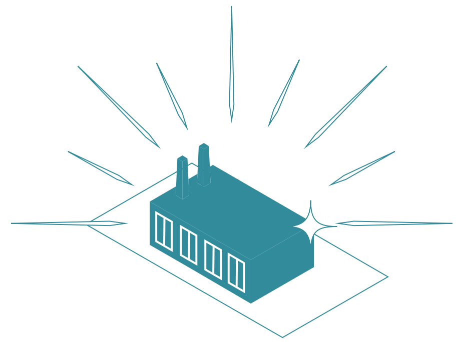
BUILDING *the* INCLUSIVE ECONOMY



FINANCING HYBRID ENTERPRISE

Strategies for Financing the Inclusive Economy:

Financing hybrid enterprise as a tool to create jobs and build community wealth

Marjorie Kelly, Violeta Duncan, and Steve Dubb *for The Democracy Collaborative*
With contributions by Oscar Perry Abello

This paper is an adapted excerpt from *Strategies for Financing the Inclusive Economy,*
the third report in Citi Community Development's Building the Inclusive Economy series.

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Building the Inclusive Economy series: Through three groundbreaking reports funded by Citi Community Development, the *Building the Inclusive Economy* series sets out effective, cutting-edge economic development models for city leaders and community development practitioners interested in embedding equity, community wealth, and sustainability into their local economic growth plan. This series, authored by The Democracy Collaborative, the Democracy at Work Institute, and Project Equity, lays out key tools and building blocks for equitable local economic growth through which all residents are able to maximize opportunities, thereby expanding urban economies where all can meaningfully participate and benefit.

The Democracy Collaborative: This nonprofit, founded in 2000, is a leader in equitable, inclusive, and sustainable development. Its work in community wealth building encompasses a range of advisory, research, policy development, and field-building activities aimed at enhancing the economic prospects of low- and moderate-income individuals. Its mission is to help shift the prevailing paradigm of economic development—and of the economy as a whole—toward a new system that is place-based, inclusive, collaborative, and ecologically sustainable.

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Broad-based ownership models bring substantial benefits to communities and workers, particularly those of low and moderate income.

INTRODUCTION

And in an economy where wages have been stagnant for decades—and a disturbing 40 percent of jobs are now part-time, temporary, or contingent—broad-based ownership models offer a promising alternative.[1]

Given their impact, worker-owned companies, employee stock ownership plan (ESOP) companies, social enterprises, municipal enterprise and new hybrid models with broad-based ownership are increasingly viewed as highly valuable tools for stemming and reversing rising economic inequality. But how to hasten their growth and build an inclusive economy, in which quality jobs are bountiful and ownership opportunities are widespread? How to increase understanding and comfort levels in these businesses' financing— *financing* being a key contributor to enterprise growth?

This paper—adapted from the *Building the Inclusive Economy* series' third report, *Strategies for Financing the Inclusive Economy*—begins to answer this question. It focuses specifically on how financial service providers, impact investors, foundations, local government, community development leaders, and others can finance hybrid enterprises to build community wealth. As hybrid enterprises spread, the role of lenders and investors will grow in coming years. That makes it critical to increase the field's understanding of the role of finance in supporting these models, how that role differs from traditional finance, and how that role is evolving.

Hybrid enterprises, in many cases, employ traditional financing. The basic tools of debt and equity still apply. Yet because hybrid enterprises are structured differently than conventional businesses, these models have some unique nuances of financing. Among the characteristics of financing hybrid enterprise models that build community wealth for low- and moderate-income residents are:

- **Investor returns on hybrid models vary across the spectrum from competitive to below-market returns.**
- **Non-traditional, specialized, and innovative forms of finance are sometimes involved, such as program related investments by foundations.**
- **Ecosystems of support can reduce risk and increase likelihood of success.**

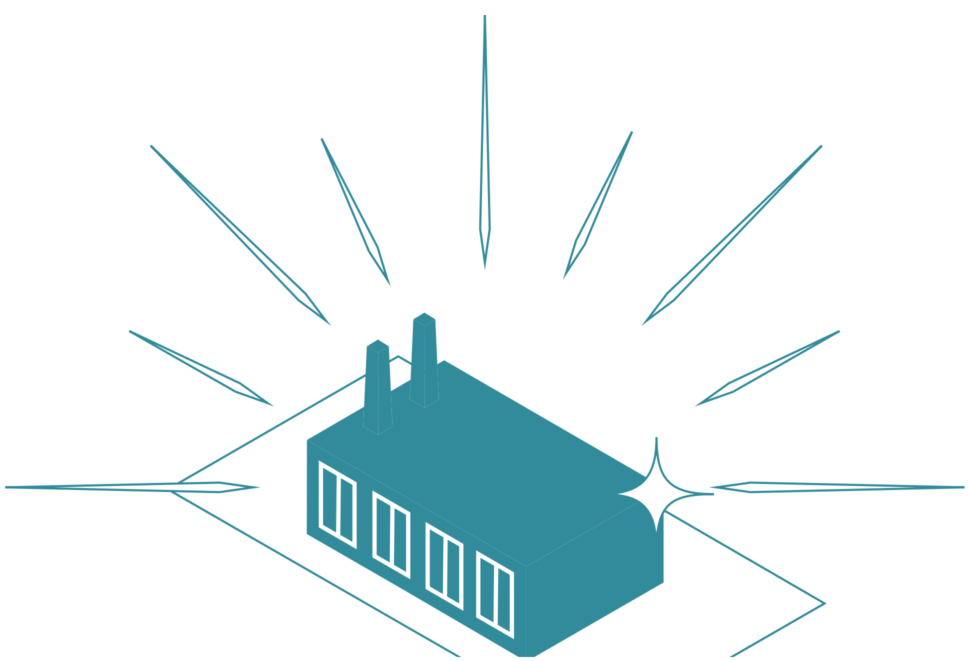
In the sections that follow, this report offers innovative financing strategies, case studies of hybrid enterprise financing, and additional resources to help scale hybrid enterprises as a tool for creating jobs and building community wealth.

Hybrid enterprises are businesses that have adopted legal forms that embed some form of social mission in their articles of incorporation and bylaws.

In the United States, two primary forms of hybrid enterprise have emerged over the past decade: low-profit limited liability corporations (L3Cs) and benefit corporations. An L3C is a limited liability company in which the profit goal is subordinated to a charitable mission. A benefit corporation, by contrast, is a form of corporation whose bylaws outline an express social mission. Nationally, there are now more than 1,300 L3Cs and 1,600 benefit corporations, a remarkable expansion from a baseline of zero a decade ago.[2]

Financing Hybrid Enterprises

Hybrid enterprise has many origins, among which are Jed Emerson's concept of "blended value" (a business blending nonprofit and for-profit approaches), and Heerad Sabeti's concept of "for-benefit" enterprises, which exist for social benefit, in contrast to "for-profit" enterprises, which exist to maximize financial returns.[3] Sabeti envisioned an emerging "fourth sector" of enterprises designed for social benefit, a sector different from the customary three sectors of government, traditional for-profit business, and nonprofit organizations.



Low-profit Limited Liability Corporations (L3Cs)

One advantage of the L3C is that, by design, it can raise funds from both investors and philanthropy. The form was in fact created primarily to facilitate the uses of program related investments from philanthropic organizations. As mentioned previously, PRIs are low-interest loans aligned with a foundation's charitable mission. Because PRIs are typically repaid, the money lent out can be recycled to benefit multiple projects.

One of the nation's leading LC3 philanthropic investors is the MacArthur Foundation in Chicago. In 2014, for example, MacArthur made two impact investments totaling $5 million to help launch Commons Energy L3C, which has a mission of helping underserved markets reduce energy and water costs. Commons Energy is a subsidiary of the nonprofit Vermont Energy Investment Corporation. Additional support for Commons Energy included a PRI of up to a $2 million from the Kresge Foundation, in the form of a credit enhancement (i.e., effectively a subsidized line of credit), as well as a $250,000 mission investment from the High Meadows Fund.[4] Commons Energy's status as an L3C may have helped it attract these mission-oriented investments. It is appropriately incorporated as a hybrid, for it is the nation's first public-purpose energy services company (ESCO). It differs from a traditional ESCO in that its goal is not maximum profit but deeper energy savings.[5] Commons Energy provides technical assistance and investment capital to owners of small and medium-sized buildings that are generally left out of the ESCO marketplace, such as schools, health care facilities, and affordable multifamily housing.[6]

Benefit Corporations

Benefit corporations or B corporations can refer to enterprises of many types, including cooperatives, ESOPs, and publicly traded companies. Essentially, being a benefit corporation is a public declaration of intent to serve the public good. An advantage of the benefit corporation model is that corporations of any size—even large publicly traded corporations—can hypothetically adopt this design as a way to help retain the primacy of the social mission over time. Kickstarter, the online crowdfunding platform, became one of the most prominent firms to become a benefit corporation in September 2015. "We don't ever want to sell or go public," cofounder and CEO Yancey Strickler told *The New York Times*. "That would push the company to make choices that we don't think are in the best interest of the company."[7]

The most feasible way for a publicly traded company to incorporate as a benefit corporation is to do so relatively early in its life, and then go public with that design in place. It is also at least theoretically possible for an existing publicly traded firm to re-charter as a benefit corporation, but it would require shareholder approval. One firm that has expressed interest in this path is Unilever, the Dutch multinational which owns Ben & Jerry's, a subsidiary that has been certified as a B Corporation.[8] Kickstarter, which reincorporated last year as a public benefit corporation in order to provide legal protection for its social mission, is one clear example of an organization that set out to solve a social problem that happens to coincide with the non-financial interests of a venture capital firm.

The B Corporation designation refers to a social certification process; this process is independent of the incorporation process that is legally required to become a benefit corporation. To date, 31 states—with five more in the pipeline—have approved legislation that enables companies to formally incorporate as benefit corporations.[9]

The nonprofit organization that certifies B Corporations is B Lab. B Lab has also been a leading advocate of benefit corporation legislation. B Lab points to growing interest among multinational and publicly traded companies committed to the social responsibility standards that are inherent in B Corporation certification. To help ensure ongoing company commitment to the public good, B Lab has created additional transparency and validation requirements for publicly traded companies.[10] It is also in the process of creating a Multinationals and Public Markets Advisory Council, which will help B Lab promote "mission-aligned corporate structures that expand fiduciary duty to include the consideration of societal—not just shareholder—interests."[11]

CHALLENGES, SOLUTIONS, OPPORTUNITIES

- **L3Cs and benefit corporations face many of the same financing challenges that traditional small business faces.** Lending for small business has been in decline since the recession following the financial crisis of 2008.[12] One solution is to approach CDFIs or other lenders or investors with a social mission.
- **Hybrid status can pose additional challenges.** While being a hybrid can enable a business to pursue multiple financing channels, it can also pose barriers. Philanthropy may shy away because the business earns a profit, making it seem inappropriate for foundation action. Traditional finance and banks may shy away because of the link to charitable mission. A key solution may be to present potential lenders and investors with a strong business plan and strong financial position, with hybrid status as a bonus, not the central selling point.
- **Being a benefit corporation or B Corporation can help a business stand out.** Impact investors can see this status as indicating authenticity about social mission.
- **Benefit corporations benefit from having a community of like-minded enterprises.** This can help in improving management practices and making connections to potential investors.

Innovative Financing for Hybrid Enterprises

Initial public offering (IPO): The IPO—selling shares to the broad public—is a traditional way growing firms access substantial capital. Yet for benefit corporations, it remains an innovation. For example, in March 2015, the Brooklyn-based online handicrafts marketplace Etsy became the largest—and one of the few—certified B Corporation to sell shares in an IPO (see case study). Etsy raised $267 million.[13] In its B Corporation certification, Etsy earned a B score of 127, significantly higher than the 80 point minimum necessary to receive certification from B Lab.[14] As a publicly traded company and a B Corporation, Etsy is likely to face pressure to maximize returns to shareholders. To protect social mission for companies like this, B Lab has created additional transparency and validation requirements.

Program Related Investments: L3Cs are specifically designed to attract foundation program related investments. The L3C institutional form was developed by Robert Lang, with the aim of simplifying for foundations the cumbersome task of a seeking a Private Letter Ruling from the IRS, which indicates whether an investment qualifies as a PRI. That process can take up to 18 months and cost $50,000 or more in legal fees. In essence, the statute under which an L3C is organized requires that the business make the same types of commitments that the IRS has traditionally required. For this reason, state L3C laws are typically designed to incorporate all of the federal tax requirements that apply to PRIs. These include stipulations that the enterprises are specifically formed to further charitable or educational purposes, and that production of income or the appreciation of property value is not a major purpose.[15] Thus far, foundations making PRIs in L3Cs are mostly found in the early adopter states such as Vermont, Illinois, and Michigan.

Municipal Support: In the 31 states which allow legal incorporation as a benefit corporation, a small but growing number of municipalities are developing strategies to offer financial support to these businesses. The City of Philadelphia began investigating the impact of Philadelphia-based benefit corporations, finding that nine out of ten are locally owned, and nearly half offer some form of employee ownership. It also found that the city's benefit corporations are three times more likely be owned by women or minorities than traditional companies, and twice as likely to offer health insurance and retirement plans. These findings encouraged the city in 2009 to establish a Sustainable Business Tax Credit, offering up to a $4,000 reduction in taxes for as many as 25 businesses each year between 2012 and 2017.[16] In awarding the tax credit, the city considers a variety of factors, including how the business provides low-income or underserved communities with beneficial products or services, and how it promotes economic opportunities beyond job creation.[17] In 2016, new legislation was introduced to double the tax credit to $8,000.[18] A similar effort to support benefit corporations is under way in San Francisco, where the city in 2012 passed an ordinance to grant benefit corporations a 4 percent bidding preference on city contracts.[19] In Maryland, State Delegate Meagan Simonaire introduced legislation in January 2016 to authorize Anne Arundel County to provide a property tax credit for benefit corporations.[20]

In March 2015, the Brooklyn-based online handicrafts marketplace Etsy became the largest certified B Corporation to sell shares in an IPO; it is one of only a few to do so. Etsy raised $267 million.

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Case Study in Financing Hybrid Enterprises

CASE STUDY

Click for info

ETSY: B CORPORATION COMPLETES A $267 MILLION IPO

The work Etsy is doing in generating income and part-time employment for low-income women is one of the modern economy's phenomenal success stories. This online handicrafts marketplace enables craftspeople and artists from all walks of life to sell their crafts on its platform. Some 24 million shoppers come each year to purchase handicrafts from 1.6 million sellers, and 86 percent of those sellers are women, whereas only 30 percent of vendors nationally are women-owned.[21] These Etsy sellers also have lower household income on average than the general population, which means the income generated can be a boon for cash-strapped households.[22] Close to one in three sellers consider Etsy sales a business or their sole occupation; 44 percent use Etsy sales to cover household expenses; and 25 percent use the sales for savings.[23]

How Etsy finances itself is an equally compelling story. Etsy, which in 2012 became a certified B Corporation, in its early stages raised capital from Union Square Ventures (USV). This venture capital firm has invested in other pathbreaking companies such as Twitter, Tumblr, and Meetup—as well as socially responsible firms like La Ruche (which connects farmers with buyers) and CrowdRise (which facilitates crowdfunding for charitable giving).[24] USV also invested in Kickstarter, which recently reincorporated as a benefit corporation under Delaware law.[25]

In March 2015, the Brooklyn-based Etsy became the largest—and one of the few—certified B Corporation to sell shares in an initial public offering, raising $267 million.[26] To expand investment opportunities for Etsy vendors and other non-institutional investors, Etsy set aside 5 percent of shares for retail investors, and it limited investments to $2,500.[27]

Etsy is well known for its social mission, including commitments to environmental sustainability, to providing a supportive work environment for its 685 employees, and to promoting women-owned businesses.[28] Etsy's mission is to foster a "world in which small businesses have significant sway in shaping the economy, local living economies are thriving everywhere, and people value authorship and provenance as much as price and convenience."[29]

Finance has a vital role to play in advancing cooperatives as a tool for job creation and reducing wealth inequality.

CONCLUSION

Local government and philanthrophy are particularly poised to advance benefit corporations and L3Cs as engines for job creation.

It is clear that community wealth building approaches centered in broad-based ownership of business are poised to grow and can be important tools for addressing the economic inequality challenges that we face. Finance cannot do it alone. Yet it is an essential partner, and potentially a powerful force in leading this work. The hybrid models highlighted here shine light on diverse ways to build the partnerships between development and finance. And, by forging these connections, finance and community development can work together effectively to build community wealth and a truly inclusive economy.

ADDITIONAL RESOURCES:

- **Benefit Corporations,** B Lab, http://www.bcorporation.net/
- **Laws for L3Cs,** Americans for Community Development, http://americansforcommunitydevelopment.org/laws
- ***Impact Investing: A Guide for Philanthropist and Social Investors,*** Social Grant Makers, 2014, https://www.socalgrantmakers.org/sites/default/files/resources/Line%20of%20Sight%20-%20Northern%20Trust%202014.pdf
- **Philadelphia's Sustainable Business Tax Credit,** City of Philadelphia, https://alpha.phila.gov/tax-credits/sustainable-business-tax-credit/

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