



# THE LENDING OPPORTUNITY *of a* GENERATION

FAQs and Case Studies for Investing in Businesses  
Converting to Worker Ownership



## The Lending Opportunity of a Generation: Worker Coop Conversion Financing FAQs and Case Studies

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The Cooperative Fund of New England (CFNE) is a Community Development Financial Institution founded in 1975. Its mission is to advance community based, cooperative and democratically owned or managed enterprises with preference to those that serve low income communities through the provision of prompt financial assistance at reasonable rates; provision of an investment opportunity that promotes socially conscious enterprise; and development of a regional reservoir of business skills with which to assist these groups. For more information please visit [www.cooperativefund.org](http://www.cooperativefund.org).

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Project Equity's mission is to foster economic resiliency in low-income communities by demonstrating and replicating strategies that increase worker ownership. We envision a future where communities (re)gain economic self-determination and today's working poor have good jobs that keep them out of poverty and enhance their lives. We see cooperatives and employee ownership as key elements of this future. For more information please visit [www.project-equity.org](http://www.project-equity.org).

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The Democracy at Work Institute advances worker ownership as a strategy to create a fairer economy and better jobs, build local wealth, and retain businesses in communities. Created by the US Federation of Worker Cooperatives, the Institute brings both a national birds-eye view and an experiential on-the-ground understanding of cooperative business. Through strategic research, organizing and capacity-building training, we are working to bring the worker cooperative movement to scale to effect transformative change for individuals and communities throughout the country. <http://institute.coop>.

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### ACKNOWLEDGEMENTS

Thank you to the worker cooperatives that gave their permission to have detailed case studies published about their conversion financing: A Yard and a Half Landscaping, Island Employee Cooperative, The New School of Montpelier, New Era Windows and Real Pickles. We also thank the many reviewers who took the time to read a draft and provide very helpful feedback.

### DISCLAIMER

**This information is not intended to constitute legal or accounting advice and should not be relied upon in lieu of consultation with appropriate legal or accounting advisors in your own jurisdiction.**

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# A LETTER TO LENDERS

I was first introduced to the idea of “employee ownership” about a dozen years ago when a director of the bank where I worked referred a company—owned by the employees—to me for a potential refinancing package. While I had worked on hundreds of loans over my twenty years in commercial lending, this was the first time that I had been exposed to a business, from a lending perspective, where the workers had a broadly held ownership stake. It quickly dawned on me that the employee ownership model could be a business retention tool for my book of business. A high percentage of my banking clients were in their late 50’s or 60’s, had no children or apparent successors in their business, had good working relationships with their employees, and would like to see their business continue into the future after they retired.

Fast forward to 2016. Much has been written about the \$10 Trillion Opportunity of the upcoming ownership changeover of private enterprises as the wave of baby boomers marches towards retirement. An estimated 70% of all private businesses is forecasted to go through an ownership transition in the next five to 20 years, including hundreds of thousands of small and middle market businesses. The vast majority of these are family owned and the “next generation” is not engaged in the business. Recent studies of family ownership show that only 15% of all businesses transition to the 2nd generation and fewer than 5% to the 3rd generation. If sold to an outside firm, the business is more likely to consolidate and transfer the bulk, if not all, of its operations to its acquirer. Not only do the local employees lose their jobs, the local service providers (banks, accountants, attorneys, consultants, etc.) lose their clients. If there is a significant amount of business loss in a community, the service provider’s jobs and livelihoods can be negatively impacted as well.

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*“Much has been written about the \$10 Trillion Opportunity of the upcoming ownership changeover of private enterprises.”*

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Employee-owned companies are more likely to maintain their local operations and not “sell their jobs” out of area. They have both short term (ongoing income) and long term (equity) stake in the enterprise, so they are motivated to maintain a profitable and sustainable business. There are approximately 7,000 enterprises with broad-based employee ownership in the U.S.; employee ownership has taken hold and demonstrated its success. A worker cooperative is a lesser-practiced form of employee ownership that can provide a powerful “succession alternative” for private business. The purpose of this paper is to provide background information about worker cooperatives and case studies to those providing financing or services to private businesses, so that they can become more familiar with and understand this form of ownership. When a private business transitions its ownership to a worker cooperative, it not only anchors the business and the jobs in the community, it also retains the demand for business services locally. It will be important for service providers to know and understand that business ownership via a worker cooperative can be successful as they look to not only maintain their book of business, but also potentially expand it, as the transfer of private business ownership accelerates in the near future.

***Roy Messing***

Ohio Employee Ownership Center





# FREQUENTLY ASKED QUESTIONS

## INTRODUCTION

Today, in spite of the many benefits of worker-owned cooperatives, there are only an estimated 300-400 in the United States, with around 7,000 worker-owners. Of the existing cooperatives in the U.S., about 40% were formed by “converting” from a traditional business structure, accomplished by the owner selling the business to its employees.

We are on the cusp of the biggest potential wealth transfer in our nation’s history as baby boomer business owners retire. This opportunity to convert businesses to worker cooperatives is increasingly becoming recognized as a strategy for strengthening our local economies. The need—and opportunity—for lenders and other capital providers to participate in these sales transactions is expected to grow significantly in the coming years.

But, there are currently only a handful of lenders in the U.S. that specialize in lending to worker coops. In talking with other lenders and impact investors interested in becoming involved—whether Community Development Financial Institutions (CDFIs), credit unions, community banks or more mainstream banks, we found a need for a basic “primer” about lending in the context of worker coop conversions. We hope that this document is able to address basic questions and serve as an introduction that begins to demystify what it means to lend to worker cooperatives. Ultimately, we aim to help more lending institutions participate in these types of business sales transactions, to enable them play an important role in strengthening our communities.

## INTRO TO WORKER COOPS

### What is a worker-owned cooperative?

Worker cooperatives are one form of employee ownership. What makes them unique is that they are businesses both owned and governed by their workers, where profits are shared based on hours worked, and strategic decision-making is democratic, adhering to the principle of one worker, one vote. Learn more about worker coops on the [Democracy at Work Institute’s website](#).

### How are worker coops managed?

There is no single way to structure a worker cooperative. Most mid- to large-size coops have traditional (hierarchical) management structures, along with a participatory culture and governance through “representative democracy.” With representative democracy, worker-owners elect the Board of Directors, which most typically hires, fires, and evaluates the General Manager. There are a small number of decisions that need to be voted on by all worker-owners (such as selling the business, electing the majority of board seats, and amending the bylaws), and sometimes, important annual decisions such as approving the budget are made by the members. Other key decisions are made by the board (e.g. hiring-firing-evaluating the chief executive, setting policy), and day-to-day business decisions are made by the appropriate manager.

Some worker coops prefer a more “flat” management structure, and some of these have used “direct democracy” at a larger scale. In direct democracy, all high-level business decisions are made by a vote of all worker-owners. Small worker coops are the ones that can usually use this approach most effectively, but there are some larger coops that have been able to continue to operate with this structure. All worker-owners are on the board, and the board makes major business decisions. Often committees are set up to manage different areas of the business, and those committees are granted defined decision-making authority within their area.

With either approach—and as in traditional business structures—effective business operations are only made possible by well-defined decision authority and processes.

## How are profits shared?

Profits in cooperatives (called “surplus”) are shared amongst worker-owners on the basis of “patronage.” For a worker-owned coop, this typically means on the basis of hours worked. Some worker coops also incorporate pay level and seniority into the formula for allocating profits, with the goal of rewarding current market value of workers’ skills and long-term contribution to the business. Most typically, and as outlined in the coop’s bylaws, some portion of the surplus is reinvested in the business and some portion of the surplus is shared with worker-owners. Of the portion shared with the worker-owners, some of it is paid out (quarterly or annually) and some of it stays in the business in the workers’ individual capital accounts (see more explanation of this below). The money in these capital accounts is owned by individual workers, but is available to the business for working or growth capital, then is paid out when the worker leaves the business.

## What are some examples of successful worker coops?

- **Cooperative Home Care Associates**
  - New York, NY
  - [www.chcany.org](http://www.chcany.org)
  - Cooperative Home Care Associates (CHCA), based in the Bronx, was founded in 1985 and is now the largest worker coop in the U.S., with more than 2,000 employees (~1,300 worker-owners), nearly all of whom are Latina and African-American women. Its mission—to deliver quality care through quality jobs—is achieved through providing gold standard training, offering full-time hours, competitive wages, and worker ownership, and integrating peer mentoring, financial literacy training, and supervision that effectively balances coaching, support, and accountability.
- **Isthmus Engineering & Manufacturing**
  - Madison, WI
  - [www.isthmuseng.com](http://www.isthmuseng.com)
  - Isthmus Engineering & Manufacturing, founded as a partnership in 1980, converted to a worker-owned cooperative in 1983. Isthmus designs and builds custom automation equipment with applications ranging from high-speed automated assembly to material handling to system integration. Its 62 employees, 32 of whom are worker-owners, together generate more than \$20M in annual revenue.

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- **Alvarado St. Bakery**
  - Petaluma, CA
  - [www.alvaradostreetbakery.com](http://www.alvaradostreetbakery.com)
  - Founded in 1981, Alvarado St. Bakery employs about 120 people in its wholesale bakery and distribution center in Petaluma, CA. Alvarado directly distributes its sprouted breads and bagels in Northern California and also sells through major retail distribution chains like Trader Joe's and Walmart, and exports to Canada and Japan. These worker-owners earn above industry average: including wages, profits and benefits, their bakers' compensation package is worth about \$85,000 per year.

## INTRO TO WORKER COOP CONVERSIONS

### Common reasons business owners decide to convert to a worker coop

We have seen four common motivations for businesses to transition to worker ownership:

1. As an exit strategy for the owner, whether leaving for retirement or other reasons
2. As a component of the business' mission, recognizing the employees as an important stakeholder group
3. To create wealth-building opportunities for employees, especially in low-wage sectors
4. Because it's good business: employee-owned businesses have demonstrated their ability to be more financially successful than their peers, and to weather economic storms more effectively

Businesses without an ownership succession plan are at risk of closing down—liquidating—when the owner retires, leaving the employees without jobs, the community without its local business, and reducing the local tax base. An employee ownership conversion can avoid this potential liquidation and keep locally-owned businesses rooted in our communities.

There have been some attempts to use employee ownership to rescue failing businesses, but this is not a good idea, unless the flaws from a business perspective are directly tied to weaknesses of a departing owner and can be easily remedied by new worker-owners. Employee-owned businesses and coops must succeed on business terms, just like any company, so a sound business model and a strong future market are essential.

### What is the current market opportunity for worker coop conversions?

Most privately-held businesses lack a succession plan—an agreement for what happens when their owners retire. Indeed, for business owners over 50, a full 7 in 10 don't have succession plans. Few family-owned businesses succeed to the 2nd generation (only 15%), with only 5% succeeding to the 3rd generation. Those that do not close are often sold to out-of-state buyers or private equity firms that may relocate jobs or the entire business. In the absence of succession planning, communities across the country lose not only vital businesses and jobs, but also lose jobs in businesses that are locally owned and controlled, and that contribute greatly to a community's financial well-being.

The pending 'silver tsunami' of retiring baby boomers makes this a critical issue for communities to address. In the U.S. today, 76% of private sector employment is in companies not traded on the





stock market (“closely-held” or “privately-held” companies). And, according to census figures, baby boomers own two-thirds of businesses with employees—nearly four million businesses, leading to forecasts like the one by Businessweek that “[t]rillions of dollars of business value are going to change hands in the next 10 to 20 years.”

The silver tsunami is forecast to be one of the biggest changeovers of privately-held businesses in U.S. history. Coop conversions enable us to tap this for the good of our workers and of our local economy.

## **What is the financing opportunity for worker coop conversions?**

To prevent business closures and create good jobs, organizations throughout the U.S. are engaging with companies to support their conversion to worker ownership. These organizations—including small business services, nonprofits, law firms, and cooperative finance institutions—analyze the feasibility of a business taking on the debt necessary to become worker-owned. Lenders can work with these organizations to access a market of vetted businesses, with business values ranging from under \$300,000 to over \$10 million that have support organizations vested in their continued success. With each passing month, more organizations are joining this effort and identifying additional candidate companies for worker coop conversions.

Furthermore, for lenders with a specific interest in financing worker cooperatives, conversions of existing businesses present the strongest opportunities based on both loan size and risk profile. Outside of the small number of existing mid-sized worker coops (those with more than 20 members), most worker coop financing opportunities are with very small or start-up ventures. With conversions of successful companies to worker coops, the companies often have established markets, positive financial history, experienced management teams, and demonstrated capacity to borrow, making conversions a relatively low-risk financing opportunity in the worker coop sector.

## **What is the difference between an ESOP and a worker cooperative and why would you choose one option over the other?**

An employee stock ownership plan, or ESOP, is a type of employee benefit plan (like a 401(k) or profit sharing plan) that can be used to transfer partial or full ownership of a company to employees. With an ESOP, shares are not held directly by employees, but through an ESOP trust, which is administered on employees’ behalf. Although both ESOPs and worker cooperatives can be used to transfer business ownership to employees, there are important differences between the forms.

Two key differences are: (1) worker cooperatives are by definition democratically governed by workers, whereas ESOPs have only minimal requirements for worker voice (although they can be governed democratically), and (2) worker cooperatives are largely unregulated, whereas federal law governs many aspects of how ESOPs are administered, including allocation, vesting, valuation, distribution, and more.

Given the costs, ESOP experts generally advise that companies with fewer than 50 employees may be too small for an ESOP, although there are many exceptions. Worker cooperatives, on the other hand, typically have much lower transaction and ongoing administration costs, and are appropriate for companies of all sizes.

## **Tactically, what is a conversion to a worker-owned cooperative?**

A worker cooperative conversion is similar to a management buy-out, but instead of just a few key managers purchasing the business, most or all employees are offered an equal ownership stake. A conversion has three basic components:

1. The creation of a business entity that is a worker-owned cooperative. Depending on the situation, this can be accomplished by converting the existing business, or forming a new cooperative entity;
2. A sales transaction executed between the current owner(s) and the new worker cooperative to sell the existing business (or its shares or assets) to the worker coop and execute a Purchase & Sale Agreement. Each worker-owner “buys in” to the coop and receives a single voting equity share. The sales transaction is typically financed by a group of lenders—the selling owner, a bank, and/or a Community Development Financial Institution (CDFI), or less commonly, by selling non-voting equity shares; and
3. A transition of roles and culture among the new worker-owners to take on the ownership responsibility of the new entity and run it under democratic governance. Often, technical assistance from coop developers specializing in this work helps smooth this transition.

## **What are the steps in a coop conversion?**

Before deciding to convert to worker ownership, a company must work with service providers to assess its readiness for a transition, including outlining goals, analyzing financial feasibility, evaluating operational readiness for the transition, and educating key stakeholders about what’s needed for the conversion. The business would also draft timelines and define decision-making processes for the conversion.

Once the decision has been made to transition to worker ownership, a business must prepare for the transition. The conversion team works to secure a business valuation, identify financing options and negotiate the terms of the sales transaction. The selling price of the company should be based on the market valuation as well the debt service capacity of the company. Lenders can play a valuable role in advocating for a price with terms that the cooperative can repay even if it does not meet forecasted performance targets. In addition to financials, the team drafts bylaws and decision-making frameworks for the new coop, and creates a training and support plan for the new worker-owners. This phase leads to a formal commitment to the coop conversion transaction by the selling business owner and the coop’s future worker-owners.

During the next phase, the conversion team finalizes the worker coop entity set up and the coop’s bylaws. The buyers and selling owner execute the agreed-upon financing options and complete the sales transaction, after which the business executes the coop governance structures and is officially a worker-owned company.

Operating a successful worker cooperative takes more than just a financial transaction. During the final phase, consultants or an internal team provide training and support for new worker-owners, support governance and decision-making processes, cultural transitions, and help former owner(s) with their exit or evolving role.

Businesses can complete this timeline in six months or over a year, depending on how ready they



are, how quickly they make decisions, and the complexity of the business sale. Visit [Project Equity's website](#) for more information about the Conversion process.

## What supports help make coop conversions successful?

A coop conversion is an ownership transition, a time of change for the business. As with any significant transition, it needs to be effectively implemented, with care given to the transition plan—both operationally and culturally. Businesses that already operate in a participatory culture are well suited to this transition.

We recommend that businesses ensure they have the right supports in place, including experts in designing worker-owned business structures, legal counsel, financial and tax advising, and accounting support to transition the books to new financial structures. Effectively structuring the financing to not overburden the new worker coop is critical.

In addition, it is important to invest in education and training for the selling owner and the future worker-owners, as well as ongoing support for key individuals who will help lead the governance and cultural transition. We recommend building in the cost of ongoing training and support into the sales financing, to ensure adequate investment for a period of 2-3 years after the transaction.

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## WORKER COOP CONVERSION FINANCING

### How are worker coop financial statements different?

Lenders who have never worked with cooperatives before may be unfamiliar with the relationship between the cooperative and its worker-owners, and how the relationship is reflected in the financial reports of a cooperative. Although cooperatives are subject to the same set of Generally Accepted Accounting Principles in their financial reporting as are all other types of business entities, there are two main areas where cooperative accounting differs from that of a typical business: the balance sheet and how profits are taxed.

- **The balance sheet:**

When a new worker-owner joins a coop (or in the case of a conversion, at the time of conversion), each worker-owner “buys in” to the coop and receives a single voting equity share. The financial amount of this buy-in is outlined in the coop’s bylaws, and can vary widely across coops (more discussion on this is below). This buy-in becomes equity on the balance sheet, and is tracked in the individual capital account of each worker-owner. Coops often lend a portion of the buy-in to worker-owners, to enable them to pay it off through payroll deductions. Worker-owner loans are subordinated to commercial lenders rights, and in some cases, though presented on the balance sheet in the liability section, more flexible lenders can view these loans more like equity, as they represent investments from cooperative members.

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- **How profits are taxed:**

A worker cooperative can elect to receive single tax treatment (also called pass through treatment) for profits generated by worker-members (called surplus), which are allocated to those members based on their labor contribution to the cooperative. As mentioned previously, cooperatives can retain this allocated surplus in the business through member (worker-owner) equity accounts instead of paying it all out in cash to worker-owners. This retained patronage is tracked in the Individual Capital Accounts in the equity section of the balance sheet.

The cooperative's bylaws provide for how members can redeem the equity in their Capital Accounts. When a worker-owner leaves the cooperative, typically their Individual Capital Account (equity) is paid out over a period of years. Equity redemptions are often subordinated to lenders' rights.

## How does an Internal Capital Account work?

When worker-owners buy in to the cooperative and receive their single voting share, their Internal Capital Account—an equity account—is established. Over time, as profits (called surplus in coops) are shared with worker-owners, some of that profit is retained in the business, but still owned by the individual workers. This retained patronage increases the value of a worker's individual Internal Capital Account. For more information about internal capital accounts, visit the [ICA Group's website](#).

## How are conversions typically financed?

Like financing any small business, financing options for worker coop conversions include a combination of debt and also equity—coming from worker-owners or outside investors. Most worker coop conversions have been primarily debt-financed. However, equity financing is increasingly being utilized through issuing non-voting equity shares, including Direct Public Offerings (DPO), described on page 8. See the

five enclosed Case Studies for specific examples of how financing has been structured.

Source	Amount	Terms
Senior Debt	\$500,000	4-8%
Senior Debt- Line of Credit	\$150,000	6-8%
Subordinated Debt- Seller Financing	\$200,000	4-10%
Owners' Equity	\$50,000	N/A
<b>Total Sources</b>	<b>\$900,000</b>	
Business Purchase	\$700,000	
Acquisition Working Capital	\$200,000	
<b>Total Uses</b>	<b>\$900,000</b>	

## How is debt financing used for coop conversions?

Debt financing for coop conversions can come from a variety of sources, including banks, CDFIs, vendors, the selling owner, members, and individuals from the community. Generally vendor-financing will take a lien on the business inventory alone, totally separate from other lenders. Bank and CDFI debt will take a primary position on other business assets in relation to members, customers and the selling owner, all of whom play a gap financing role and often are subordinate or unsecured. Which stakeholders provide gap financing varies by the business, depending on which have the resources.



Multiple lenders can clarify their relationships with each other through inter-creditor agreements, depending on what the lenders and the business feel is the best way to structure the deal.

Existing lenders that have experience lending to worker coops (listed on page 14) bring experience both with financing coops and with coordinating various lenders in a deal, so they can be a great option to play a coordinating role in situations with multiple lenders.

## How is equity financing used for coop conversions?

The sale of voting shares to members through payment of the member buy-in is the central equity source in worker coop conversions, though often quantitatively small. These are sold on a one member, one share basis and each equity share imparts one vote to the holder. As such, these shares form the basis

of the worker-owners' democratic control of the coop. This is distinct from many non-cooperative businesses, where votes are distributed in proportion to capital investment. These voting shares generally do not offer a return, but do grant access to a patronage-based share of financial surplus (aka profit) that the coop generates.

There is wide variability on the buy-in cost based on the capitalization needs of the coop and the capacity of the worker-owners to afford the shares. For example, both the need for and capacity to provide equity to a business might be higher in a manufacturing company than a house cleaning business. Frequently, the coop will lend a portion of the buy-in to a new worker-owner, enabling full payment to be completed over time through a payroll deduction. Unless there is significant time between starting the coop organizing effort and the sale transaction, most of this equity won't be available at the time of conversion. However, some lenders still take this equity pledge into account.

To raise additional equity, coops can sell preferred shares, including private offerings, which may include accredited investors, unaccredited sophisticated investors or some combination of the two; or Direct Public Offerings (DPOs), open to anyone within certain geographic constraints based on filings

<i>Conversion Sources of Capital</i>	
Source of capital	Notes
<b>DEBT</b>	
Institutions (Banks, CDFIs)	Generally collateral is required. Personal guarantees are not required but helpful in lieu of collateral. Primary position on all assets except a secondary position on inventory; set repayment schedule
Vendors	Primary lien on business inventory
Selling owner	Subordinate, often unsecured; repayment contingent on primary debt repayment
Individuals (Members, customers, community, friends, family)	Subordinate, often unsecured; repayment contingent on primary debt repayment
<b>EQUITY</b>	
Worker-owner buy-in	Voting shares; usually small % of sources
Accredited Investors (Private Placements)	Non-voting shares; Targeted rate of return subject to coop performance
Non-accredited investors (Direct Public Offerings)	Non-voting shares; \$1,000 minimum; Targeted rate of return subject to coop performance
Contributions or grants	No repayment required

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and state laws. These shares, like equity in traditional companies, offer a targeted rate of return on investment, dependent on the financial success of the coop's operations. They often do not carry any voting rights. The ability of coops to raise private equity given the limited control these shares offer speaks to coops' ability to attract investors interested in social as well as financial returns.

Internally, the cooperative will also build up equity over time through worker-owner Internal Capital Accounts and retained earnings reinvested into the business. As described in the section "How are worker coop financial statements different?" the tax code allows coops to avoid double taxation of dividends paid to worker-members based on their labor, even when that equity is not paid out to members in cash. As long as the distribution meets certain legal requirements, retained patronage is not taxed, and the cooperative's accumulation of reserves is enhanced. For a detailed explanation of how coop equity distribution works, refer to the Patronage and Tax section of the [co-oplaw.org](http://co-oplaw.org) website.

Finally, some worker coops have succeeded in raising equity through contributions and grants, due to the coop's social benefit. We have seen start-up worker coops bring enough equity to the table through contributions in order to attract other lenders, but haven't yet seen it widely used for coop conversions. Grants or donations can also be leveraged to fund outside technical assistance (TA) support, which is often critical to complete the initial feasibility assessment.

## What role can loan guarantees play?

In a worker coop, in which many individuals own a small part of the business, personal guarantees can be a challenge to enforce and collect on. As a result, when lenders are unable to collateralize the loan using only business assets, limited loan guarantees can play an important role, for example:

- Limited guarantees from the selling owner or top management. These guarantees might expire after a set period of time or cover a fixed amount of the debt.
- Given the community benefit of coops, family or community foundations, cities or other public entities, coop customers, or even other coops may provide guarantees.

CDFIs may have more flexibility than banks, given the regulatory differences. Coop-focused lenders like those listed on page xx have used limited guarantees and have also used a vehicle similar to a CD-backed guarantee, where a guarantor provides a cash investment with a promissory note clarifying that the investment is at risk if the coop defaults. Structuring a guarantee this way provides interest income to the guarantor while assuring the lender that the cash will be available if needed. CDFIs generally provide a higher rate of return on these guarantees than a bank's CD or money market fund rate. Furthermore, if the CDFI is a nonprofit and the guarantee is called upon, the amount is a tax-deductible donation, giving the guarantor favorable tax treatment. This option is not available to all CDFIs, depending on their policies and sources of funds.

## Should lenders have industry expertise to finance a conversion in that industry?

The need for industry expertise does not differ between underwriting a conversion or a conventional financing applicant, though lenders should ensure that the valuation was conducted by a firm with industry expertise and access to industry-specific data. Lenders can also reach out to conversion





experts with experience in the industry or converted companies in that industry for support around effective practices and common issues that may arise.

## **How are working capital and growth capital needs taken into account?**

As with any business, converted coops need access to sufficient working capital. In the case where the available business collateral is fully committed for the business acquisition loan, lenders might struggle to approve additional working capital debt. As the case studies detailed below illustrate, rarely are member equity and senior debt sufficient to finance a conversion. The other financing sources, including subordinated debt and outside investor preferred equity, are essential not only to the coop's ability to buy the business, but also to its continued operational and growth needs.

## **How is a conversion different when the selling owner plans to stay?**

When the selling owner is also a key manager in the business, it's important to understand whether and how that owner is staying with the coop after the transition. The owner may leave immediately, stay for a fixed amount of time to support the transition, or stay on indefinitely as a worker-owner in the coop.

There are a few benefits to the seller staying, even if just for a fixed amount of time. First, preserving the top manager in the business allows more time to train new management, whether a member-owner or a new hire. The amount of time needed varies. It can depend on the extent to which the selling owner has already shared management responsibilities with the employees, and how integrally involved the owner is in the day-to-day business operations and in setting and leading the strategic direction of the company. Second, retaining the selling owner in the coop also retains his or her business relationships with vendors, customers, and other stakeholders, which minimizes risk that the conversion will disrupt business operations. Third, by retaining the selling owner, the risk of the seller starting another business or joining a competitor is minimized. Finally, when the selling owner stays in the business, he or she may be more willing to keep more personal financing in the coop, including taking a promissory note from the coop in lieu of full cash payment for the business.

Some selling owners are not able or willing to stay with the coop, so including this as a requirement could prevent an otherwise attractive deal. Also, there can be some challenges when the selling owner stays on as a worker-owner. In cases where the selling owner had a bad relationship with employees, vendors, or customers, the coop might benefit by having the owner transition out of the business altogether. Finally, an existing employer-employee dynamic may continue, inhibiting the ability of the worker-owners to think and act like owners, and realize the full benefits of democratic governance.

Depending on the particular deal dynamics, lenders might require non-compete agreements, to avoid competition from an exiting owner; personal guarantees or other financial contributions by the selling owner, to help ensure that the seller is leaving the coop in good shape; multi-year technical assistance contracts, to develop the management and governance capacity of the coop, financed as part of the conversion package; or other tools in lieu of their continued leadership.

## **Who signs for a loan on behalf of the coop?**

There is no inherent difference between coops and other business types regarding signatory powers. They are governed by the bylaws. Frequently, General Managers will have the right to execute loan documents, but board approval is required before taking on debt.

## THE 5 CS OF CREDIT APPLIED TO WORKER COOP CONVERSION FINANCING

In most ways, underwriting coop conversions follows the same principles as underwriting other small businesses, with a focus on the 5 C's of Credit framework. The major differences are rooted in core structural differences between coops and other business forms: shared ownership and democratic control by many worker-members.

### **Capacity: Is the applicant able to repay the loan through operations?**

Of the 5 C's, capacity might be the most similar between coop underwriting and other small business underwriting. Coop lenders review past and projected financial statements, assessing whether projections are in line with historic trends and business plans, and whether projections demonstrate enough post-expense cash flow to service the debt and any other senior or pari passu debt.

Conversion financing is different from a typical working capital loan, however, because of the sheer amount of the financing needed to buy the company. The business is typically financing 80% - 100% of its market value, mostly through debt, to pay off the selling owner(s), and potentially more than its market value, taking working capital financing into account. Although there is not currently sufficient deal flow in worker cooperative conversions to understand trends in repayment rates for these deals, comparable transactions are commonplace with employee stock ownership plans (ESOPs) and leveraged management buy-outs. Despite the large leverage amount, ESOP companies have a very low default rate (0.5% according to the National Center for Employee Ownership). Seller financing, which is generally the most flexible debt in the deal, can be restructured to provide more flexibility in payback. It is beneficial to set expectations with the selling owners in the beginning that if the new cooperative needs more flexibility to repay the various lenders, that the selling owner is expected to restructure the terms of their financing.

### **Capital: Is the applicant taking on sufficient risk of failure?**

Given the community-oriented nature of coops, consider not only member equity and loans, but also outside equity, contributions and grants, and subordinate debt to ensure that you are not the only party with skin in the game.

In coops comprised of many voting worker-owners, lenders should pay attention to how member equity enters and leaves the coop. Particularly, it's important to confirm that redemption of equity to exiting worker-owners is subordinate to any and all lenders' rights. Bylaws can clarify that equity can be redeemed over a period of years, rather than immediately, to help alleviate cash stresses.

Similarly, with likely multiple layers of financing, it's important for lenders to understand how payments to other lenders and equity investors could affect their own payments. There needs to be enough flexibility to attract sufficient capital to make the deal work, but also enough clarity to know that the agreed-upon repayment terms are protected.

Additionally, with the seller having an incentive to complete the transaction, consider whether they have any ongoing investment in the coop's success, as a member, guarantor, or lender.



## **Collateral: If things don't go as planned, how will the lender be repaid?**

Regarding collateral, the main difference between coops and conventional small businesses is the availability of personal guarantees. This is also one area where unregulated lenders, like CDFI loan funds, may have more flexibility than regulated banks and credit unions.

While much of the lending world relies on personal guarantees as a core component of collateral assessment, personal guarantees are tricky to apply to cooperative businesses (though not impossible). Ideally, lenders could underwrite coop loans based only on business assets. When this is not possible, loan guarantees can help (see discussion above about loan guarantee options). Some cooperative lenders structure their guarantees proportionally by putting a cap on each member's portion of the obligation to ensure that collection will not be targeted inequitably, but this could become cumbersome with a large number of guarantors.

## **Character: If the applicant is able to repay, will they? Do they have the skill and credibility to implement their plans?**

Traditional lenders use credit scores to assess the character of loan applicants. Due to coops having many owners, this is not a viable option. Instead, consider:

- The commitment of the worker-owners to developing an ownership culture;
- The attractiveness of ownership to the workers based on the percentage of workers who will become owners or will be on an ownership track;
- The skill and experience in governance and management within the coop (or long-term commitments by external advisors to develop this capacity); and
- The strength and depth of leadership within the organization.

Furthermore, it may make sense for the lender to meet more than one representative of the business to ensure the representative is accurately representing the group.

If the selling owner is leaving the business after selling it to the employees, ideally, a group of fully-trained worker-owners would be ready to step in to governance roles, and fill any management gaps left by the departing owner. This is often not feasible when the selling owner wants to leave the coop in a short timeframe. Lenders can mitigate this by requiring long-term contracts with external advisors that fill experience gaps, and can support the development of governance, leadership and management capacity in the coop. Having provisions for long-term support written in as a loan covenant can give lenders more leverage if needed. Another potential solution is to have the business sale occur in phases, allowing more time to establish a new ownership culture and train key staff in the skills that will be lost when the owner leaves.

## **Conditions: What broader economic context might impact the borrower?**

The final of the 5 C's of Credit—Conditions—is largely the same for coops as for traditional businesses. It involves looking at trends in the economic sector and the geography of the applicant.

In addition to resources available to all small businesses, coops can access two additional types of resources to bolster their chances of success. Training and consulting services from coop-oriented associations and consultancies provide both business and cooperative support for coops nationally.

# THE LENDING OPPORTUNITY *of a* GENERATION

Additionally, coops are uniquely positioned to take advantage of community support for local businesses, as their structure inherently creates many owners and spreads wealth broadly in a community. Making sure that coops are taking advantage of these resources and supports can make for a stronger borrower.

## **ADDITIONAL CONSIDERATIONS**

### **What is the success rate of worker coop conversion loans?**

There hasn't been sufficient deal volume to create data on the success rate of conversion financing.

### **Is there a secondary market for coop loans?**

At this point there is no secondary market for coop loans that enables banks to sell their loans to free up liquidity. Potentially, banks that are seeking to free up liquidity could sell their loans to financial institutions committed to financing cooperatives, like those listed on page 14. At the time of publication, there are efforts to develop secondary markets for CDFI debt, which include cooperative lenders.

## **HOW LENDERS CAN PARTICIPATE IN COOP CONVERSIONS FINANCING**

There are dozens of worker cooperative organizations and professionals in the U.S. working to identify potential candidates for a conversion to worker ownership, including Carolina Common Enterprise, the Cooperative Development Institute, the Cooperative Fund of New England, the Democracy at Work Institute, the ICA Group, the Ohio Employee Ownership Center, Project Equity, the University of Wisconsin Center for Cooperatives, the Vermont Employee Ownership Center, the Working World, and more. By partnering with these organizations to finance the deals they have identified, lenders can participate in conversions that have already been vetted and that have a built-in business support network invested in the company's continued success.

Furthermore, lenders likely have current banking clients who are whole or part owners of companies that may be good candidates for a worker cooperative conversion. Lenders can refer clients who are considering their succession planning options to a worker cooperative conversion expert to discuss whether converting is feasible and would meet the owner's goals. If the owner decides to pursue a conversion, the lender's existing relationship with the owner may make the financing process easier.

For financial institutions and impact investors interested in participating in conversion deals without being the primary lender, there are a couple of ways to start financing coop conversions. The most hands-off approach with the most diversified risk portfolio is to invest in existing cooperative loan funds. The Cooperative Fund of New England, Local Enterprise Assistance Fund, Shared Capital Cooperative, The Working World, and other cooperative-specific lenders offer this type of investment option.

Alternatively, a lender could purchase part of an experienced coop lender's particular loan as a participant. The experienced coop lender would fully service the loan and correspond directly with the borrower while the participant would limit their risk to the performance of a particular business.



Finally, an investor could co-lend with an experienced coop lender, drawing up their own loan documents with the borrower, and signing an inter-creditor agreement with the coop lender to clarify the rights of each lender.

## SOURCES OF FINANCING

- **Capital Impact Partners**

[www.capitalimpact.org](http://www.capitalimpact.org)

Capital Impact Partners is a Community Development Financial Institution committed to transforming underserved communities into strong, vibrant places of opportunity. The organization has a 30-year history delivering strategic financing, social innovation programs and capacity building that create social change and deliver financial impact nationwide.

- **Common Wealth Revolving Loan Fund**

<http://dept.kent.edu/oeoc/cwrlf>

Common Wealth Revolving Loan Fund (CWRLF), founded in 1987, is a non-profit community development financial institution operated by the Ohio Employee Ownership Center, serving Ohio and the nearby areas of contiguous states. The mission of CWRLF is to lend money to employee-owned companies or coops for expansion, facilities, machinery and equipment, vehicles, and working capital or for employee-buyouts.

- **Cooperative Fund of New England**

[www.cooperativefund.org](http://www.cooperativefund.org)

The Cooperative Fund of New England is a Community Development Financial Institution founded in 1975. Its mission is to advance community based, cooperative and democratically owned or managed enterprises with preference to those that serve low income communities through the provision of prompt financial assistance at reasonable rates; provision of an investment opportunity that promotes socially conscious enterprise; and development of a regional reservoir of business skills with which to assist these groups.

- **Local Enterprise Assistance Fund (LEAF)**

<http://leaffund.org/>

LEAF is a nonprofit certified-CDFI whose mission is to promote human and economic development by providing financing and development assistance to cooperatives and social purpose ventures that create and save jobs for low-income people. LEAF lends to coops nationally and since its founding over 30 years ago, has invested and leveraged over \$98 million, resulting in the creation or retention of more than 7,600 jobs.

- **National Cooperative Bank**

[www.ncb.coop](http://www.ncb.coop)

National Cooperative Bank (NCB) provides comprehensive banking services to cooperatives and other member-owned organizations throughout the country. What makes NCB unique is that the bank was created to address the financial needs of an underserved market niche – people who join together cooperatively to meet personal, social or business needs, especially in low-income communities.

# THE LENDING OPPORTUNITY *of a* GENERATION

- **Shared Capital Cooperative**

<http://sharedcapital.coop>

Shared Capital Cooperative (formerly Northcountry Cooperative Development Fund) is a national loan fund and federally certified Community Development Financial Institution that provides financing to cooperative businesses and housing throughout the United States. Shared Capital's mission is to foster economic democracy by investing in cooperative enterprises, with a focus on providing financing to coops to create wealth in low-income and economically disadvantaged communities.

- **The Working World**

[www.theworkingworld.org](http://www.theworkingworld.org)

The Working World builds cooperative businesses in low-income communities, using a unique model that combines non-extractive finance with tailor-made business support. The Working World only secures financing with collateral purchased with the loan, does not use personal guarantees, and the loans are repaid only after the company is profitable.

## CONCLUSION

The wave of baby boomer retirees—who are estimated to own nearly 70% of privately held businesses represent a \$10 trillion market opportunity for lenders and other capital providers. They also represent a significant portion of banks' current commercial lending, which is at risk if retiring owners don't have succession plans, or decide to sell to a larger acquirer. Helping to advance conversions to worker ownership as a strategy for strengthening our local economy, keeps locally-owned businesses—and their service providers—thriving. Lenders or investors can learn more and gain experience with worker coops by proactively seeking out opportunities either directly—by helping their retiring business owners assess this option with support from coop developers that provide TA support, or indirectly—by investing through established coop loan or investment funds.





# FINANCING CASE STUDIES

The following case studies provide a detailed look at how worker cooperative conversions have historically been financed by coop-specific loan funds / CDFIs that are uniquely positioned to provide flexible and favorable loan terms. Each provides general background information about the deal, the financing sources and uses, how the 5 C's of credit were analyzed, as well as key lessons learned and how the cooperative is performing today. As the table below demonstrates, the sources, terms, and uses vary widely from company to company.

<i>Financing Terms of Case Study Companies</i>					
Source	A Yard & A Half Landscaping	New Era Windows	Island Employee Cooperative	Real Pickles	New School of Montpelier
Primary financing	4%, 7-year term loan from Cooperative Fund of New England	5%, 10 year term loan with deferred repayment from The Working World	5.5%, 7-year term loan, one year interest only from a partnership of lenders including CFNE, CEI, and NCB	Preferred non-voting equity through a DPO with a targeted 4% dividend	6%, 5-year term loan Cooperative Fund of New England
Working capital as % of total	29.1%	49.4%	19.7%	16.9%	36.5%
Equity & grants as % of total	10.6%	2.4%	0%	70.8%	0%
Seller financing as % of total	12.1%	N/A	26.8%	0%	15.9%
Total financing	\$635,000	\$850,000	\$5,600,000	\$749,000	\$315,000

# THE LENDING OPPORTUNITY *of a* GENERATION



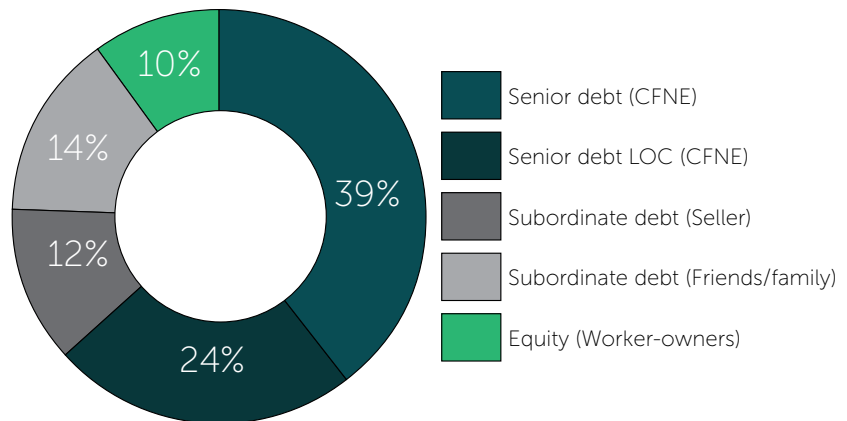
## A Yard & A Half Landscaping

[www.ayardandahalf.com](http://www.ayardandahalf.com)

### AT A GLANCE

A Yard & A Half Landscaping cultivated a cooperative culture for many years before actually converting.

- Industry: Landscaping
- Location: Boston
- Year converted: 2013
- Total capital: \$635,000
- Annual revenue at sale date: \$2 million
- Worker-owner buy-in: \$7,000
- Worker-owners: 20
- Primary financing source: 4% term loan from Cooperative Fund of New England
- Lenders: 4



### BACKGROUND

#### Industry

A Yard & A Half Landscaping is a design/build/maintain landscaping company founded by Eileen Michaels in 1988. According to their website, she grew the company to a place in the top 15% of U.S. landscaping companies and the top 3% of all women-owned companies by annual sales. Committed to sustainable and organic practices, their mission is to design, build, and maintain beautiful and healthy outdoor spaces that enrich the lives of their co-workers, clients, and community in the Boston area.

#### Size

At the time of conversion there were approximately 20 employees (16 members of the construction crew, and 4 team leaders), generating approximately \$2M in annual sales with 12-13% net income.



## Cause of Conversion

Michaels wanted to retire at the end of 2013, and decided to sell the company to her employees. The company had historically operated with open books, shared profits with employees, and involved employees in decision-making, so the cooperative model was a logical extension. A Yard & A Half Landscaping Cooperative, Inc. was formed in 2013 to preserve and continue to develop a locally-owned, safe, just, and democratic workplace in an industry where workers often face exploitation, wage theft, and hazardous working conditions.

As a predominantly low-moderate income, immigrant, and minority cooperative, they lacked easy access to private capital and culturally appropriate technical assistance. They believed that if they could not purchase the business, Michaels would have to sell it to someone outside of the company. They had witnessed the sale of a close competitor's business to a large national company, and wages and self-determination there suffered. The Cooperative engaged business planning consultants and attorneys that specialize in cooperatives to educate the employees about the transition option.

## Sale Price

In 2009, Michaels obtained a business valuation of \$400,000. In 2013, she and the newly-formed cooperative agreed that while this old valuation was likely below the current market valuation, the old valuation was sufficient to determine sales price. The Cooperative ultimately paid her \$450,000 and obtained an additional \$192,000 of working capital through a combination of equity contributions to the business and debt financing.

## FINANCING

The Cooperative approached the Cooperative Fund of New England in August 2012 to begin the loan application process and pave the way for Michael's retirement 16 months later. Cooperative Fund of New England was the sole institutional lender for this conversion, complementing loans from the seller and some long-term clients, friends and family. The financing structure was as follows:

Source	Amount	Notes
CFNE (senior debt)	\$250,000	\$250,000 term loan at 4%, including \$25,000 that was unsecured
CFNE (senior debt)	\$150,000	\$150,000 line of credit at 6%. Only \$75,000 was drawn at closing
Seller-Owner Financing (subordinated debt)	\$77,000	Unsecured
Friends/Family Financing (subordinated debt)	\$91,000	Unsecured
Worker-Owners Equity	\$62,000	
Contributions	\$5,000	
<b>Total Sources</b>	<b>\$635,000</b>	
Business Purchase	\$450,000	
Acquisition Working Capital	\$185,000	
<b>Total Uses</b>	<b>\$635,000</b>	

# THE LENDING OPPORTUNITY *of a* GENERATION

## UNDERWRITING

The financing was made easier by the strength of the business, the commitment of the selling-owner, and the fact that CFNE was brought in relatively early as a partner in the conversion. There were concerns about collateral and capacity to repay, that CFNE sought to remedy with seller-owner guarantees. When these were not available, the cooperative found investors to provide further support by investing in CFNE.

- **Collateral (+/-)**

Collateral consisted of \$420,000 of contracts that we accepted at 85% of face value, or \$357,000, and a lien on all business assets. The contracts receivable collateral was enhanced by the business' ability to obtain 3-year signed contracts for all their on-going maintenance contracts, guaranteed by the selling owner. CFNE also accepted some equipment that was not already securing debt, valued at \$15,000, and obtained \$15,000 of investments in the Cooperative Fund that served as collateral for the loan. The total collateral value at time of underwriting was \$387,000. CFNE was able to supplement this by using \$25,000 from their collateral pool, which are funds designated by the Board to serve as a more risk tolerant pool of money. While the retiring owner did not provide any personal guarantees, vendors accepted personal guarantees from members of the cooperative based on the strong relationships and solid past payment history.

- **Capacity (+)**

The business had a solid track record of sales and strong growth prospects in the market, and a history of profitable operations. The business was averaging \$2 million in annual sales for the previous two years with 50% gross profit margin, and 12-13% net income percentages. Projected debt service coverage was high at 35 to 1.

- **Capital (+)**

The equity buy-in for member-owners was set at \$7,000 per member, high enough to ensure commitment, but not so high as to preclude participation. And indeed, all of the worker-owners were able to invest prior to the sale, either through the help of family and friends, personal loans, or employee loans financed through salary deductions. The pre-conversion debt to equity ratio was low at less than 1, so the business could sustain additional debt.

- **Character (+)**

The company had a good reputation with loyal customers, a long-term management team with shared knowledge of the company's financial information and that practiced participation in the decision-making. The management team members had from 6 to 18 years of experience with the business, and the 16 month time frame between intake and approval meant that CFNE had more than enough time to gain confidence in the management's integrity.

CFNE noted that the company had little debt outstanding – just that related to certain vehicles and equipment – and that their history of repayment was excellent. The company had a history of being a conservative borrower, only using the previous line of credit minimally. Additionally, CFNE's character assessment was bolstered by the maturity of the business; ongoing support of the current owner through board participation, seller financing, and personal guarantees to



vendors for a two-year period; and participation in the network of Boston-area cooperative businesses. As described in the coop’s loan application:

“We have received guidance in the transition from members of WORC’N [the local network of worker cooperatives] as well as Namaste Solar. Because we have a firm foundation in our current business model, we are primarily focusing the transition process on developing our skills in democratic participation and learning about business ownership. We plan to continue a slow but steady growth pattern, so that current members can grow in our careers and areas of interest, while creating opportunities for right livelihood for others in our community.”

## Conditions (+)

Market conditions were deemed to be favorable for the landscaping business and particularly the market niche for organic, sustainable practices. The landscaping industry is subject to climate conditions, and the company demonstrated an ability to manage cash flows effectively through the seasonal nature of the business cycle. To increase sales and profitability, it was noted that the new worker-owners were motivated to develop a marketing plan, plan to expand and add to existing services, reduce waste and increase recycling and composting, improve the efficiency of internal procedures and decrease time spent on bidding on jobs.

## *Financial Analysis - Summarized Financial Information at Time of Underwriting:*

Summarized Balance Sheet on June 30, 2013	
Current Assets	\$328,000
Assets	459,000
Current Liabilities	57,000
Liabilities	182,000
Equity	277,000
Financial analysis:	
Current ratio	5.72
Debt to equity	0.66
Debt Service Coverage* (2014 projected)	35
Acquisition Loan to Value **	104%

\* EBITDA divided by P&I

\*\* CFNE total loan to collateral

## TODAY

In May 2015, the Cooperative Fund of New England increased the line of credit to \$200,000 on the strength of operations and repayment history, to refinance remaining seller-financing. Total sales for 2014 were \$2.4 million, gross profit was consistent at 50%, and net income was solid at 15%.

## Key lessons/effective practices

The fact that the business had cultivated a cooperative culture for years prior to conversion ensured that the long-term management team could themselves convert from employees to owners with less than the typical amount of outside technical assistance. While this gave the cooperative a great start, the value of ongoing technical assistance in the areas of self-management and self-governance cannot be underestimated. Had the coop engaged more culturally appropriate technical assistance during the conversion process, they may have been able to address some key decisions in a more efficient manner. The selling-owner had been planning for 10 years to sell to employees and so began in 2003 to create a leadership team to replace her, to educate and to transition various roles and responsibilities to employees. This was enhanced by their participation in the Boston area worker-coop network, and connections with other worker-owned businesses. Two years later, the cooperative owners had proven their ability to steward the business and contribute additional equity in the form of owner-loans to the cooperative. This helped CFNE increase its line of credit to the coop.

# THE LENDING OPPORTUNITY *of a* GENERATION



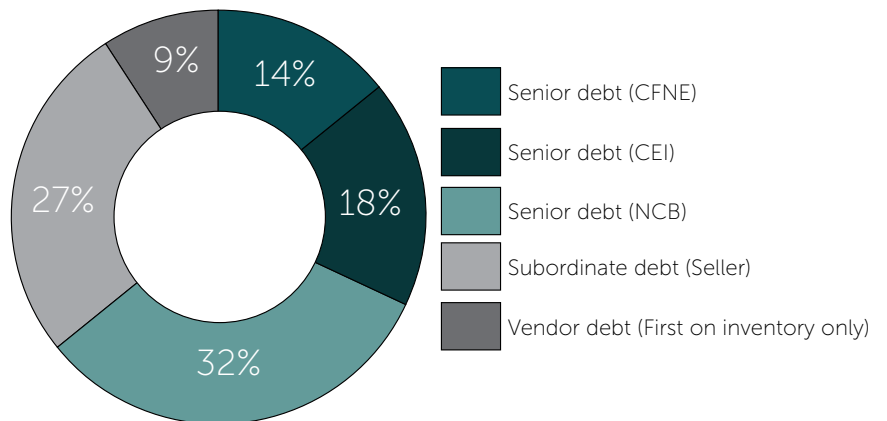
## Island Employee Cooperative

<http://www.iecoop.org/>

### AT A GLANCE

Island Employee Cooperative is Maine's largest worker cooperative. The retailer made this transition with the support of outside expertise.

- Industry: Grocery/Retail Variety
- Location: Maine
- Year converted: 2014
- Total capital: \$5,600,000
- Annual revenue at sale date: \$12 million
- Worker-owner buy-in: \$7,000
- Worker-owners: 45 (62 employees)
- Primary financing source: 5.5%, 7-year term loan, one year interest only, from Cooperative Fund of New England and Coastal Enterprise, Inc.
- Lenders: 5



Note: Member buy-in equity was not a part of the close--even though there was \$70,000 in equity paid at closing. The 45 new worker-owners committed to paying \$7,000 each in equity, totally \$315,000, mostly in payroll deductions over time. This money will be used to pay down the debt.

### BACKGROUND

#### Industry

Island Employee Cooperative, Inc. (IEC, or the Cooperative) is comprised of three successful retail grocery and variety businesses located on the island towns of Stonington and Deer Isle, ME. The Cooperative owns the following:





1. Burnt Cove Market (est. 1961), a full service grocery store offering a large array of groceries from major manufacturers and locally produced products serving the residents of Stonington, Maine. (Stonington is on the southern end of Deer Isle);
2. The Galley (est. 1972), a supermarket built to serve the needs of Deer Isle citizens, offering a full array of grocery products as well; and
3. V&S Variety (est. 1990), which serves the needs of the island by offering a wide range of items including greeting cards, fabric, yard goods, house wares, small appliances, clothes, everyday hardware, and a full service pharmacy. V&S Variety is also the island's gas station.

In addition to these businesses, there are also six rental properties owned by IEC, and managed separately from the three businesses above. The rental properties located in Stonington are adjacent to Burnt Cove Market and in Deer Isle.

## Size

IEC purchased a 42-year old business with over \$12M in annual sales and 62 employees at the time of conversion.

## Cause of Conversion

In 2013, the founding owners, Vern and Sandra Seile (Sellers), decided to sell the stores and retire. The Independent Retailers Shared Services Cooperative (IRSSC) and the Cooperative Development Institute (CDI), became aware of the opportunity and collaborated to facilitate a transition to a worker-owned cooperative.

For several months, the two organizations worked closely with store employees to explore the feasibility and interest, and when 45 employees committed to make investments in the cooperative, they moved forward to incorporate as a cooperative under Maine statutes and negotiate a sale.

## How Sales Price was Determined

The sales price of \$4,250,000 was based on expert independent market valuation and property appraisal. The Cooperative negotiated final price with the assistance of the IRSSC.

The transaction was structured as a Stock Purchase Agreement, wherein the Cooperative purchased all the outstanding shares of The Galley (the corporation that owned the businesses and properties described above).

## FINANCING:

The Cooperative Fund of New England (CFNE) partnered with Coastal Enterprises, Inc. (CEI), another Community Development Financial Institution (CDFI) to finance one third of the sale and almost two-thirds was bridge-financed by sellers. An independent grocers' association (which is itself a cooperative) financed the purchase of inventory.

After conversion, the National Cooperative Bank bought part of the sellers' debt as had been anticipated in the deal.

Prior to the closing, the two CDFIs shared a \$25,000 pre-development loan that was re-paid three months later, once permanent financing was secured. Permanent financing of \$5.6 M was coordinated by CEI and described in the table below.

# THE LENDING OPPORTUNITY *of a* GENERATION

Source	Amount	Notes
CFNE	\$800,000	5.5%, 7 year (amortized over 20), one year interest-only, with 1st position shared proportionately with other lenders, except shared 2nd position on inventory, guaranteed by The Galley
CEI	\$1,000,000	1st position shared proportionately with other lenders, except shared 2nd position on inventory, guaranteed by The Galley
Seller financing	\$1,800,000	1st position shared proportionately with other lenders, except shared 2nd position on inventory, guaranteed by The Galley. This loan was bought by the National Cooperative Bank shortly after closing.
Seller financing	\$1,500,000	2nd position on all property, except 3rd position on inventory, guaranteed by The Galley
Associated Grocers of New England (AGNE)	\$500,000	1st position in inventory, and interest in all other assets junior to the 1st and 2nd lien holders
<b>Total</b>	<b>\$5,600,000</b>	
Use	Amount	
Purchase of Business	\$4,250,000	
Inventory	\$930,000	
Working Capital	\$175,000	
Closing Costs	\$130,000	Costs included: business valuation, an environmental survey, repayment of a predevelopment loan, legal fees), title insurance, loan fees, and other filing fees
Technical Assistance	\$115,000	Technical assistance fees paid at closing, which covered the first year of of assistance from three organizations
<b>Total</b>	<b>\$5,600,000</b>	

## UNDERWRITING

- **Character (+)**

In addition to being well-respected businesses in the community for over 40 years, the key employees managing the stores and becoming worker-owners in the Cooperative have many years of experience in the various roles and a deep connection to the local community. The top seven key employees have over 150 years of experience with the business ranging from eight years to 41 years.

This strength was also one of the key risks identified, namely that training long-time employees to become owners would take time and attention. This risk was mitigated by the careful planning and preparation that went into this conversion, the participation of cooperative developers CDI and IRSSC and the five year training contracts with the three technical assistance providers- CDI for coop governance, IRSSC for industry expertise, and Specialized Accounting Services, for accounting.



- **Capacity (+)**

All the businesses and rental properties demonstrated successful financial histories. Previous two years of consolidated financial performance indicated strong sales at \$12.5 million in 2012, and \$12.7 million in 2013, gross margins of 24% and 24.5%, and positive net income of 672k and 750k, respectively. Gross profit margins were expected to improve in future years with a planned contract with a larger wholesale supplier that would reduce supply chain costs.

- **Capital (-)**

Equity in the business was minimal, with a very high post-closing debt to equity ratio of 1140 to 1. However, as a matter of raising capital for purchase, the Board of the Cooperative determined to issue Class B stock for purchase by all Founding Members.

Each Founding Member agreed to purchase one (1) Class A share [voting] for \$1,000 per share for founding members, and six (6) Class B shares [non-voting], also for \$1,000 per share. These Class B shares earn a targeted dividend and have a 5 year term, at which time the Board may call the shares or may extend the term, depending on the finances of the corporation. Class A shares are available to new employees after one year of service and will cost \$7,000 per share. The lower purchase price for founding members partially compensates them for their significant sweat equity contributions during the predevelopment stage.

At closing, 45 of the 62 employees had signed Membership Agreements and Membership Payment Agreements, committing themselves to the cooperative and to paying for their Class A and Class B share purchases either through one lump sum, installments within one year, or payroll deductions over a number of years. Indeed 10 members had made the investment up front, another 8-10 were making the investment over the course of the first year, and the remainder would pay in \$50 payroll deductions.

Members agreed that 80% of patronage would be retained in the Cooperative (in accordance with tax laws) to build retained earnings. Nonetheless, the business would be highly leveraged for several years into the future.

- **Collateral (-/+)**

Collateral available to secure the 1st position \$3.6 million debt consisted of property with appraised property value of \$1.475 million, and other assets with book value of \$283,000. Additionally the business was independently valued at \$2.8 million. Total collateral value was in excess of \$4.275 million.

The inventory at closing with book value of \$1 million secured AGNE's \$500,000 loan.

- **Conditions (+)**

The retail grocery industry is highly competitive with significant price and margin pressures. At the time of conversion, the hardware store's sales were recovering from 2008 housing bubble burst, as home sales and renovations began to rise. The pharmacy and drug store industry was expected to grow for two reasons: 1) demand for prescription drugs was expected to continue to increase due to the aging population, and 2) a decline in unemployment coupled with an increase in the availability of affordable insurance for consumers under the new healthcare law. Competition was slim as there are no other supermarkets or pharmacies on Deer Isle and only one other hardware store.

# THE LENDING OPPORTUNITY *of a* GENERATION

There was significant technical assistance committed to support the success of the conversion. The coop had contracted the services of:

- Cooperative Development Institute (CDI) for governance support including directors' roles and responsibilities, financial oversight, leadership development and strategic planning;
- Specialized Accounting Services (SAS) for accounting and bookkeeping support; and
- Independent Retailers Shared Services Cooperative (IRSSC) for management support including due diligence, direct supply chain negotiations, and business planning, training, custom business management tools, and services throughout the conversion of ownership and ongoing for 5 years.

<i>Financial Analysis - Summarized Financial Information at Time of Underwriting:</i>	
Summarized Balance Sheet on Apr. 30, 2014	
Current Assets	\$1,165,000
Assets	\$5,705,000
Current Liabilities	\$0
Liabilities	\$5,700,000
Equity	\$5,000
Financial analysis:	
Current ratio	N/A
Debt to equity	1140
Debt Service Coverage projected 2015	1.89
Loan to Value (excluding AGNE Inventory loan)	84%

## TODAY

Island Employee Cooperative (IEC) is now Maine's largest worker cooperative and one of the larger worker coops in the United States.

### Key lessons / effective practices

In all cases, the best practice in buying a business is to require the selling business to provide independently audited financial statements, and not rely solely on internally-generated financial records. This proved true here as well.

Careful planning and consideration in establishing the first board of directors of the new cooperative can also avoid problems down the road. Until the cooperative is functioning fully, and staggered term elections can occur, a first board might consist of independent industry experts or professionals to provide mentoring to emerging leaders of the cooperative. When the business is large in number of employees and the management structure is hierarchical, it may not be in the best interest of the whole cooperative to have management comprise the full board, as was discovered here.

Ultimately, key to the success of the transition was the collaboration and support among cooperative developers, community development financial institutions, and industry-specific support organizations.



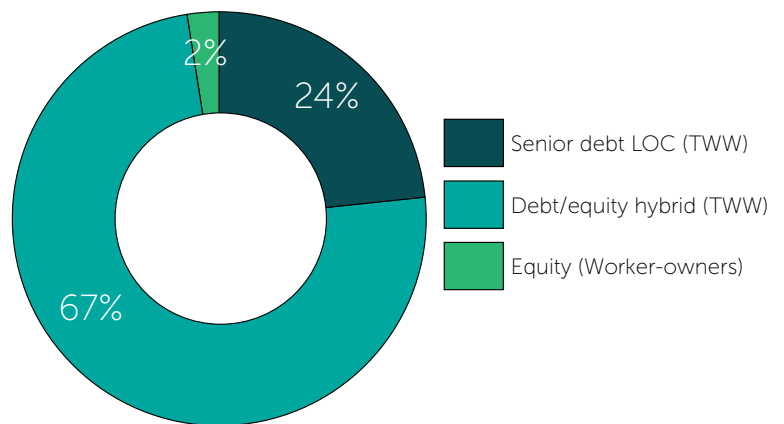
## New Era Windows

<http://newerawindows.com>

### AT A GLANCE

New Era Windows is a cooperative started by workers from the remains of their bankrupt former employer. Union organizing laid the foundation for its development and it received significant outside cooperative development support.

- Industry: Manufacturing (Windows)
- Location: Chicago
- Year converted: 2013
- Total capital: \$850,000
- Annual revenue at sale date: \$0
- Worker-owner buy-in: \$1,000
- Worker-owners: 16 (20 employees)
- Primary financing source: 10 year term loan at 5%, interest accrues but repayment only when company is profitable, from The Working World
- Lenders: 1



### BACKGROUND

#### Industry

New Era Windows is a Chicago-based window manufacturer that offers energy-efficient vinyl windows. The company has a stated mission to support community, to keep quality jobs in America, and make the Chicago area economy stronger.

#### Size

The company currently has 20 employees (16 members and 4 other employees) and generated \$1M in gross revenue in 2015, its most recent year.

# THE LENDING OPPORTUNITY *of a* GENERATION

## Cause of Conversion

New Era Windows has a unique conversion story. In 2008, a company called Republic Windows and Doors filed for bankruptcy and closed, despite the fact that the business was generating profits. The workers were told that their jobs would be terminated immediately, and that they would not be given their contractually obligated backpay or severance. The workers decided to occupy the factory in protest, and the community came out to support them. The workers and the community won enough of this struggle to get the money that was owed to them.

A new green construction company, Serious Energy, took control of the factory and partially reopened it. Serious Energy's business plan, which only involved the windows factory in a tertiary role, never functioned, and the company had to severely cut back on its operations, including closing the factory again in 2012. The workers decided to reopen the company as a worker cooperative, and sought the help of the United Electrical Workers Union, The Working World, and the Center for Workplace Democracy. The new cooperative started generating revenue in 2013.

## Sale Price

New Era Windows did not technically purchase a business. The workers purchased assets from the former factory, which were being auctioned by its creditors. The workers had the option to decide which what assets to purchase, and the equipment they chose went for a total of \$430,000.

## FINANCING

A key partner in the conversion process, the Working World provided all of New Era's outside financing, including both the asset purchase and working capital.

Source	Amount	Notes
The Working World	\$430,000	10 year term loan at 5% for \$430,000 asset purchase, fully secured by equipment purchased with the loan (which was bought at salvage price). Interest accrues, but repayment only when the company is profitable.
The Working World	\$200,000	10 year term loan at 5%, plus the equivalent of one member's profit share. Interest accrues, but repayment only when the company is profitable. Unsecured
The Working World	\$200,000	\$200,000 line of credit at 5%. Secured with any materials purchased with the funds
Worker-Owners Equity	\$20,000	Equity buy-in set at \$1,000 per member
Total	\$850,000	
Use	Amount	
Asset Purchase	\$430,000	
Acquisition Working Capital	\$420,000	
Total	\$850,000	





## UNDERWRITING

The Working World has a unique model that only secures financing with collateral purchased with the loan and does not use personal guarantees. To offset risk, the Working World provided extensive technical assistance to New Era Windows to increase the likelihood of the company's success, which is subsidized with grant funding. Although some of the financing for the New Era Windows transaction is secured with assets purchased with funds provided by the Working World, an estimated 50%-75% of the financing is unsecured.

- **Collateral (+/-)**

Collateral primarily consisted of the \$430,000 in purchased equipment, which likely has a value at or near the purchase price because of the reduced rate paid at auction. The additional \$200,000 of working capital provided at closing is not collateralized. The line of credit is not fully secured, but has a lower risk profile because the company primarily purchases raw materials with the line of credit, which are collateral, and repays the draws frequently.

- **Capacity (-)**

At the time of conversion, New Era Windows was not yet generating revenue. While workers had the experience and skills necessary to produce the product, there were capacity gaps with regard to sales experience and administrative skills. Knowing there was not enough capital to hire additional personnel—and in order to deepen their own experience inside cooperatives—the Working World helped to fill these gaps with their own personnel, subsidized through grant funding. The company now has sales and administrative staff, and the Working World is phasing into a reduced technical assistance role. The company had \$500,000 in revenues in 2014, which doubled to \$1,000,000 in 2015.

- **Capital (+/-)**

The equity buy-in for member-owners was set at \$1,000 per member. Almost all workers were able to provide the purchase price up front, resulting in approximately \$20,000 in equity. The debt to equity ratio after the conversion has been between 1.5 and 1.7 depending on the draw on the line of credit.

- **Character (+)**

At the time of conversion, New Era Windows did not have a credit history and the worker-owners did not have a history of running a business independently. However, they had demonstrated their commitment to starting a business together through their willingness to occupy their factory and attend many planning meetings. The Working World worked closely with the founding worker-members, who demonstrated strong problem-solving skills and other leadership qualities.

Brendan Martin, Executive Director of the Working World, describes an incident that demonstrated their leadership skills and commitment:

Soon after we had purchased the equipment and had only raised \$200,000 in working capital, we learned that we would need all \$200,000 to move the equipment to the new factory. That was not financially feasible, so the workers asked, "How can we do this

# THE LENDING OPPORTUNITY *of a* GENERATION

ourselves?” Drawing from their personal resources and networks, they were able to move all the equipment for only \$18,000. The only things that were broken were moved by outside professionals.

In addition to their confidence in the founding worker-owners, the Working World provides additional staff capacity to the business to make it more likely to succeed, and closely monitors line of credit draws.

- **Conditions (+)**

With the housing market crash, window sales dropped precipitously in 2008. In 2012, the market was in a time of potential growth. In its most profitable years, Republic Windows and Doors brought in \$100M in revenue, and New Era Windows bought all of the necessary equipment for only \$430,000. It was a significant consideration that New Era Windows was buying in at the bottom of the market.

Because of the weather conditions in Chicago, there is a large market for energy efficient windows, and there is also a lot of competition. New Era Windows was positioned to distinguish itself through the craftsmanship and quality service that is augmented by the worker ownership model, as well as the unique story and press the workers received through the factory occupations.

Note: Because the Working World was not basing its underwriting on the financials of an established business, we have omitted a table summarizing the financial information for the company at the time of underwriting.

## TODAY

New Era Windows has consistently drawn and repaid its line of credit. No repayments have yet been made on the original asset purchase loan or the working capital loan, as is permitted by the terms of the financing. Total revenues for 2014 were \$500,000, which increased to \$1M in 2015, and another increase is expected in 2016.

### Key lessons/effective practices

Not having administrative and sales staff hindered New Era Windows' ability to reach profitability in the first two years. The company was able to manage by filling capacity gaps with the existing worker-owners (as well as staff from the Working World) and found that to be very important. In many cases, existing workers have more of the skills and know-how needed to successfully run a business than funders, or even the workers themselves, might expect. However, when there are genuine capacity gaps, it is important to fill those roles by hiring individuals with the requisite skills and experience. In the future, when it identifies such capacity gaps, the Working World will encourage companies to hire the necessary personnel instead of saving money by training internal staff.



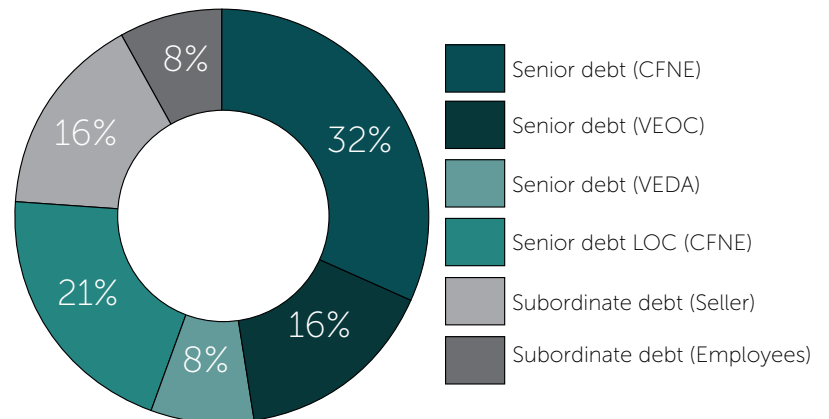
## The New School of Montpelier

[www.nsmvt.org](http://www.nsmvt.org)

### AT A GLANCE

The New School of Montpelier demonstrates the transition process for businesses wanting to maintain a strong mission (education), strong outside support, and collaboration among lenders.

- Industry: Special Education
- Location: Vermont
- Year converted: 2015
- Total capital: \$315,000
- Annual revenue at sale date: \$2 million
- Worker-owner buy-in: \$500
- Worker-owners: 37 (44 employees)
- Primary financing source: 6% over 5 years, from Cooperative Fund of New England
- Lenders: 4



### BACKGROUND

#### Industry

The New School of Montpelier (NSM or the School) is a year-round special education day school for Vermont's unique learners, ages 6-22, approved by the Vermont State Board of Education. Founded in 2005 by Susan Kimmerly, the NSM serves primarily children and young adults with autism, cognitive disabilities, and challenging behaviors, often related to trauma. The NSM provides a safe and encouraging environment for students to form relationships, develop trust, gain life skills and the social competencies necessary to become successful learners and contributing members of their communities.

The employees of the school formed a cooperative to purchase the school and continue its operations as an employee-owned cooperative. The cooperative incorporated as a C-Corp, with

# THE LENDING OPPORTUNITY *of a* GENERATION

all members owning equal shares. The member-owners elect a Board of Directors who hire a director to manage the day-to-day operations. All employees are eligible for membership after two years of employment and, after three years, are required to apply for membership or request an exception. Aside from establishing a democratically elected board of directors, the previous hierarchic management structure remains intact.

## **Size**

The School has served 24 public schools and 64 students, has 44 employees, and gross revenues of approximately \$2 million annually. The school operates in three rented buildings – two are owned by the selling owner of the school. The cooperative has the option to purchase these two buildings once the debt to purchase the business has been repaid. The cooperative rents a third property from the VT College of Fine Arts.

At the time of conversion, 37 of the eligible 38 employees committed to becoming worker-owners. It was noted by steering committee members that employee retention had improved noticeably since the cooperative development process began in 2012.

## **Cause of Conversion**

The conversion process at the New School began as owner Susan Kimmerly began to consider her succession planning options. She was not interested in selling the school to the most likely buyers, mostly for fear of what would happen to the quality of service. Susan first learned about employee ownership after Marcel Rocheleau, her husband and co-owner, attended a seminar offered by the Vermont Employee Ownership Center (VEOC) entitled "Selling to the Employees: Employee Ownership as a Path for Business." Susan and other employees decided to learn more about the process at the VEOC's annual conference, after which they reached out to Don Jamison, program director at VEOC, to discuss next steps.

Susan liked the idea of selling to employees, and felt that the cooperative ethos would be a good fit for the school and the culture of caring that had developed there over the years. After gauging interest with the current employees of New School, VEOC proposed to provide the owners and employees with program management services designed to facilitate a transition from the school's present ownership and governance structure to a worker cooperative structure. VEOC worked with New School to find the right service providers, educate staff about worker cooperatives, help New School establish committees to lead the company through the process, and more.

## **How Sales Price was Determined**

The purchase price of \$200,000 was based on a valuation prepared by a mutually-agreed upon local valuation expert, and the sale was structured as a stock rather than asset sale, so the coop could retain the school's license and contracts.

## **FINANCING:**

The business purchase was finalized on March 30, 2015, and financing for the deal was secured through a collaboration between the Cooperative Fund of New England, the Vermont Employee Ownership Center's Vermont Employee Ownership Loan Fund (VEOC), and the Vermont Economic Development Authority (VEDA).



Source	Amount	Notes
CFNE	\$100,000	6%, 5 years (amortized over longer period), shared 1st position with VEOC
VEOC	\$50,000	Participation with CFNE for total \$150k loan
CFNE LOC	\$65,000	6% working capital line of credit
VEDA	\$25,000	Inter-creditor agreements
Seller Financing	\$50,000	Subordinated
Employee Loans	\$25,000	Subordinated
<b>Total</b>	<b>\$315,000</b>	
Use	Amount	
Purchase of Business	\$200,000	
Working Capital	\$115,000	
<b>Total</b>	<b>\$315,000</b>	

The above sources do not include the expected \$19,000 of member equity to be invested in the School by the end of their first year, which represents 38 worker-owners' \$500 equity investment.

## UNDERWRITING

- **Character (+)**

The cooperative incorporated as a C-Corp, with all members owning equal shares. During the transition, a five-member steering committee met weekly, while an eight-member management team including the selling director-owner managed the School. Together, these groups devoted over 2,500 hours to cooperative development.

The worker-owners elect a Board of Directors who hire a director to manage the day-to-day operations. Aside from establishment of a board of directors, the management structure has remained the same as a cooperative as it was under the sole-proprietorship. The selling owner agreed to stay on for two years, through 2016, to assist with the transition.

- **Capacity (+)**

Projected cash flows support the debt repayment. Loan repayment is accomplished through the School's sole source of income: student tuition funded by federal sources and administered by local schools and school districts. The rates for services are set by the Vermont Board of Education.

The School had suffered operating losses when the Vermont Board of Education instituted a tuition freeze, but the School appealed and was approved for subsequent rate increases. School management demonstrated its ability to weather these challenges and maintain positive net equity.

Through the purchase, the business assumed debt of \$200,000 which exceeded what it had serviced in the past. The calculated debt service coverage ratio was strong for years one (1.40)

# THE LENDING OPPORTUNITY *of a* GENERATION

and two (1.69); and the fact that the business had weathered tight cash flow successfully in the past was considered by the loan committee.

- **Capital (+)**

Almost all employees became or are committed to becoming worker-owners, including both teachers and other personnel. The equity requirement is \$500 per member, with \$19,000 due in the first year. There were also \$25,000 of worker-owner loans, and net equity (retained earnings) of almost \$140,000 at the time of purchase.

- **Collateral (-)**

As a service business operating in leased property, the coop's collateral was limited to contracts for its business and furniture and equipment. Tuition contract receivables at the end of the school year (July 1, 2014) totaled \$2.5 million, discounted 50% provided a collateral value of \$1.25 million. Equipment collateral value was \$15,000.

Because of the weak nature of the collateral, the CFNE loan committee considered requesting personal guarantees from the worker-owners. Ultimately, it was decided that personal guarantees were not necessary. And further, CFNE was able to provide the loan from funds in its designated collateral pool, until accounts receivable were available to serve as collateral.

## *Financial Analysis - Summarized Financial Information at Time of Underwriting:*

### Summarized Balance Sheet on Nov. 30, 2014

Current Assets	\$200,891
Assets	\$205,730
Current Liabilities	\$66,378
Liabilities	\$66,378
Equity	\$139,352
Financial analysis:	
Current ratio	3.0
Debt to equity	0.5
Debt Service Coverage Projected in 1st year	1.40
Loan (Total CFNE, VEDA, VEOC) to Value	6.2

- **Conditions (+)**

The New School has a distinct market niche to serve students with special needs that cannot be met by the public school system. There is often a waiting list for the School's services. The School has created and maintains strong connections with the cooperative movement and the Vermont Employee Ownership Center and they have demonstrated receptivity to peer and consultant advice.

## TODAY

### Key lessons / effective practices

There was a strong mission fit for the CFNE with the ability to preserve 44 jobs and enable a business succession to cooperative ownership.

Key to the success was the significant amount of technical assistance provided by the Vermont Employee Ownership Center which assisted in the cooperative's formation, and in the structuring of





the financing package. Where there were financing gaps and lack of collateral, the worker-owner loans and seller financing provided the bridge.

This deal highlights the importance of cooperation among lenders, to work together to negotiate collateral positions, and structure a deal that serves everyone.

Note: The Vermont Employee Ownership Center is a statewide nonprofit with the mission to promote and foster employee ownership in order to broaden capital ownership, deepen employee participation, retain jobs, increase living standards for working families, and stabilize communities. To learn more, visit [www.veoc.org](http://www.veoc.org).

# THE LENDING OPPORTUNITY *of a* GENERATION



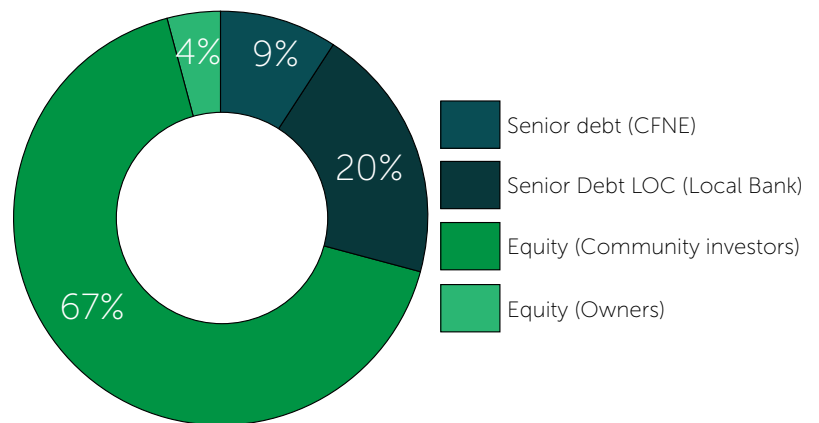
## Real Pickles Cooperative

[www.realpickles.com](http://www.realpickles.com)

### AT A GLANCE

Real Pickles Cooperative illustrates the benefits of a deep customer and community network, which enabled its use of a Direct Public Offering to raise capital.

- Industry: Food Manufacturing
- Location: Massachusetts
- Year converted: 2013
- Total capital: \$749,000
- Annual revenue at sale date: \$581,000
- Worker-owner buy-in: \$6,000
- Worker-owners: 5
- Primary financing source: Preferred non-voting equity through a direct public offering with a targeted 4% annual dividend
- Lenders: 2



### BACKGROUND

#### Industry

Real Pickles (RP) is a mission-driven, food manufacturing company based in Greenfield, MA, creating high-quality, locally-grown, organic, fermented vegetables (including pickles), since 2001. RP's mission is to promote human and ecological health by providing people with delicious, nourishing food and by working toward a regional, organic food system. They have a clearly stated social mission that includes supporting expansion of the local food arena in western MA and the Northeast.



## Size

Until the conversion in 2013, Real Pickles had been a sole proprietorship with two owners (Dan Rosenberg and Addie Holland, who are married to one another). The five original worker-owners had been employees under the sole proprietorship.

Real Pickles began operating out of its own facility in 2009 with annual sales of \$290,000. At the time of conversion, in 2012, annual sales had doubled to \$581,000. Their latest fiscal year, ending March 31, 2015, showed significant growth, with sales reaching \$1,013,000, and ownership expanding to seven workers.

## Cause of Conversion

Conversion to a worker-owned coop was initiated by owners and achieved to provide long-term social mission protection, enhance workplace democracy, create incentives for staff to remain at RP on a long-term basis, and eventually allow the business to operate effectively without dependence on its founders.

The founding owner Dan Rosenberg would stay on with the business, and he continues today to serve as General Manager, as well, Addie Rose Holland stayed on as Marketing Manager. The conversion from a proprietorship to a cooperative corporation as defined by Massachusetts General Law Chapter 157 was accomplished in May 2013.

## Sale Price

The coop and the owners agreed upon a sale price of \$523,795, which included \$400,000 of goodwill, based on a five-year sales and marketing plan developed by the founding worker-owners that showed reasonable assurance that the debt would be repaid. The coop relied on two accountants to affirm that this price was reasonable, first by the company's accountant, and then by a second, independent, accountant using an industry-standard multiple of eight to eleven times cash flow.

## FINANCING

### Cooperative Capital Fund

CFNE utilized funds from its patient capital pool, the Cooperative Capital Fund, to help fund the conversion. This was a five year, interest only \$69,000 loan secured by a second position on all business assets. First position was held by a small local bank's \$150,000 line of credit.

Unlike privately-owned or publicly-traded corporations, cooperatively-owned businesses must avoid raising equity by selling controlling shares of the company to anyone who is not an employee-owner. The usual investing avenues of seeking venture capital or common stock offerings are not as readily available. However, the use of preferred shares that do not convey any ownership rights is a viable option.

Real Pickles augmented the CCF patient capital loan by making a direct public offering (DPO) that raised equity through the sale of non-voting preferred stock. In two months, in early 2013, RP raised \$500,000 from seventy-seven local investors. The DPO allowed the coop to raise needed equity without ceding governance control to outside interests and, therefore, maintaining the business' social mission. The coop set an annual target dividend on these shares at 4%, with the shares redeemable by the holder after five years. Finally, each worker-owner committed to contribute \$6,000 each towards

# THE LENDING OPPORTUNITY *of a* GENERATION

the purchase of a voting share. This contribution was determined to show a significant commitment by the worker-owners while maintaining affordability.

Source	Amount	Notes
Cooperative Capital Fund	\$69,000	Patient capital 8% interest only terms for 5 years
DPO: non-voting preferred shares	\$500,000	From 77 investors
Worker-owner equity	\$30,000	Member fees (\$6,000 each, 5 worker-owners)
Bank Line of Credit	\$150,000	Local bank
<b>Total</b>	<b>\$749,000</b>	
Use	Amount	
Purchase of Business	\$622,239	
Working Capital	\$126,761	
<b>Total</b>	<b>\$749,000</b>	

## UNDERWRITING

In this case, CFNE made the loan from a separate, affiliated, entity: The Cooperative Capital Fund, which provides longer-term, patient capital to CFNE borrowers and new, expanding, and developing cooperatives.

- **Character (+)**

Real Pickles was an existing successful business with strong reputation in the community and clear mission alignment. The original owners intended to stay on and continue contributing expertise and growing the business. The conversion was supported by a healthy network of cooperative technical assistance providers, accountants and attorneys. Prior to conversion, the five worker-owners had been meeting on a weekly basis for many months to plan the conversion.

The cooperative's governance structure was appropriate to support the business goals. Board meetings are held monthly or based on agreed-upon frequency. In the coop, which was organized based on Massachusetts worker coop laws chapter 157A, each worker-owner has one vote and controls an equal share of the value of the business. Though the leadership and governance of the coop is democratic, the management of the business is hierarchical. The Board oversees the general manager, who oversees other workers.

- **Capacity (+/-)**

The business had a solid track record of sales and strong growth prospects in the market. The business valuation, based on 5-year sales and marketing forecast developed by the future worker-owners, founding owner, and their CPA, appeared reasonable and was supported by second opinion evaluation by a different CPA. This provided some assurance that the fledging cooperative was not over-paying for the company.



The company prior to sale was already highly leveraged at almost 3 to 1, and this would be true after conversion as well. It was important that the sale of the company not increase the burden of debt to the new cooperative.

- **Capital (+)**

The equity buy-in for member-owners was set at \$6,000 which was considered significant to ensure commitment, but not so high as to preclude participation. Additional capital was to be raised through a DPO process. Indeed, this would provide the primary source of financing the sale.

The founding owners demonstrated strong commitment to support the transition, including a willingness to provide some seller-financing if needed, and an employment contract requiring five-year retention and minimum hours worked.

Workers and owners committed significant planning time to plan the conversion, advised by a strong network of coop advisors. While not evident on a balance sheet, one of the businesses strongest assets was its network of cooperative advisors who provided support for governance policies and procedures, legal structure, financial education, and support for the DPO process. Some of those advisors included employee-owners of Equal Exchange (a successful worker-owned cooperative business), members of the PV Grows Network of food-based business advisors, loan officers and technical assistance providers affiliated with the Cooperative Fund of New England, and consultants from Cutting Edge Capital.

- **Collateral (-/+)**

There was a lack of collateral. The business had a \$145,000 line of credit with local bank that was secured by a 1st position on all business assets, and the line was extended to the new cooperative. Any new lenders would be second in line.

This weakness was somewhat mitigated by the relatively small investment by CFNE relative to the overall size of the deal, and that CFNE's investment held priority to the relatively large equity investments.

- **Conditions (+)**

Growth in the organic, fermented, healthy food market was strong, both locally and nationally. Market conditions were sound.

There was strong support in the region for local investing opportunities for local food businesses and cooperatives supporting the success of the DPO. Due to the timing of CFNE's investment and the DPO opening, there was a risk of the DPO failing to raise sufficient funds to complete the deal. This was partially mitigated by a commitment by the selling owners to extend the coop a \$150,000, 4% interest loan. (Ultimately this was not necessary due to the success of the DPO.)

## Financial Analysis

Before conversion the proprietorship held \$145,000 line of credit with local bank, and \$67,000 in unsecured loans from owners' friends and family (5 year, 6% due 2013, retained by owners).

# THE LENDING OPPORTUNITY *of a* GENERATION

After the conversion, the cooperative assumed the \$145,000 line of credit with the local bank, and to fund the purchase a five-year, 8%, interest-only loan from CCF of \$69,000.

## TODAY

In the second year of the operations as a cooperative (FY15), RP has eighteen employees, seven worker-owners, some part-time and some full-time, and over a \$1M in annual sales.

### Key lessons / effective practices

Lenders evaluating the strength of a potential deal should consider not only the maturity and success of the existing business, but also the depth, breadth and effectiveness of the existing business' network of community support and reputational capital.

According to Dan Rosenberg, as quoted in a previously published Project Equity Case Study of Real Pickles, "Over the last twelve years in business, Real Pickles developed a strong community network, and the backing of this network was absolutely vital to our success."

As further noted in that case study, and relevant to lenders to cooperative conversions: "Another key lesson to be learned from Real Pickles' example is the importance of maintaining a strong network of external support throughout the conversion process. The diverse group of advisors assembled by Real Pickles to guide it through its transition provided invaluable financial advice, legal advice, and general cooperative mentorship to Real Pickles."

Additionally, in the absence of personal guarantees or strong collateral, where there is some risk tolerance on the lender's part - favorable market conditions, substantial worker buy-in both financial and time, and the ongoing involvement of the founding owners are key elements in the success of this deal.

### *Financial Analysis - Summarized Financial Information at Time of Underwriting:*

Summarized Balance Sheet on June. 30, 2012	
Current Assets	\$112,400
Assets	\$140,100
Current Liabilities	\$17,700
Liabilities	\$84,700
Equity	\$55,400
Financial analysis:	
Current ratio	2.06
Quick ratio	0.81
Debt to equity	2.75
Debt Service Coverage	N/A
Loan to Value	N/A



## **ABOUT COOPERATIVE FUND OF NEW ENGLAND**

The Cooperative Fund of New England is a Community Development Financial Institution founded in 1975. Its mission is to advance community based, cooperative and democratically owned or managed enterprises with preference to those that serve low income communities through the provision of prompt financial assistance at reasonable rates; provision of an investment opportunity that promotes socially conscious enterprise; and development of a regional reservoir of business skills with which to assist these groups. For more information please visit [www.cooperativefund.org](http://www.cooperativefund.org).

## **ABOUT PROJECT EQUITY**

Project Equity's mission is to foster economic resiliency in low-income communities by demonstrating and replicating strategies that increase worker ownership. We envision a future where communities (re)gain economic self-determination and today's working poor have good jobs that keep them out of poverty and enhance their lives. We see cooperatives and employee ownership as key elements of this future. For more information please visit [www.project-equity.org](http://www.project-equity.org).

## **ABOUT DEMOCRACY AT WORK INSTITUTE**

The Democracy at Work Institute advances worker ownership as a strategy to create a fairer economy and better jobs, build local wealth, and retain businesses in communities. Created by the US Federation of Worker Cooperatives, the Institute brings both a national birds-eye view and an experiential on-the-ground understanding of cooperative business. Through strategic research, organizing and capacity-building training, we are working to bring the worker cooperative movement to scale to effect transformative change for individuals and communities throughout the country. <http://institute.coop>



The organizations that authored this resource are members of *Workers to Owners*, a national collaborative of finance institutions, cooperative developers, employee ownership advocates, legal professionals, and other organizations committed to bringing worker ownership to scale through conversions of existing businesses. Learn more at <http://www.becomingEO.org>.