed to what the priorities for the Community Capital Fund should be.

### **PRIORITY BUSINESS STAGE**

*Once you've picked the kinds of businesses you wish to prioritize, how do you pick the right stage of business? For example, should you prioritize startups or existing businesses?*

The business stage targeted may determine the type of finance you wish to provide. For example, small loans are probably more appropriate for startup entrepreneurs than for expansions of well-established businesses. The experience of the pilot fund of PVGrows was that the region already had a significant number of loan funds that could support startup and expansion companies with loan dollars. We interviewed the heads of loan funds and other sources of finance in the region, most of whom were members of the PVGrows Finance Working Group, to understand how much capital was available — and where the gaps might be. Essentially, this was a market analysis, assessing the strengths and weaknesses of our investment “competitors.”

We found that while the region had adequate, traditional debt to offer farm and food businesses, it was less able to provide long-term, low-cost patient capital. We also observed that most local loan funds get their money from banks or government sources that they must pay back. Furthermore, they have to cover their own operating costs from the difference between the cost of the money they borrow and the rate at which they lend it, so it is hard for them to lend money out at low interest rates.

We found a remarkable number of funds in our region already assisting local food businesses, though none were quite doing what we wanted to do. Two of the small number of funds nationwide open to unaccredited investors, the Equity Trust and the Cooperative Fund of New England, are based in the Pioneer Valley. But both fund a much wider range of businesses than food companies, and their geographic ranges are national and regional, respectively. The Franklin County Community Development Corporation has a revolving loan fund, locally focused, but supports a broader range of businesses than just food and farming. Common Capital, based locally, also targets a broad range of small businesses throughout New England (and a few nationally as well), and its recently launched Community First Fund is open to unaccredited investors. The Carrot Project, based in Massachusetts, supports local farm

businesses throughout New England, including in the Pioneer Valley. While we were undertaking our research, the Fair Food Network, based in Ann Arbor, had just received a major grant to launch a new investment fund for small food businesses based in the Northeast. In addition, of course, there was the early lending experience of PVGrows pilot loan fund.

The entities above comprise an unusually strong network of funding mechanisms for local food business. Most regions in the United States would be lucky to have even one of these funds. However, almost all these funds focused on loans, typically (though not exclusively) issued at a very small scale. One local fund manager confided having difficulty making loans during the financial crisis, because so many local businesses and entrepreneurs were already overextended with debt. This is the reality everywhere right now. The entire country is coping with second-mortgages that are underwater, credit cards that are maxed out, and ramped-up repayment demands by financial institutions that have caused a record number of bankruptcies.

The bottom line was clear: Simply increasing the level of debt capital would do little to finance the 25% shift. A growing number of entrepreneurs in the Pioneer Valley were looking for equity or equity-like kinds of finance that would not put them in further debt, or at least not put them in a cash crunch during their early growth phase. Moreover, many of the businesses needed for the 25% shift — meat processing; food manufacturing, packaging, and distribution; and institutional food service — simply cannot be helped by small loans. The scale of these enterprises, and the capital required for them, is too large.

## **BUSINESS NEEDS**

*What exactly are the capital needs of your targeted businesses?*

Even if you know that your community needs more business in certain sectors, you ultimately have to evaluate the capital needs of particular businesses. If you start businesses from scratch, there's a greater chance that you will be supporting businesspeople or business plans that are not up to the task. If you are encouraging a business to expand — rather than supporting entrepreneurs with well-thought-through expansion plans — there's a greater chance you might be distracting it from its preference to continue business as usual.

The PVGrows Finance Working Group came to the conclusion that since it was focusing on a small geographic area, it would need to be open to a wider range of business plans to ensure deal flow. So startups, pre-revenue companies, and serious expansions of existing companies were all welcome to apply to the existing pilot loan fund.

## **THE BASIC MATH**

*What's the business case for your fund? How can you make sure that you won't lose your investors' money?*

Even if you envision philanthropic or government money supporting your fund, it's valuable to pencil out a model that “cash flows” positively.

Start with your expected costs. How many hours of someone's time do you need to attract investors, to report your progress, to vet potential businesses, and to troubleshoot those that are not meeting your targets? What's the overhead required for this person for office, computer, and telephone? What are the annual costs for lawyers, accountants, and tax form preparers? How about the costs of letters, annual reports, and other forms of regular communication with your investors? Experience suggests that even a very modest fund, run by a part-time staff person, is going to have costs of at least \$100,000 per year.

If you use 1% of your deal flow per year to cover costs, you will need \$10 million in deals. If you only have \$1 million in deals, then you need to use 10% per year to cover costs — which most investors would regard as excessive.

It's understandable why the pilot loan fund of PVGrows, which was merely \$750,000, had to be administered by an outside group — in this case, Common Capital of Holyoke. The scale was way too small to justify anything approaching a full-time staff person.

Let's imagine \$10 million as a baseline for a single staff person. If the typical deal is \$100,000, the fund would require 100 deals. Even a red-hot investment genius, however, could not perform due diligence on 100 deals per year — essentially, two top-to-bottom reviews per week. Remember that for every deal that the fund agrees to, that genius will probably need to look at four or five potential deals. Are there even 500 potential deals in the Pioneer Valley in a generation, let alone in one year? A smarter way to go would be to find 10-20 deals, each \$500,000 to \$1 million. Yet a brilliant staff person would still be extremely challenged to approve one deal every two to four weeks.

One can start to appreciate why a fund might want to find grant money to underwrite a staff person's time for the first few years as it builds out its portfolio and hones its expertise.

**To make the math work reasonably well, a fund should strive for all the following:**

- Have an existing fund provide administrative services through part of an experienced staff person's time.
- Identify a sustainable overhead percentage. (Many funds charge 2-3% per year on assets under management.)
- Focus on larger deals first, smaller deals later.
- Keep investor expectations of profit very modest.

Note that we haven't yet really considered any returns for the investor at all. Suppose we have deals with ten companies, each for \$1 million. If one company goes out of business, the other nine will each have to generate more than an 11% rate of return for the fund to break even. If two companies go out of business, the break-even rate of return for the remaining eight companies will need to be 25%!

**So here are the additional ground rules that a successful investment fund must adopt:**

- Stretch out your portfolio over multiple years so that losses can be spread out. If your fund lasts for five years, for example, one loss could be covered by the other nine companies each generating a 2-3% return per year.
- The smaller your fund and the fewer companies you have in your portfolio, the more important it is that you minimize risk, probably by betting only on mature companies.
- The more small investments you make, the more it will cost to administer the fund, as due diligence costs are relatively similar for any business borrower irrespective of size.
- Develop a good plan for supporting client businesses and, if possible, ask existing business support organizations — perhaps your local Small Business Development Center — to pick up the cost of doing this. If there are foundations in your community interested in your fund, this also may be the sweet spot to ask for grants.

**NEEDED SIZE**

*What size must the fund be to realize its mission? Is it realistic to raise that much capital?*

To estimate how much additional capital might be needed for a 25% shift toward local food in the Pioneer Valley, we turned to the most recent edition of *Statistical Abstract*, which has a helpful table called “Net Stock of Private Fixed Assets.”<sup>11</sup> Chart 2 below shows these values nationally for food businesses, and then scales them by population for the Pioneer Valley. Assuming the food system has a constant relationship between jobs and capital, we showed that the additional capital required for the 25% shift is \$279 million. This number could be higher if business expansions turn out to be more capital intensive.

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<sup>11</sup> Table 781, for the year 2009. Food-related wholesale is assumed to be 10% of the total.

**Chart # 2. Capital Requirements for 25% Shift (2010 Data)**

<b>Private Assets for Food Businesses (\$millions)</b>		
	<b>United States</b>	<b>Pioneer Valley</b>
<b>Agriculture</b>	\$493,000	\$1,120
<b>Food Manufacturing</b>	\$238,000	\$541
<b>Food Retail &amp; Wholesale</b>	\$154,000	\$350
<b>Food Services</b>	\$269,000	\$611
<b>TOTAL</b>	\$1,154,000	\$2,622
<b>Population</b>		
<b>Total Population</b>	307,000,000	697,458
<b>Population %</b>	100%	0.0022%
<b>Food-Related Jobs</b>		
<b>Existing Food Jobs</b>		37,825
<b>Additional Jobs with 25% Shift</b>		4,026
<b>Percent Expansion</b>		10.64
<b>Additional Capital Requirement</b>		\$279,000,000

Of course, \$279 million is a very large number. But it's helpful to put this in perspective with the level of savings in the Pioneer Valley. Chart 3, drawn from the finance calculators of the Business Alliance for Local Living Economies (BALLE), shows that residents have approximately \$18 billion of savings in short-term accounts and \$62 billion in long-term accounts. Reallocating less than two percent of the former or less than half of one percent of the latter could fully finance the businesses needed for the 25% shift.

**Chart # 3. Estimated Household & Nonprofit Capital (2010 Data)**

<b>Pioneer Valley (\$millions)</b>	
<b>SHORT-TERM SAVINGS</b>	
<b>Checking</b>	6,749
<b>Savings</b>	14,085
<b>Money Market</b>	3,024
<b>TOTAL</b>	23,858
<b>LONG-TERM SAVINGS</b>	
<b>Corporate Stock</b>	1,719
<b>Corporate Bonds</b>	5,063
<b>Mutual Funds</b>	9,563
<b>Pension Funds</b>	27,522
<b>Insurance Funds</b>	2,860
<b>TOTAL</b>	46,727



For the region to amass \$279 million for local food businesses, it might only need to come up with a small percentage — perhaps 20% — in equity. So PVGrows concluded from this data that a fund of \$56 million might be able to leverage the remainder in loans from existing financial institutions in the region. That was, then, the broad target we set.

Should we do nothing until \$56 million is in hand? If you set the bar too high before you get started, it is less likely that you'll reach it. Even if you ultimately do reach it, you won't be able to do anything with the money while you are fund-raising. Investors who see their money sitting in a bank account, doing nothing, not feeding the community development advertised, get irritated — and may wish to pull their funds out. So we decided to set the bar lower. We would get started with the new fund when \$500,000 was in hand and seek a preliminary raise of \$2.5 million.

How we would amass that money and more afterwards — how we could transform potential local investors into actual investors — is taken up later.

## **MISSION STATEMENT**

*What's a succinct summary of what you're trying to accomplish?*

**A good mission statement should tie together all the points in this section.** Here is how the PVGrows Finance Working Group summarized and goals in a recent communication:

The objective is to aggregate flexible investment capital from accredited and nonaccredited investors to generate a flexible layer of capital for local food and agriculture enterprises in the Pioneer Valley, placed by a disciplined financial institution with the capacity to provide ongoing support for investees. Businesses supported would be viable, but not fully bankable, and the fund would likely partner with other like funds (including Finance Working Group Members), or more traditional institutions in many deals.

***Short-Term Goal:*** To connect a first generation set of investors, who are eager to put some portion of their investment portfolio to work in their local food economy, with food and agriculture enterprises that are in need of capital.

***Long-Term Goal:*** To connect individual investors to a mature and efficient set of investment vehicles for local economy investing, that will be safe, while filling a missing niche in the capital marketplace to promote a stronger, larger, and more equitable local food economy.

***The Basic Vision:*** To coordinate these first generation investment dollars in some type of pool, so that there is more efficient intermediation and professional management of investments across a set of investments.

### III. Making The Right Types of Investment

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You've now scoped out the kinds of businesses your investment fund should target. What exactly is the best way to assist these businesses? How can you help minimize the chances that the businesses will fail? Below are a series of questions to answer about the type of finance you're providing to target businesses, the size of the finance, the terms, and the accompanying technical assistance.

#### **TYPE OF FINANCE**

*What is the kind of investment you intend to make in the target businesses? Debt? Equity? Something in between? Why?*

In the world of investment theory, there's a continuum of risk between secured loans in well-established companies (lower risk) and equity investments in startups (higher risk). In between, of course, are a variety of other types of finance, including:

- unsecured loans;
- subordinated loans (where the lender takes a second position in getting repaid);
- convertible debt (where the lender has an option to convert debt into an equity position under certain circumstances);
- royalty finance (where the investor gets paid a percentage of revenue or profits); and
- warrants and options (where the investor has the right to purchase stock at a specified price).

Some analysts present these types of investments as located on different parts of a risk continuum. The truth is that the details of each type will govern how risky each is. Unsecured loans, for example, can be very risky or unriskey depending on the borrower.

The choice of which kind of finance to offer will depend on the preferences of target businesses and of target investors. Ideally, you would interview representatives from both groups to test various possibilities.

While planning the Community Capital Fund, we were drawn to the concept of royalty finance. While the idea has been adopted by a number of institutions, we were especially intrigued that the Vermont Sustainable Jobs Fund had embraced it for its new Flexible Capital Fund to support value-added agriculture, sustainable forest products, renewable energy, green technology, and waste management. Properly designed, royalty finance can minimize payment burdens on businesses during tough times but pay attractive returns during good times.

The PVGrows Finance Working Group members were also drawn to royalty finance because of the cyclical nature of food and farming businesses. Even during years of good climate, there are seasons for planting and for harvesting and selling. Of course, farming has bad years too. Food

businesses can be seasonal as well. Restaurants in the Pioneer Valley, for example, do better during the peak tourist months of the summer. It seemed that embracing royalty finance, where a company's payments are calibrated to its cash flow, might be a smart way of shaping repayment burdens around the specific needs of food businesses.

It should be added that the exact details of the royalty finance still need to be decided. Here are some of the questions that need to be considered:

- Will it be based on revenue or profit? The argument for basing it on profit is that it ensures that repayment burdens only kick in when the company is doing well. But defining profit is tricky. The argument for basing it on revenue is that the fund will receive a more consistent and reliable stream of repayments.
- Should the royalty payment be done annually, quarterly, or monthly?
- Should the royalty payment be capped at repayment of the principal plus a certain rate of return?<sup>12</sup> If so, at what rate of return? Avoiding a cap might increase the potential returns to the fund. But if the fund is a nonprofit, a cap might be more consistent with its mission.

Another option we are considering is whether to have different investment vehicles for different types of financial needs. For example, it still might make sense to offer loans for land and equipment, and then use the physical assets as collateral. Royalty finance could then be focused on the more uncertain universe of working capital.

## **SIZE OF FINANCE**

*What size should be the typical financial package for a business? How broad can the variation from low to high be?*

Again, most financial institutions prefer bigger deals. Every deal requires due diligence, which means many hours scrutinizing the business plan, the management team, the board, the market, the collateral, and so forth. It's easier and cheaper to perform this once for one million-dollar deal than 100 times for ten thousand dollar deals.

A local investment fund has to respect this logic, too, up to a point. As we saw, it's inconceivable that one part-time person, which may be all a local fund can afford, can review dozens of deals in a year. But a local investment fund must also be mindful that its mission is to support the development of many small businesses, and that the size of a financial package should relate to the sophistication of the business and its stage of development. Small investments make more sense for unproven startup businesses, while larger packages make sense for successful businesses that are expanding.

In the Pioneer Valley the fact that multiple small loan funds already existed and arguably had exhausted the borrowing demand of small businesses underscored the importance of our

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<sup>12</sup> Royalty streams that follow this pattern are really more accurately viewed debt arrangements.

creating a new fund providing larger investments. The effective problem facing many entrepreneurs is this: They are sick of debt, especially since most small business lenders demand that the entrepreneur put his or her house on the line (SBA loan guarantees require this, for example). If the entrepreneur promises his or her spouse that this will only happen once, it may be hard to turn around and put another huge lien on the house for another decade.

Experience suggests that established businesses growing to the next level require something in the range of \$100,000 to \$1 million. Since our fund is targeting established food businesses that need patient capital, this was the range of finance we anticipated providing.

There is still, of course, ten times more work doing due diligence for ten \$100,000 packages than for one \$1 million package. Focusing on established entrepreneurs and businesses, however, usually means that the due diligence has already been performed on each candidate business by other financial institutions involved in earlier stage finance. So a key for our fund is maintaining good relationships with these institutions. For its initial loan fund, PVGrows involved many key local financial institutions, as well as nonprofits like CISA, which helped to “ground truth” the investment decisions. This kind of oversight will be essential for the Community Capital Fund as well.

## **SUPPORT**

*What kind of technical assistance, if any, should accompany the financial package? Who should provide it?*

The New Hampshire Community Loan Fund, mentioned in the Introduction, provides three levels of funding for small businesses: microloans under \$10,000; loans between \$10,000 and \$100,000, and higher-risk investments between \$100,000 and \$500,000. The qualifications for each level differ, as do the requirements and due diligence required for each. Perhaps the biggest difference, however, is the technical assistance for each. At the lower rungs, entrepreneurs must take formal training classes and enter technical assistance programs, whereas at the higher rungs, such expertise is presumed.

For microloan programs, technical assistance programs are big expense items. It underscores why most of these programs, run by nonprofits, must raise funds from foundations and government programs to cover the cost of technical assistance; and why for-profit microlenders often charge very high interest rates (sometimes even higher than credit card rates) to cover their costs. Because many communities often have these programs anyway — entrepreneurship classes at the community college, business-plan assistance through the Small Business Development Center, mentorship through the SCORE program (made up of retirees willing to share their business experience) — a smart finance program will harness as many free or low-cost resources as possible. The quality of these programs varies, however, so it is essential that the fund vet these programs before requiring its investees to use them. Low-quality technical assistance is worse than none at all, because it wastes valuable time the entrepreneur needs to succeed.

For the Pioneer Valley, the decision to focus on existing businesses mitigated some of this requirement. That said, even experienced entrepreneurs have weaknesses. So we anticipate tapping resources throughout the Pioneer Valley — and, in partnership with the Fair Food Fund, resources throughout New England -- to assist the recipients of finance. Fortunately, this is an area where the participating fund managers and nonprofits in PVGrows have long been working.

## IV. Choosing the Right Legal Structure

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What legal structure will you want for your fund? To answer this question, you must begin by looking at the Investment Company Act of 1940. Generally speaking, the Act covers all funds. A community-oriented investment fund will want to avoid being classified as an Investment Company under the Act, because compliance with its many regulations is complicated, difficult, and very expensive.

What exemption, then, might apply to your fund and relieve the potential burdens on you? Are there other options for creating a local pool of capital that are worth considering? Might you just piggyback onto an existing fund?

### EXEMPTIONS

*How can I ensure that my fund is not covered by the Investment Company Act of 1940?*

While PVGrows decided to use the nonprofit exemption to this Act, other routes are available. As discussed earlier, you might set up a company that acquires local businesses as subsidiaries and then, after developing them for a time, sells them back to community investors. Or you might create a fund with fewer than 100 investors, though there are challenges to including unaccredited investors this way.<sup>13</sup>

Another route is to create a company around a specific community business, and then carefully make sure that less than 40% of the assets are used for investment purposes. In the Pioneer Valley, for example, this is the strategy used by Co-op Power, a consumer cooperative that helps its 400 members buy low-cost energy efficiency and renewable energy equipment,

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<sup>13</sup> According to the Hedge Fund Law Blog, such funds face the following difficulties: “Many startup hedge fund managers want to know if their friends and family can invest in the startup hedge fund. Most of the time, such friends and family do not fall within the definition of accredited investor under the Regulation D rules. The regulation D rules allow a maximum of 35 non-accredited investors to invest in any single offering. Because a hedge fund offering is continuous, the limit of 35 non-accredited investors is cumulative. That means that over the life of the . there can be no more than 35 non-accredited investors (as opposed to 35 non-accredited investors in the fund at any single point in time).

While some managers will allow non-accredited investors to invest in their hedge fund, many managers will not because of two reasons.

“The first reason is that non-accredited investors, by definition, do not have as many assets and therefore are unlikely to make a significant investment into the hedge fund. Often the costs of having an investor with a small contribution outweigh the benefits of having the investor in the fund (especially if the fund is nearing the 99 investor requirement under Section 3(c)(1)). Such investors also probably will not fall within the definition of qualified clients so the manager would probably not be able to charge these investors a performance fee which is one reason managers will prefer not accept non-accredited investors if possible.

“The second reason why managers tend to disallow non-accredited investors into the fund is that there is a perceived bias by regulators toward the non-accredited investor. In the event that the fund loses money, state securities regulators are going to be more sympathetic towards a non-accredited investor than an accredited investor all things being equal. While we have seen no empirical studies suggesting this is the case, we feel this is probably a justified perception.

“Typically hedge funds with non-accredited investors will need to have a yearly audit. This is in contrast to hedge funds without non-accredited investors which can, if properly documented in the hedge fund offering documents, choose whether or not to have an audit (although the default for most hedge funds is to have a yearly audit).”

See <http://www.hedgefundlawblog.com/non-accredited-investors-in-hedge-funds.html>.

supplies, and services. It has asked most of its members to put in \$1,000 of capital, and it then reinvests some of it (under 40%) in promising local companies performing energy audits, installing solar energy equipment, producing biofuels, or manufacturing wood chips. One could certainly imagine a multipurpose food cooperative deploying a similar strategy.

Still another possibility is to create a Business Development Company (BDC). BDCs are not exempt from the Investment Company Act, but they are regulated more lightly. To qualify, a firm must target its investment dollars on smaller businesses, and provide them with significant managerial assistance. Assistance can include recruiting management personnel, serving on the board, and evaluating acquisition and divestiture opportunities. One could imagine, for example, a business incubator being formed under this provision. Unfortunately, legal compliance with the requirements for BDCs could easily exceed \$100,000 annually, as these are public companies and therefore subject to myriad SEC filing requirements.

After reviewing these various options, PVGrows opted for the nonprofit structure. It was not interested in getting into the business of buying and selling companies, or in creating another business that would occupy most (>60%) of the capital. There was a desire to recruit more than 100 investors and to make the offering to the general public. The legal expenses of a nonprofit are much lighter than those of a BDC. There is also a state law in Massachusetts that exempts from expensive registration filings any securities “issued by any person organized and operated not for private profit but exclusively for religious, educational, benevolent, charitable, fraternal, social, athletic, or reformatory purposes, or as a chamber of commerce or a trade or professional association.”<sup>14</sup>

This last point is an important reminder that besides federal law, you must always look at state law, too. State securities laws impose requirements on top of federal law. This underscores why, eventually, you must have an attorney working with you.

## **OTHER OPTIONS**

*Are there other, simpler ways to create pools of capital for local investment?*

If you and your attorney get exasperated by the complexities of investment companies and the exemptions, you might want to consider some other, outside-the-box alternatives. Rather than creating a fund, you could focus on making direct public offerings (DPOs) in local food businesses, which would allow unaccredited investors to participate. If all goes as expected, crowdfunding web sites will begin to receive their licenses from the SEC in 2014, which will permit many small businesses to issue securities for purchase by unaccredited investors.

With so many options, might investors be able to pool their money to invest in a portfolio of small local businesses and diversify their risks? The answer is a qualified “yes.” As these local public offerings proliferate, unaccredited investors will be able to surf over to a local web site, review a variety of local stock investment opportunities, and then assemble their own diversified portfolios. You essentially can become your own investment manager. The challenge

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<sup>14</sup> 950 Code of Massachusetts Regulations, Section 14.401 (a) (9).

is how to sell the securities once you acquire them. Some local companies will provide opportunities for resale, but others won't. You will therefore need to understand the fine print of each investment before buying.

Another option might be to use the emerging pooled products on the fast proliferating crowdfunding portals. Mission Markets in New York, for example, is currently considering creating special relationships between community portals and local broker-dealers, where the latter are encouraged to create (in consultation with the local portal operators) specialized portfolios for customers. These portfolios are essentially local exchange traded funds (ETFs). So, for example, a customer might be able to buy a bundle of, say, municipal bonds and local securities.

A third option is to form an investment club. Many Americans do this already, though they use the club to invest in the conventional stocks and bonds of global companies. The basic rule of investment clubs is that a group of fewer than 100 adults can pool their money and collectively invest however they see fit. When the members contribute to the investment club, the purchase of equity in the club is not considered a security, because all the members are actively involved in the investment decisions. Therefore, the club does not have to register its own offering to its members with state or federal securities regulators. The moment one person is appointed to make decisions for the group, however, the SEC will deem investment in the group to be a securities offering that requires federal and state registration. It's also worth pointing out that collective decision-making need not be unanimous. A smart investment club still needs to put all its decisions to a vote, carefully recording the involvement of members in every investment decision.

An example of an investment club that focuses on local business is No Small Potatoes, an offshoot of Slow Money in Maine. No Small Potatoes is a group of about twenty individuals who formed an LLC and placed \$5-10,000 each into a pot. Several times per year, they come together to lend their money (usually in small, several-thousand dollar increments) to worthy farmers or local food businesses. Between meetings, small groups of members interview potential candidates for funding.

Investment clubs are available to unaccredited investors as well as accredited ones. But there's a catch. Investors cannot use these options to circumvent other securities law requirements. Unless the club itself is an accredited investor by having more than \$5 million in assets, it can only invest in businesses that allow unaccredited investors to participate (for example, businesses that have gone through the mechanics of crowdfunding).

The disadvantage of all these self-management options is that they can require a lot of work. The advantage is that these tools invite more people in a community to take an active role in learning about the local business community, discovering promising investment opportunities, and developing tools for sound local investing.

From the standpoint of the Pioneer Valley, we could not see — yet — many locals using these alternative tools for pooling. This was another reason to create our own fund. Moreover, the



spread of these tools could bring more locals, especially those who were unaccredited and looking for pooled investment opportunities, into our fund.

## **PIGGYBACKING**

*Might it make sense to hire an existing fund to manage ours?*

If your community, state, or region already has a fund, it might make sense to hire them to run your fund. The obvious advantage is that it avoids all the legal hassle and expense of creating a new entity, and paying an existing fund manager for part of his or her time to manage a new fund might be less expensive than hiring a new staff person and creating a new office from scratch. The potential disadvantage is that it may be difficult to locate a fund manager who shares your values and priorities.

The PVGrows Finance Working Group came to the conclusion that getting one of the existing funds in the region to manage the new Community Capital Fund made sense. To make this hiring decision, we prepared an RFP for a management team and invited bids from these and other funds in the region. Among the key questions asked were these:

- Is the fund aligned with our values? Does it share our commitment to locally owned companies? Our tolerance for risk? Our desire for blended returns?
- Does the staff have the right expertise to evaluate local food businesses? If not, will they be willing to defer to the expertise in our FWG Committee?
- Is the fund administratively sound? Does it attend carefully to its reporting, accounting, legal, and tax responsibilities? Are its overhead costs reasonably low?
- Is the fund's portfolio well balanced? Or are too many of its existing obligations too risky? What's the fund's track record?
- Will the fund be comfortable with our moving our business into our own nonprofit at some point?

## V. Mobilizing the Right Investors

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If you build it, will they come? Perhaps, but you better have a good marketing plan for aggressively recruiting investors. Like any good business, a local investment fund requires a good sense of the local capital marketplace. A community arguably always has businesses looking for more capital, but it may not have investors who are eager to take money out of their conventional investment vehicles and invest locally. Before embarking on the creation of a local investment fund, it's helpful to have a plan — or at least a design or a theory — about how you will raise the funds.

What kind of investors are you looking for? Accredited investors? Unaccredited? Institutions? CDFIs? How much do you wish to involve them in the fund?

In the Pioneer Valley, it helped that several local business funds were already operating. Funds like Common Capital and the Equity Trust had essentially begun to develop the market for local investment. We would be building on their success.

In addition, individual investors in the Pioneer Valley have supported several local businesses in the recent past. Individual investors lent River Valley Market over one million dollars to launch a startup food coop. Co-op Power, as referenced earlier, has raised money from individuals for a variety of projects. More recently, Real Pickles raised \$500,000 from individual investors to support its conversion to a worker-owned cooperative. These modest successes laid a solid foundation for the Community Investment Fund.

### **INVESTOR MOTIVATIONS**

*What kind of investors are you looking for?*

Different kinds of funds look for different kinds of investors. Bank savings accounts, for example, are looking for investors who are interested in safety and are willing to accept a low rate of return for a government guarantee on their money. Venture funds, in contrast, are looking for investors who want spectacular, double-digit rates of return with companies promising high growth and a public exit, but who also understand that these deals are extremely risky and they may lose everything.

It's worth recalling our earlier discussion about the expectations of investors versus the real world of market performance. Many venture capital funds, for example, promise double-digit rates of return but underperform the market. Remember that the the market itself, or at least the stock market, is typically returning 2.6% per year. Today, in a period of relatively low inflation and low interest rates, most "safe" investments, like bank CDs, are promising less than 1% per year. As the risk increases, say for corporate or municipal bonds, the return rate increases to 3-5%. So really smart investors in your community should be expecting somewhere around 1-5% annual rate of return. (If inflation or interest rates rise, these numbers will rise accordingly.)

Part of the job of your fund, therefore, is to match investor expectations with what the real world of local businesses can deliver. Our experience with local investment in the Pioneer Valley led us to appreciate that our local investors fell somewhere in between these two extremes. Few local investors (at this point) are looking primarily for a high rate of return. Instead, they are motivated by the desire to strengthen the local economy and prove models of triple bottom line businesses. Some investors, such as those who put in very small amounts of money (say, \$100) or those who represent other mission-driven institutions like foundations, think of their investments more like donations. Others want to see their money do good locally, though they emphatically do not want to lose money.

The truth is that you cannot possibly know how well you'll perform. Some businesses in your portfolio won't perform as expected — that's reality. The secret sauce for helping small businesses succeed is, frankly, still a work in progress. So the smartest strategy is to promise small, deliver big. If you exceed investors' expectations, they will be thrilled with you. If you set investor expectations high and you underperform, they may get scared and pull their money out *pronto haste*.

This raises a second, related question about investor expectations — exit. How long must investors commit to participating in the fund? Again, most of the funds we examined insist on commitments of at least one year and sometimes two or more years. Recall the earlier point that asking investors for a longer commitment, even for five years, is one way the fund can succeed even if one of the businesses fails. In fact, given that food and farm enterprises really need long-term investments, you may want to offer some of your investors an opportunity to invest on a very long-term basis, possibly ten or more years.

Your investors should know that the mission of the fund is not to promote short-term windfall profits but long-term sustainable growth. Moreover, the businesses your fund is supporting need adequate time to grow. Neither they nor you can afford to have money rapidly flowing in and out of the fund, unpredictably.

No one wants to tie up his or her money indefinitely. So one way most community-development funds handle this is to increase rewards for longer commitments — just like banks do with CDs. You might promise a 1% return for a one-year commitment, a 2% return for a three-year commitment, and a 3% return for a five-year commitment. This approach, however, should be used cautiously. Words like “promise” may be inappropriate, given how uncertain returns will be. It may be better to use phrases like “We set an annual payment target of...”

Giving your investors more options may make investment in your fund more attractive. Yet it can also make your own job more difficult. If most of your investors opt for one-year notes, you will need to amass the cash to pay them back at the end of one year. There's not much you can then do with that capital. You certainly can't make any long-term commitments to companies. If you provide short-term options for your investors, you should be sure to create inducements for them to rollover their commitments before they expire.

If you issue your investors notes, you might give them permission to sell them to other investors — though you may want to restrict their resale to other local investors. As Mission

Markets and others spread their community portals, you will then have places where you can have your shares listed and sold for a small fee.

## **TRADITIONAL SOURCES OF COMMUNITY CAPITAL**

*Given the motivations of likely investors, where is the capital for your fund most likely to come from?*

It's helpful to sketch the investment marketplace, as we did in Chapter II. If you expect a small number of deep-pocket individuals to put up most of the capital, it makes sense to talk with them personally first and discern the depth of their commitment. If you expect a larger number of less wealthy individuals to participate, it would be good to conduct a focus group to gauge their interest.

If you are forming a nonprofit fund, many sources of capital in the community development world are relevant. For example:

- **Community Revolving Loan Funds** — Some existing revolving loan funds are looking for other funds in which to invest rather than just individual businesses.
- **Program Related Investments and Mission-Related Investments** — You should inventory all the foundations that provide grants to economic development and community development projects in your region. These foundations might be persuaded to invest some of their long-term capital into your fund.
- **Community Development Financial Institutions** — Banks, funds, and other organizations in your area that have the CDFI designation from the U.S. Treasury Department are natural partners for your venture.
- **New Markets Tax Credits** — Another potential partner is the institution (or institutions) in your area licensed to take money from accredited investors and provide them with seven-year New Markets Tax Credits.
- **Community Reinvestment Act Credits** — Private banks in your region, particularly bigger and nonlocal banks, may be looking to gain credit under the Community Reinvestment Act that they can apply for future mergers or branching decisions.

In our case, we knew that all these sources had supported other funds in the region: the concept was proven. But we were also interested in grassroots participation in the fund — that is, the involvement of unaccredited investors.

## **UNACCREDITED INVESTORS**

*Should unaccredited investors be included?*

A threshold question is whether unaccredited investors should be included at all. Generally, even small funds exempt from the Investment Company Act — that is, funds with fewer than 100 investors -- may face more federal compliance challenges if they involve any unaccredited investors (see note 13 above). You also must analyze whether your state creates additional

layers of costly legal work if you include unaccredited investors. As we noted, Massachusetts law was helpful here, exempting securities issued by a nonprofit fund from registration requirements.

One way forward in some states may be to enter a direct negotiation with the state securities department. For example, when the Economic and Community Development Institute, based in Columbus, Ohio, decided to include unaccredited investors in its 14th revolving loan fund, it worked shoulder-to-shoulder with the state securities regulators to create an acceptable standard for participation. That standard allowed many, though not all, unaccredited investors to participate.

The decision to include unaccredited investors involves more than purely legal questions. Does a fund prefer hundreds, even thousands, of unaccredited investors rather than a few dozen accredited ones? The more people involved, the more administrative hassles, the more customers to “care and feed,” the more things that can go wrong. Moreover, are there enough accredited investors in the region who share the appropriate motivation for the investment and can tolerate the risk?

Grassroots participation brings benefits as well. Generating community excitement about local businesses may help recruit investors for the fund. Small investors might be less demanding about the rate of return — and more appreciative of the community’s rate of return — than wealthy, professional investors. A grassroots group of investors also might support the target business in other ways. For example, the Columbus Invest Ohio Fund mobilizes its members to support its borrowers with local buying, which reduces the risk of the businesses failing.

Unaccredited investors also offer the potential to conduct a huge campaign to mobilize residents to roll over their tax-deferred IRAs into self-directed IRAs, which in turn could invest in your fund. Most IRAs are managed through mutual funds and, again, none of the existing 7,500 mutual funds invest in local small business. But if you move your IRA into the hands of your own “custodian,” you can invest in local CDs, your co-op, local stock, other local investment funds, property, you name it (as long as the issuer has complied with applicable securities law). The only thing you really cannot invest in is your own business or your own home (or your relatives’ business or home). To find a local custodian, just Google “self-directed IRA.” The fee can be as low as \$200-300 per year (plus, sometimes, additional transaction fees).

For our Community Capital Fund, we calculated that one way we could assemble \$56 million would be to encourage residents to shift part of their long-term savings into self-directed IRAs. If two percent of residents in the Pioneer Valley — one in twenty households -- shifted 5% of their long-term savings accordingly, we could easily amass the fund’s target. This kind of campaign seems like a natural outgrowth of more than a decade of cutting-edge consciousness raising and business building in the region around local food.

## **VOICE**

*What level of involvement do you want your investors to have?*

Most investment funds have a strict division of responsibilities. The managers invest funds according to their best judgment. The investors leave the managers alone, read the managers' statements and newsletters, and occasionally ask questions by email or phone. The former are active, the latter passive. This framework is clean, simple, and standard.

Still, there may be good reasons to engage your investors more actively. Some investors might be more interested in participating if they are able to play some role. RSF Social Finance, for example, has gotten high marks from its investors for putting together annual gatherings where lenders and borrowers get together and negotiate the appropriate interest rate. And recall the Invest Local Ohio Fund, which mobilizes investors to buy local from businesses receiving loans.

Within the Pioneer Valley, where grassroots local investment has reached a critical mass, there's an assumption that investors should be encouraged to participate. Common Capital, for example, has committees vetting investments with representatives of the community. The Cooperative Fund of New England and the Equity Trust both are proud of their levels of grassroots engagement. The PVGrows Pilot Loan Fund was overseen by a board involving the leaders of all these funds plus other grassroots organizations.

Given the degree to which direct democracy imbues Town Halls throughout New England, we too are committed to weaving participatory networks into the Community Capital Fund and tapping the wisdom of the residents in the Pioneer Valley. We have been impressed by how Co-op Power — which, as described earlier, takes members' capital and places it strategically in local firms involved in energy efficiency, solar installation, and biofuels — has taken advantage of the expertise of its members by creating an elaborate structure of supporters and community councils.

## VI. Fine-Tuning

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Okay, if you've followed all the steps thus far, you've got a basic business plan and a good sense of your ideal businesses and investors. There are still some nuts and bolts you'll need to add to ensure that your plan is a sturdy one. Is your fund going to be open-ended or closed-ended? How long do you expect your fund to go on for? Who will you hire to perform day-to-day operations? How will you handle setbacks and failures of your businesses? What will you regard as success?

### **OPEN VS. CLOSED FUND**

*Once you hit your startup target, will you fund be open or closed to new investors?*

A major distinction in the Investment Company Act of 1940 is whether a fund is open-ended or closed-ended. Most people think of this distinction with respect to mutual funds, but it really applies to all kinds of funds. An open-ended fund allows new investors to come in, and as more funds are added to the pot, more investments are made. A closed-ended fund sets a goal for the fund — say, \$25 million — and once that goal is reached, the fund is then closed to new investors. Closed-ended funds can have provisions for new investors to take the position of old ones should they decide to exit.

Since PVGrows chooses to operate both its pilot loan fund and the new Community Capital Fund as a nonprofit and be exempt from the Act, the legal consequences of this distinction don't matter so much. But it is still a structural and business choice of consequence. Part of the decision turns on the capacity of the fund to locate, vet, and manage new investments, and the related concern, outlined earlier, that having funds collected but uninvested could make investors unhappy. We decided, therefore, to make our fund closed.

A softer way to make this decision might be to create "tranches," essentially stages of development for the fund. Hence PVGrows decided to make its first tranche, for the new Community Capital Fund, \$2.5 million. This way we can get experience with new types of investing, beyond lending, before going to scale. Once we can demonstrate our ability to locate deals and manage them successfully, more investors will feel confident putting money into the fund.

### **LIFE CYCLE**

*How long do you expect your fund to live?*

Your investors will want to know whether your fund will last in perpetuity or end on a certain date. Many loan funds are called revolving funds, because as one set of loans is paid off, the expectation is that returned funds will be lent again, forever. Or, at least, until the fund managers decide to stop, disband, and return funds to the investors.

This question is related to, but differs, from that of exit for investors. A closed fund can declare, as a venture fund might, that its investments are tied up for seven years, and only after that point might it liquidate all deals and return funds to investors. Or it might allow investors who wish to enter to replace those who wish to exit.

PVGrrows decided that its initial loan fund, being a prototype, would not last forever. As the initial loans are being repaid, there's a strong presumption against lending the funds again. Instead, the question is whether to encourage investors to roll over their investment into the new fund. Indeed, since many of the initial investors were foundations and economic development institutions, the real question is whether repayment from the first fund should be converted into new investments to start the second.

## **OPERATIONS**

*What's your plan for ongoing operations?*

Setting up an investment fund is the easy part. Running it successfully is what's tough. A successful fund, even if it can avoid the onerous requirements of being an Investment Company, must keep detailed records of everything, especially the flow of funds. The books should be spotless. Audits should be conducted annually. Taxes and other reports need to be filed in a timely way to the appropriate federal, state, and local authorities. Your investors will require periodic information as well.

How often do you want to communicate with investors? Most investors expect reports at least quarterly. Some might even welcome monthly reports. You also might decide that these reports will drive your company to make unwise short-term decisions that shortchange long-term success. It was this reason that recently drove the head of Unilever to renounce quarterly reporting.

What about staffing? Consider three very different kinds of ongoing activities the fund will need to carry out, each focused on different constituencies:

- A promoter needs to market the fund to investors and businesses. It helps if this person is a good salesperson, outgoing, energetic, charismatic, visionary. This person also may need to meet certain legal requirements, such as having a broker-dealer's license, before selling anything.
- A tough decision-maker needs to work with the target businesses, gather data, assess risks, make deals, and enforce agreements. This person needs to be analytical, communicative, patient, nurturing, and flexible.
- An accountant or compliance manager with a meticulous ability to capture details needs to follow and record the flow of funds and comply with state and federal securities, nonprofit, and other applicable laws. This person is usually inward-focused, cautious, methodical.



The point of reviewing these job descriptions is that it's very hard to find all three skill sets in a single person. In fact, it's probably dangerous to depend on one individual, since a successful fund will establish checks and balances not only between the board and the management but also within the staff. Yet a small fund might not be able to hire even one full-time person. This underscores the importance of having a participatory board. It also suggests the wisdom of hiring another fund to manage your fund, which might get you slices of several people's time.

Outsourcing administration is just one option you might consider. If you can find funds doing similar work in your community, you might just place your money into those funds — that is, your fund itself becomes a local investor. Or you might approach a large local nonprofit that already is investing a significant endowment and ask it to add your funds to its portfolio.

## **BUSINESS FAILURE**

*What are the best ways of anticipating that your businesses are not succeeding?*

Business is fraught with risk, and no investment fund has a perfect record (except, perhaps, Bernie Madoff's, before being exposed as a Pyramid Scheme). A key to your success is to develop early warning signals, and a series of responses so that some failures are reduced to qualified successes.

Every business has strengths and weaknesses. Identify early and often the likely weaknesses of your portfolio businesses. You might withhold your finance until a plausible plan is in place to address the weakness. So, for example, if a company has weak accounting, you might condition your investment on its books getting cleaned up and a trustworthy accountant hired.

Each target business probably anticipates growth from your investment. Measure it — growth in sales, net assets, media mentions, whatever. You and the target business should agree on which indicators matter, and what progress should be made by when.

When a company is falling short — even when there's a good explanation — that's the time to begin preparing a plan to mitigate the problems.

## **SUCCESS**

*What are your indicators of progress?*

Just like the businesses you are financing, your fund needs a well-thought-through plan for success. There should be indicators along the way to let you and your investors know that you are on target. Among the helpful indicators might be these:

- When do you anticipate raising your investment capital and closing your first tranche?
- By when do you expect to invest your first tranche?
- What is the flow of repayments or returns you expect to receive?

- What is the anticipated return you expect to pay to investors?
- What is your anticipated failure rate?

It's important — for you, your investees, and your investors — to meet or beat your indicator goals. Early success boosts your confidence that you're doing something right. Early shortcomings give you guidance on what you need to change.

If your investors didn't trust you, they never would have put money into your fund. But you can't take that trust for granted. That's why you need to report to them regularly. Beyond the quarterly reports, you might send out a monthly or weekly e-mail reporting on new developments. If the news is bad, your communication must be even more frequent.

It also underscores why, as we noted earlier, it's wise to set investor expectations low — and, if you can, exceed them.

Once a year, you might want to hold a dinner or a special event, to celebrate what you've accomplished over the previous year, to take stock, to reward hard work. If you do succeed, you should take pride in doing the essential work in building your economy — and in showing the way so that thousands of other communities in the United States and elsewhere can follow in your footsteps. For us, real success will be measured by the Pioneer Valley's ability to scale up the local food economy.

## Epilogue

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You're probably wondering how it all turned out for PVGrows. What's the Community Capital Fund doing now?

As of this writing, the Financial Working Group just made several important decisions about how to proceed:

- The target level of funding will be \$2.5 million, and the fund will get started — in legalese, it will break escrow — at \$500,000. As new deals emerge, the fund will expand by bringing in just-in-time investors. This will prevent extra funds from accumulating and doing nothing, and provide specific stories to bring in new investors.
- The initial management will continue to be done by an existing, capable, outside organization, enabling PVGrows to minimize its own staff.
- The PVGrows Financial Working Group will continue to play a major role in vetting potential businesses and guiding the managing fund.
- Three types of investors will be initially targeted. For the first tranche, at least the first 10% of the fund will be covered by philanthropists and foundations making program-related investments, and perhaps by institutional investors like the local university, hospital, and pension funds. The second tranche will be covered by institutions and accredited investors. A third tranche will be available to unaccredited investors, though they would have to invest at least \$1,000 (\$10,000 maximum).
- The targeted returns for investors will depend on the tranche. The anticipated payouts will all be in the 0-3% range, with longer commitments rewarded with higher payouts. Additional rewards will be given to investors who renew their commitments after the initial periods expire.
- To diversify risk, the fund will consider placing up to 25% of its capital in New England regional partnerships.
- Each investment will likely be at least \$25,000, though no more than 10% of the fund will be committed to any one company.
- At least 10% of the assets will be invested in businesses serving underserved communities, and at least 10% in businesses managed by people of color.
- PVGrows will seek to raise additional donations and grants to cover its administrative costs in the early phases.

Stay tuned to the PVGrows web site ([www.pvgrows.net](http://www.pvgrows.net)) for further progress. We wish we were further along in our work, and that this guide book could be 100% filled with retrospective lessons. Alas, the world is moving too fast for this traditional, clunky approach to a handbook. We hope the lessons we've shared here inspire and help others, so that we can all begin learning together. For those of you using this guide to create your own community funds,

whether focused on food or on other local businesses, we look forward to working with you to co-author Version 2.0.

Our goal is for successive iteration of this guide to get better and involve more people. We know that there are many people in this country frustrated by their inability to align their investments with their values and eager to create new tools for local investment. We look forward to working with them to share stories and grow our wisdom.

We envision a day where hundreds of communities offer multiple portals for multiple local investing options; where MBA programs offer curriculum focused on local investment funds; where policy makers, political leaders, and community activists see these funds as critical parts of their economic-development policies; and where consumer-investors everywhere take pride in creating their own local food systems.

## Appendix A.

# Community Investment Worksheet

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We've taken the basic questions from the report and gathered them here for your convenience. When you've answered these questions, you will be well on your way to creating economic and environmental capital in your community. Good luck with your work.

### Clarifying Your Objectives

#### **GEOGRAPHIC FOCUS**

*How do you define your community?*

#### **ECONOMIC MISSION**

*Which social or economic problems are you trying to solve? Exactly what kinds of local businesses do you wish to support?*

#### **RISK AND REWARD**

*How much risk is the fund prepared to tolerate? How much desire does the fund have-and really its investors-for potential rewards? How willing are these investors to lose money?*

#### **PRIORITY BUSINESSES**

*Exactly which local businesses are your highest priorities for finance by your fund? How should you decide?*

#### **PRIORITY BUSINESS STAGE**

*Once you've picked the kinds of businesses you wish to prioritize, how do you pick the right stage of business? For example, should you prioritize startups or existing businesses?*

#### **BUSINESS NEEDS**

*What exactly are the capital needs of your targeted businesses?*

#### **THE BASIC MATH**

*What's the business case for your fund? How can you make sure that you won't lose your investors' money?*

**NEEDED SIZE**

*What size must the fund be to realize its mission? Is it realistic to raise that much capital?*

**MISSION STATEMENT**

*What's a succinct summary of what you're trying to accomplish?*

**Making The Right Types of Investment****TYPE OF FINANCE**

*What is the kind of investment you intend to make in the target businesses? Debt? Equity? Something in between? Why?*

**SIZE OF FINANCE**

*What size should be the typical financial package for a business? How broad can the variation from low to high be?*

**SUPPORT**

*What kind of technical assistance, if any, should accompany the financial package? Who should provide it?*

**Choosing the Right Legal Structure****EXEMPTIONS**

*How can I ensure that my fund is not covered by the Investment Company Act of 1940?*

**OTHER OPTIONS**

*Are there other, simpler ways to create pools of capital for local investment?*

**PIGGYBACKING**

*Might it make sense to hire an existing fund to manage ours?*

**Mobilizing the Right Investors****INVESTOR MOTIVATIONS**

*What kind of investors are you looking for?*

## **TRADITIONAL SOURCES OF COMMUNITY CAPITAL**

*Given the motivations of likely investors, where is the capital for your fund most likely to come from?*

## **UNACCREDITED INVESTORS**

*Should unaccredited investors be included?*

## **VOICE**

*What level of involvement do you want your investors to have?*

## **Fine-Tuning**

## **OPEN VS. CLOSED FUND**

*Once you hit your startup target, will your fund be open or closed to new investors?*

## **LIFE CYCLE**

*How long do you expect your fund to live?*

## **OPERATIONS**

*What's your plan for ongoing operations?*

## **BUSINESS FAILURE**

*What are the best ways of anticipating that your businesses are not succeeding?*

## **SUCCESS**

*What are your indicators of progress?*