THE REVOLUTION IN CORPORATE FINANCE (NONPROFIT & OTHERWISE)

by Brett White

In today's retail financial markets, revenues associated with fees for acting as an intermediary in financial transactions are collapsing. Why pay a broker anymore when I can buy and sell stocks/bonds, research my purchases and consult other investors and highly paid analysts for advise over the Internet? The retail securities business is so large, so liquid and the infrastructure so well developed that day trading and individualized funds management is not only a possibility, it's a genuine phenomenon. With more and more investors able to directly execute transactions sans broker/dealers (and their mark-up), the result is "disintermediation" and it is fundamentally reshaping the landscape of the investment community. For very similar reasons, institutional finance (the art and science of structuring and managing capital flows within and on behalf of an organization) is beset with enormous change, stripping away layers of 'middlemen' and dramatically altering the ways in which institutions both access and use capital.

INTERMEDIARIES & INSTRUMENTS

One of our shared difficulties is that the nonprofit financial marketplace has never exactly been overrun with intermediaries of the type so common in the for-profit sector. We don't currently have the type of infrastructure, the sophistication of data, the number of competitive market makers, the ready availability of information or the broadly liquid marketplace so fundamental to the success of Wall Street, the TSE, NASDAQ, or new ECNs (electronic communications networks) like Archipelago. In the absence of these requisites, we as a sector of the economy remain classically underinvested vis-à-vis capital sourcing.

Beyond intermediation, of course, lies product - the actual instruments, tools, and processes by which capital exchange takes place. It is in this realm that so much innovation has taken place during the past two decades, as financial markets have exploded and investors (both socially-oriented and nasty old profiteers alike) have searched for ways to better put their money to work.

In the realms of both intermediation and instrumentation, significant opportunity exists for today's CED practitioner, but many know little or nothing of it.

Are you aware, for instance, that there are ways in which nonprofit organizations can utilize equity and its equivalents to secure genuine (non-subsidized) long-term investment in community economic development projects? Did you also know that well-established methods of low-cost debt financing (at rates much lower than through typical commercial bank lending) go want-

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ing for qualified borrowers? This is due to a dearth of quality deals and to the fact that these tools simply aren't well known to the average nonprofit executive. And what of the much-vaunted "venture capital"? There are at least three different means by which CED practitioners can gain access to VCs, and none of them require a visit to Silicon Valley (which is fortunate, because we wouldn't even make it through the front door of any self-respecting Sand Hill Road boutique).

EQUITY & EQUIVALENTS

Equity is the cornerstone of nearly any growth strategy. Wealth, in its myriad forms, is elementally constituted through the appreciation of economic value inherent in that ownership. The world of the nonprofit corporation, though, is largely predicated upon a quid-pro-quo - support from the breadth of the community (as reflected through incentives such as exemption from taxation) in exchange for both implicit and explicit assurances that the community itself will benefit over the interests of individuals. That sometimes makes it simple for some service-oriented organizations to underestimate the importance of equity on their balance sheets, but without it, you can kiss most forms of debt goodbye as well. So it appears a conundrum to solve that private ownership might find its way to support the common good.

Obviously, subsidiating assets (that is, establishing a separate for-profit entity through which to conduct specific development activities) provides the opportunity for standard equity utilization. But under the aegis of a nonprofit itself, use of traditional equity instruments becomes a more difficult (though not impossible) task. Hence the growth of equity equivalents, or eq2s. The actual form that eq2s can take are numerous, but a common approach is that deeply subordinated debt is added to an organization's capital structure (perhaps through a program-related investment on part of a foundation, an outright grant, or even a structured loan guarantee). From the perspective of most commercial financial institutions, this appears like equity, since they know that in the event of any liquidation they will get their money out first due to the subordination feature. In short, this is the risk/reward associated with ownership – when things go good, values rise disproportionately; when things go badly, debt holders go to the front of the line and equity holders get what (if anything) is left over.

Another approach is to add a convertible feature to the eq2, providing the subordinated debt holder an opportunity to realize "equity" appreciation in the event that performance benchmarks are achieved.

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An eq2 allows a nonprofit to leverage additional investment (both equity and debt) without the necessity for outright ownership of the tangible assets upon which the equivalent is based. Clearly, these can be relatively complicated instruments (and the detail is outside the realm of this short article), but this approach is applicable in a number of nonprofit circumstances and certainly when long-term debt is deemed appropriate.

DEBT

In the U.S., one underappreciated tool exists within the realm of capital facilities finance. Tax-exempt bonds, underwritten by both public and private entities, provide long-term financing for facilities to be used in the performance of a nonprofit's mission. This includes things like classrooms, worker-training centres, daycare centres, counseling offices, community theatres, mental health facilities, even livestock barns. To the degree that the proceeds are invested in a capital asset that generates income sufficient to adequately serve the outstanding bond and that directly serves the express purpose of the issuer, tax-exempt bond financing is a highly attractive instrument.

For public entities underwriting the issuance of the bonds, the beauty of this instrument is that there are no regulatory caps on the number or amount of nonprofit bonds that can be issued annually, meaning that any number of projects can be financed and, moreover, that those instruments underwritten for tax-exempt facilities generally have no deleterious impact upon the number or value of tax-exempt affordable housing bonds that can be issued during the same period. For private underwriters (such as Bank One Capital Markets in Chicago), the growing need for CRA-eligible loan products and socially-responsible investment funds seeking mission-oriented products means that a significant market exists for tax-exempt bonds. Aside from those involved in capital facilities planning for universities and hospitals, you are likely unaware that this entire market has been awaiting a project just like yours.

VENTURE CAPITAL

Has there been any more surreal a profession over the past few decade than that of the VC? One more story about a dot com millionaire and the travails of those who finance them will just about put me over the edge.

Giving away money is not difficult. Making money from that which you've already spent is. A trained monkey can take money that doesn't belong to him and give it to one of the thirty-nine gazillion people walking around today with sure-fire business plans. True talent (and a bit of self-created luck as well) lies with those who can consistently identify that select number of investments with genuine potential, viable markets, and able management. The world is full of need and overloaded with plans focussed on serving them. What is at a premium, though, are legitimate, viable, self-sustaining ways to successfully fulfill those promises. This is as important, if not more so, in the world of CED as it is in software development, biotechnology, optical networking, or any of the other Mr. Wizard-like fields grabbing headlines and causing headaches around the globe.

Now, to let you down softly. Your typical CED project will never get significant attention from mainstream VCs. Never. Ever.

The good news? A series of organizations (some new, some with gray hair of their own) are deeply involved in bringing venture capital to the community and even to the neighbourhood level. This is an interrelated but separate realm from that addressed under the rubric of community development venture capital (CDVC) as discussed in Julia Sass Rubin's article in this edition (see p. 18). Two examples might prove valuable.

Murex Investments, Inc. is a wholly owned subsidiary of Resources for Human Development (RHD), a $72 million+ nonprofit social service agency headquartered in Philadelphia. Murex is operated by RHD's Capital to People program and is recognized by the U.S. Treasury Department as a Community Development Financial Institution (CDFI). With the self-defined objective of creating community wealth, Murex serves as a venture capital vehicle providing three key services (access to capital, workforce development, and intensive management development assistance) to businesses that

- pay a living wage.
- locate in and/or hire members of distressed communities.
- provide profit sharing *and* a significant percentage of worker ownership.

To date, over US$3.3 million have been raised by Murex and invested in businesses such as Thermal Flux Corporation (an industrial tire/wheel recycler), Computer Systems and Solutions (a laptop computer repair and sales firm) and Laser Labs (a high-tech eyeglass lens manufacturer).

Enron, the global utility and trading concern based in Houston, is known for many, many innovative ideas. It is not known, however, for its charitable treatment of anyone. So it is perhaps a bit surprising to find that this veritable juggernaut of capitalism has found great business deals in the inner city. Enron Investment Partners (EIP) is the first corporate venture capital fund devoted to women- and minority-owned businesses started by a non-financial institution. Begun in February of 1999 with an initial $20 million investment and leveraged by additional investments by Bank of America, Wells Fargo, Washington Mutual, and a local Houston investment firm, EIP's Houston Economic Opportunity Fund has $38 million in investible capital and has, to date, placed $28 million of that in 14 different companies in and about the Houston area. Next on EIP's list ... the $150 million dollar Cambium Fund, targeted at minority businesses in New York, Los Angeles, Chicago, and Atlanta.

Do any of these tools represent *the* answer for CED practitioners? Probably not. Are they part of the answer? For some of us actively involved in the "new" nonprofit capital marketplace, we bet that the answer for an increasing number of CED organizations will indeed be "yes."