Double Bottom Line Investment Funds: A New Source of Capital for Community Economic Development Projects

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Executive Summary

Many community economic development projects in North Carolina cannot access necessary capital. These projects, when successfully executed, create two important returns: financial returns for investors and economic, environmental, and social returns for communities. One tool to help finance these projects is a double bottom line investment fund. The purpose of this research is to present how the contractual model, one of this fund type's four models, has been implemented by various non-profit organizations. Important components of this fund as well as types of projects supported are explored.

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INTRODUCTION

An emerging source of capital for community economic development ("CED") projects, particularly in low- to moderate-income communities, is the Double Bottom Line Equity Real Estate Investment Fund ("DBL Fund"). CED does not have a "standard definition," but can be described as a "strategy" of broad economic activities and programs aimed at "developing low-income communities" (Clay and Jones, 2009, p. 257). Examples of CED activities include development of affordable housing, local real estate projects, and small businesses (Blaustein, 1970).

CED projects typically cannot access conventional financing such as a loan from a bank (Hamer and LeVeen Farr, 2009). One reason why is because capital does not flow easily into low-income communities, where CED projects are located. Research has identified several market barriers that explain why these communities do not receive as much capital (Hagerman et. al., 2007). One of these barriers is that information and transaction costs are higher in low-income communities because it is expensive to identify the players and learn where opportunities exist (Hagerman et. al., 2007).

DBL funds have a track record of successfully investing in CED projects because its capital stack is primarily composed of private equity. Unlike most forms of capital, private equity is "supply leading, rather than supply following" (Economic Innovation International, 2004, p. 24). Therefore, these DBL Funds are able to use private equity to create economic opportunities that might not have existed without this type of capital (Economic Innovation International, 2004).

Since 1998, DBL Funds have attracted more than $20 billion in capital (La Franchi, 2008). These DBL Funds are not dependent on federal or state subsidies such as Federal Historic Rehabilitation Tax Credits or Low-Income Housing Tax Credits. DBL Funds differ from traditional private equity investment funds because they require all investments to meet a first and second bottom line (Daniels and La Franchi, 2012). The first bottom line of DBL Funds is the market-rates of return financial investors expect, typically mid to high teens (Flynn et. al., 2007). The second bottom line represents a range of the economic, environmental, and social returns such as job creation and preservation of cultural resources (Flynn et. al., 2007).

The literature identifies four models of DBL Funds. Each model differs by its operating structure (Hagerman et. al., 2007).

- In the **Contractual Model**, a non-profit initiates a DBL Fund and contracts with a for-profit fund manager to manage the fund.
- The **Fund Manager Model** involves only the for-profit fund manager that establishes and manages its own fund.
- State legislation is needed to create the **Legislative Model**. This model has only been used by the insurance industry in Massachusetts.
- In the **Ownership Model**, the non-profit fund sponsor owns the for-profit fund manager.

Contractual Model DBL Funds have raised more than $2 billion (Flynn et. al., 2007). Literature identifies the Contractual Model as part of the "second generation" of DBL Funds because they engage "proven fund managers" and raise "large-scale capital" (Daniels and Nixon, 2003).

PURPOSE OF STUDY

The purpose of this study is to provide information to non-profit organizations evaluating whether to sponsor a Contractual Model DBL Fund. These Funds are discussed in the literature, but from a more theoretical perspective. This study researches important components of how these funds have been implemented by various non-profit organizations. These components include the legal and operating structures of Contractual

Model DBL Funds, potential operating requirements of the Fund Sponsor, as well as compensation for Fund Sponsors and Fund Managers. Finally, the types of projects Contractual Model DBL Funds invest in are explored to help non-profit organizations understand whether this model helps advance their mission.

METHODOLOGY

The author conducted four phone interviews with current or former leaders of four non-profit Fund Sponsors that currently or previously sponsored a Contractual Model DBL Fund that invested in CED projects, primarily in low- to moderate-income communities. Interviews were requested of the four Fund Sponsors most often cited as examples in the literature. Three of these four Fund Sponsors accepted requests for interviews. The fourth Fund Sponsor did not respond to several interview requests over a period of three weeks. The fifth Fund Sponsor, Strategic Action Council, was selected because it established the first Contractual Model DBL Fund targeted at rural communities. Also, it sponsored one of and possibly the smallest capitalized Contractual Model DBL Funds.

Interviews were conducted with the following Fund Sponsors: Bay Area Council (sponsored three Bay Area Family of Funds) Genesis LA (sponsored four Genesis LA Family of Funds), San Diego Capital Collaborative (sponsored the San Diego Smart Growth Fund), and Strategic Action Council (sponsored the Northwest Louisiana Community Development Fund). More information about each of these Fund Sponsors is available in Appendix A.

Extensive research was completed on each fund prior to the phone interview. During the interviews, the author requested information about each fund's legal and operating structures not identified in previous research. Fund Sponsors were also asked to evaluate the Contractual Model by discussing advantages, disadvantages, and recommended changes if they hypothetically launched an additional fund. If additional information was needed after each interview, follow-up questions were asked through e-mail correspondence.

An additional phone interview was conducted with Mr. Belden Daniels of Economic Innovation Institute. E-mail correspondence also took place with Ms. Deborah La Franchi of Strategic Development Solutions (SDS) Group. Information about these two DBL Fund experts is provided in Appendix B.

FINDINGS

<u>Legal Structure</u>

The Contractual Model DBL Fund requires the creation of several legal structures. When a new Fund is formed, a new legal entity is established with the for-profit entity that manages the fund ("Fund Manager"), the Investors, and sometimes the non-profit organization that sponsors the Fund ("Fund Sponsor"). This new legal entity, according to the literature, is commonly formed as either a Limited Liability Company ("LLC") or a Limited Partnership ("LP") (Flynn et. al., 2007). In practice, the LLC structure appears to be more commonly used for these real estate DBL Funds. The eight real estate focused Contractual Model DBL Funds sponsored by the four Fund Sponsors interviewed designed their funds with the LLC legal structure. The previous Executive Vice President of the Bay Area Council, stated the LLC structure is predominately used for real estate investment funds and the LP for venture capital funds (Ferguson, 2014).

In the LLC structure, the Fund Manager assumes the role of Managing Member and Investors as Non-Managing Members. Of the four Fund Sponsors interviewed, two were included as a Special Member in the LLC entity, Bay Area Council and the Strategic Action Council. The San Diego Capital Collaborative was not a Special Member due to concerns from the Fund's investors. The previous President & CEO of the San Diego Capital Collaborative, explained that investors did not want the financial returns of the San Diego

Smart Growth Fund to be “dragged down” by the second bottom line return expectations (Schultz, 2014). According to this executive, it is “more acceptable” today to include the Fund Sponsor in the LLC as a Special Member because that is how more recent funds are structured (Schultz, 2014).

Governance of the management and investment of Contractual Model DBL Funds is created through a Private Placement Memorandum and either an Operating Agreement for LLCs or Partnership Agreement for LPs. These documents identify the specific investment objectives and strategies of the DBL Fund such as first and second bottom line return expectations. Additionally, these documents identify the roles and responsibilities of the Fund Sponsor and Fund Manager.

Contractual Model DBL Funds also create additional legal entities for each investment. Interviews identified two reasons for these additional legal structures. The first is holding an investment in a separate legal structure will isolate potential risk of each project from affecting other investments. The second reason is to prevent cross collateralization. This also protects the DBL Fund because it prevents additional entities from staking a claim in the investment’s collateral.

Operating Structure and Requirements

Another important component of the Contractual Model DBL Fund is the operating structure and roles of each party. The operating structure involves a Fund Sponsor, Fund Manager, and sometimes a Fund Builder. Compared to the Fund Sponsor and Fund Manager, the role of the Fund Builder is relatively more defined in a DBL Fund. Fund Builders primarily assist Fund Sponsors in designing and structuring DBL Funds. Another important role of the Fund Builder is helping raise capital through the relationships the Fund Builder has developed with investors. Some Fund Builders can provide additional services. For example, the Economic Innovation Institute partners with the Sustainable Systems to produce Second Bottom Line Performance Reports for the Northwest Louisiana Community Development Fund (“NW LA CD Fund”).

Interviews identified that the roles for Fund Sponsors and Fund Managers in a Contractual Model DBL Fund vary depending on the expertise of the Fund Sponsor. Appendix C identifies the primary tasks of a DBL Fund. The roles of three Contractual Model Fund Sponsors are also provided. Fund Sponsors primarily manage or co-manage tasks in which they have expertise. For example, most Fund Sponsors assign either the Fund Builder or Fund Manager with raising capital because of the relationships they have developed with investors. However, the San Diego Capital Collaborative decided to raise capital for their fund because they already had established relationships with potential corporations and institutional investors.

This flexibility in choosing which roles a Fund Sponsor will be responsible for is a benefit the Contractual Model DBL Fund offers. The remaining tasks can then be assigned to the Fund Manager, Fund Builder, or an additional consulting firm. For example, the Bay Area Council hired a consulting firm to assist projects with meeting their second bottom line return expectations.

While the operating requirements of a Fund Sponsor is driven by the role it chooses to manage, other factors also impact the amount of staff time a Fund Sponsor must dedicate. One significant variable is the stage of the DBL Fund. The four primary stages of a DBL Fund include conception, marketing, investment, and holding. The investment and holding stages are generally the longest and each can continue for up to five or six years.

The previously discussed Appendix C also identifies the stage of each of the DBL Fund’s tasks. As shown, all but one role is limited to a particular stage. Therefore, the operating requirements of a Fund Sponsor depends on the stage of the Fund and what, if any, roles the Fund Sponsor manages during that stage. Operating requirements of the Fund Sponsor can change during each stage of the Fund. For example, the

Strategic Action Council, Fund Sponsor for the NW LA CD Fund, dedicated about 75 percent of its Managing Director's time during the investment stage and less than 25 percent during the holding stage.

A second variable that affects the operating requirements of a Fund Sponsor is the amount of capital under management. Larger DBL Funds as well as the sponsoring of multiple Funds will require more staff time from the Fund Sponsor. However, these Fund Sponsors do appear to achieve operating efficiencies. The Bay Area Council only dedicated three full-time employees to manage its three DBL Funds capitalized at $196.25 million.

Compensation for Fund Manager and Fund Sponsor

The Fund Manager typically is responsible for managing the day-to-day operations of the Fund and receives compensation through an asset management fee. On average, the asset management fee is set at one to two percent of the annual aggregate committed capital that has not been returned to investors. This fee is paid quarterly. The Fund Sponsor, regardless whether it is a Special Member in the LLC, also receives a smaller asset management fee, between half a percent to one percent. The asset management fees the Fund Manager and Fund Sponsor receive are minimal and targeted to reimburse them for operating costs associated with operating the DBL Fund. Fund Managers can also be reimbursed for eligible startup costs.

Income generated through the Contractual Model of the DBL Fund is distributed to the Fund Manager, Fund Sponsor, and Investors according to a pre-determined policy that involves several "hurdles" or priorities. Initially, all income generated is repaid to investors for their invested capital. Once all invested capital is returned, the first hurdle, Investors receive an annual preferred return that can range from six to 12 percent of their invested capital. With any excess annual income after the preferred return or second hurdle is met, the remaining revenue called carried interest is commonly allocated 79 percent to the Fund Manager, 19 percent to Investors, and two percent to the Fund Sponsor. The carried interest distributed to Investors is allocated based on their share of invested capital.

The primary source of revenues the Fund Manager will receive from the Contractual Model DBL Fund is the carried interest. These hurdles are designed to incentivize the Fund Manager to excel in its performance in order to receive more carried interest.

TYPES OF INVESTMENTS AND SUCCESS OF FUNDS

The Contractual Model DBL Funds have a strong track record of investing in CED projects. The San Diego Smart Growth Fund invested in three workforce-housing ventures and two office projects. Genesis LA Real Estate Fund I invested in an 18-acre industrial park. This project built eight buildings with more than 300,000 square feet of industrial and office space targeted at local small businesses. The three most common types of CED projects supported by Contractual Model DBL Funds are housing (affordable, mixed-income, and workforce), office space, and retail centers.

These investments are commonly made in low- to moderate-income communities. For example, the NW LA CD Fund in the Investment Strategy of its Term Sheet stated "[t]o be considered for investment, real estate development projects must be within the low and moderate-income neighborhoods of this region. These neighborhoods are further defined by family incomes being less than 80% of the median family incomes in the surrounding areas" (Economic Innovation International, 2004, p. 96).

Contractual Model DBL Funds make very large investments in CED projects. The NW LA CD Fund invested $10.9 million in four equity deals for an average investment of $2.7 million. The larger Bay Area Smart Growth Fund I invested $80 million into 15 investments for an average of $5.3 million per investment. Along with these large investments, projects also have large budgets. The Genesis LA Real Estate Fund I only targeted projects with a minimum size of $6 million. By only investing in projects with large budgets greater than $5 million, a large percentage of potential CED projects are not eligible for investments from Contractual Model DBL Funds.

With these large-scale investments, Contractual Model DBL Funds invest in a small number of projects. The NW LA CD Fund made one loan in addition to its four equity investments. This limited number of investments also confines the potential impact of the Contractual Model DBL Fund to a small number of communities. For non-profit organizations with a smaller service area, this limited number of investments might not be important. However, non-profit organizations targeting a larger geographic area such as the State of North Carolina might want to consider whether the Contractual Model would help them advance their mission.

The four Fund Sponsors interviewed had mixed first and second bottom line returns. Five of the eight Contractual Model DBL Funds, as identified in Figure 2 in Appendix A, were dissolved between 2007 and 2009 as a result of either significant losses or lack of deal flow due to the impacts of the "Great Recession" on the real estate market. These significant losses were not abnormal for Contractual Model DBL Funds during this period. Research of 378 private equity real estate funds found the value-weighted average internal rate of return ("IRR") between 2005 to 2008 to be -6.5 percent (Fisher and Hartzell, 2013).

Investments in these CED projects are creating strong second bottom line returns. For example, in the NW LA CD Fund's Second Bottom Line Report from August 2013, the report projects this Fund will create about 240 construction jobs, 27 permanent jobs, and 415 rental units of affordable or workforce housing. Excerpts from this report are available in Appendix D.

While the DBL Funds had mixed first and second bottom line returns, not all Fund Sponsors stated they would create a future DBL Fund using the Contractual Model. One reason why is the tension that exists between Fund Sponsors and their Fund Managers about the type of investments the DBL Funds were making. While Fund Managers are required to meet second bottom line objectives as described in the Fund's legal documents, Fund Managers primary focus appears to be investments with higher financial returns. Three of the four Fund Sponsors stated if they were to sponsor another DBL Fund, they would consider not using the Contractual Model and think about whether they could start their own Fund Manager in-house using the Ownership Model. The Ownership Model requires more from Fund Sponsors because the Fund Manager they establish is responsible for the majority of the tasks of a DBL Fund. Not all non-profit organizations would be able to execute successfully this model. One option non-profit organizations could explore is how to strengthen the second bottom line return expectations of the Contractual Model DBL Funds such as insisting the Fund Sponsor has a first right of refusal for proposed investments.

CONCLUSION

The Contractual Model DBL Fund has a successful track record in raising and deploying high levels of capital in CED projects located in low- to moderate-income communities. An important factor in the success of these funds is the involvement of a proven Fund Manager that can help the Fund Sponsor achieve its mission of providing capital for CED Projects. However, the Contractual Model DBL Fund does limit the types of projects and the potential widespread impact the Fund Sponsor might want to have in its service area.

Prior to making any decision about the type of DBL Fund model a non-profit organization should pursue, additional research should be completed for the alternative model, the Ownership Model. This model demands more from the Fund Sponsor, but does provide the Fund Sponsor with more control over investments. Non-profit organizations should also research additional strategies for the Contractual Model to strengthen the second bottom line return expectations such as first right of refusal.

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APPENDIX A

The author conducted phone interviews with four individuals representing different Fund Sponsors. Figure 1 provides information about the interviewees and Figure 2 provides information about the DBL Funds these Fund Sponsors established and identifies funds that dissolved.

Figure 1 – List of Individuals Interviewed from Fund Sponsors

Interviewee	Date of Interview	Fund Sponsor Represented	Relationship to Fund Sponsor	Role with DBL Funds
Mr. Tom De Simone	1/10/2014	Genesis LA	President & CEO of Fund Sponsor	Not employed by Fund Sponsor when DBL Funds were active
Mr. David Aubrey	1/22/2014	Strategic Action Council	Managing Director of Fund Sponsor	Employed shortly after launch of DBL Fund
Ms. Elizabeth Ferguson	1/27/2014	Bay Area Council	No Longer Employed by Fund Sponsor	Previously was Executive Vice President of Fund Sponsor that managed all Fund Sponsor related activities
Mr. Barry Schultz	2/3/2014	San Diego Capital Collaborative	No Longer Employed by Fund Sponsor	Employed as President & CEO of Fund Sponsor at launch of Fund

Figure 2 – List of Fund Sponsors and their Contractual Model DBL Equity Real Estate Funds

Fund Sponsor	DBL Fund	Size	Fund Manager	Inception Year
Bay Area Council	Bay Area Smart Growth Fund I	$80 million	Pacific Coast Capital Partners	2001
	Bay Area Smart Growth Fund II	$41.25 million	Kennedy Wilson	2007
Genesis LA	Genesis LA Real Estate Fund I*	$85 million	Shamrock Capital Advisors	2000
	Genesis Workforce Housing Fund I*	$103 million	Phoenix Realty Group	2004
	Genesis LA Real Estate Fund II*	$104 million	Shamrock Capital Advisors	2005
	Genesis Workforce Housing Fund II*	$176 million	Phoenix Realty Group	2007
San Diego Capital Collaborative	San Diego Smart Growth Fund*	$90 million	Phoenix Realty Group	2006
Strategic Action Council	Northwest Louisiana Community Development Fund	$15.25 million	Kennedy Wilson	2007

**Fund Managers dissolved these funds as a result of either significant losses or lack of deal flow due to the impacts of the "Great Recession" on the real estate market.*

APPENDIX B

The author interviewed Mr. Belden Hull Daniels on January 15, 2014. Mr. Daniels is Founder and President of Economic Innovation Institute, a consulting firm, and Co-Founder of the National New Markets Fund, a national New Market Tax Credit (NMTC) Fund. Since the 1970s, Mr. Daniels has worked on designing, structuring, and building more than $150 billion of privately capitalized investment institutions, including multiple regional DBL Funds, throughout the world. Mr. Daniels has published numerous articles and books on economic development and development finance. He also taught classes at Harvard University and at Massachusetts Institute of Technology (MIT).

All four Fund Sponsors interviewed hired Mr. Daniels to assist with various roles in the formation of their Funds.

The author also communicated through e-mail with Ms. Deborah La Franchi during January 2014. Ms. La Franchi founded Strategic Development Solutions (SDS) Group in 2006 and serves as its President & CEO. SDS Group has partnered with Mr. Belden Hull Daniels of Economic Innovation Institute to build and capitalize DFL Funds. Together these two firms have built multiple funds throughout the country totaling more than $2 billion. Prior to founding SDS Group, Ms. La Franchi was the first CEO of Genesis LA and established its DBL Funds.

The San Diego Capital Collaborative and the Strategic Action Council both hired Ms. La Franchi to assist with various roles in the formation of their Funds.

APPENDIX C

The requirements of operating a DBL Fund is dependent on the tasks of a DBL Fund the Fund Sponsor chooses to manage. Figure 3 identifies eight primary tasks of a DBL Fund. (The author developed this list of tasks.) Also provided in Figure 3 is the stage of the DBL Fund that each of these tasks occurs. Finally, Figure 3 provides examples of how three Fund Sponsors divided these tasks between Fund Sponsor, Fund Builder, and Fund Manager.

Figure 3 – Primary Tasks of a Contractual Model DBL Fund and their Responsible Party in Three Fund Sponsors

Tasks of a DBL Fund	Stage(s) of DBL Fund	Fund Sponsors Interviewed		
		Bay Area Council	**NW LA CD Fund**	**San Diego Capital Collaborative**
Design and structure fund	Conception	Fund Builder	Fund Builder	Fund Builder
Raise capital	Marketing	Fund Sponsor/ Fund Builder	Fund Builder	Fund Sponsor
Source potential deals	Investment	Fund Sponsor/ Fund Manager	Fund Sponsor/ Fund Manager	Fund Sponsor/ Fund Manager
Underwrite potential deals	Investment	Fund Manager	Fund Manager	Fund Manager
Manage day to day activities	Investment/Holding	Fund Sponsor	Fund Manager	Fund Manager
Provide assistance to strengthen first bottom line	Holding	Fund Manager	Fund Manager	Fund Manager
Provide assistance to strengthen second bottom line	Holding	Fund Sponsor (through contract with consulting firm)	Fund Sponsor	Fund Sponsor
Monitor and evaluate fund performance	Holding	Fund Sponsor	Fund Manager/ Fund Builder	Fund Sponsor

APPENDIX D

The following is an excerpt from pages 10 and 11 of the Northwest Louisiana Community Development Fund Second Bottom Line Report from August 9, 2013. This second discusses the second bottom line return projections of this Fund's investments into four projects: RiverScape Parkway, RiverScape Apartment Homes, Village Square Apartment Homes, and Southern Oaks Apartment Homes.

IV. Meeting the Second Bottom Line Criteria

The individual projects of the Fund and the portfolio of the Fund as a whole are meeting the second bottom line criteria established for the Fund. Second bottom line performance is summarized below:

Geographic Scope:

- All four projects are located in LMI census tracts in the ten Parish Northwest Louisiana Region.

Economic Impact:

- All four projects are producing positive economic impact in the neighborhoods in which they are located.

- Village Square and Southern Oaks are making significant contributions to the revitalization of severely blighted LMI neighborhoods. Two thirds of all renovations on both Village Square and Southern Oaks are being performed by African American sub-contractors chosen through a competitive bid process, with a total value of approximately $550,000 and 45 construction jobs. Permanent employment totals six professionals, all African American, with total annual benefits of approximately $200,000. The partnership with Provenance House is helping stabilize the homeless population in the city and these neighborhoods. The overall economic multiplier of these substantially improved projects is significant in both neighborhoods.

- RiverScape Parkway and RiverScape Apartments have already stimulated positive economic activity in the adjacent LMI Stoner Hill neighborhood, and much more is coming in 2013 and beyond.

- RiverScape Parkway is expected to have commercial, retail and office space for local businesses when fully developed.

- To date, the projects have generated a total of 165 construction jobs and approximately 7 permanent jobs.

- Upon full completion, the projects are projected to produce a total of approximately 240 construction jobs and 27 permanent jobs.

Wealth Creation:

- Upon completion, RiverScape Parkway is projected to provide 100 units of mixed income and mixed race for sale housing leading to increased homeownership opportunities for these families, and creating a healthy and diverse community in Shreveport.

- Through the potential sale to African American investors, both Village Square and Southern Oaks can provide significant opportunities for wealth creation in the African American community.

- Once completed, RiverScape Apartments also are expected to provide the potential for some African American ownership opportunities in the partnership.

Community Impact:

- The RiverScape Parkway and RiverScape Apartments are joint ventures between Vintage Realty, the Fund, and Trinity One, a not-for-profit community development corporation. Trinity One is affiliated with an African American Church and led by an African American pastor who first imagined Riverscape as a mixed-use, mixed-income, mixed-race housing, educational, civic, commercial and retail neighborhood development in the center city of Shreveport, which is what RiverScape Parkway is becoming.

- RiverScape Apartments will provide 208 rental units of mixed income and mixed race workforce housing, providing these families with amenities beyond which those available to them before.

- Village Square and Southern Oaks are providing a total of 207 units of safe, clean and affordable housing where previously there was dilapidation, deterioration and crime. Village Square is now 95% leased with a responsible tenancy, and Southern Oaks occupancy is currently 93% with a similar tenant base.

- In the renovations of Village Square and Southern Oaks, two thirds of all sub-contractors are African American.

- Village Square and Southern Oaks have established a relationship with Provenance House to provide transitional housing leading to permanent housing for formerly homeless families. This partnership has importance beyond Village Square and Southern Oaks as a model partnership for other housing developers and managers.

- The 7 acre site sold adjacent to Riverscape Parkway is the first new charter school in Caddo Parish, The Magnolia School of Excellence.

Environmental Impact:

- RiverScape Apartments has incorporated energy star appliances.

- The RiverScape Parkway project will be a mixed-use, mixed income, walkable neighborhood, with the attendant environmental benefits.