# Capitalizing Healthy Food Retail Initiatives

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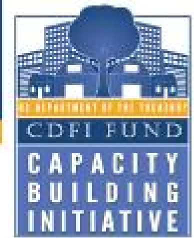



## Introduction to Capitalization

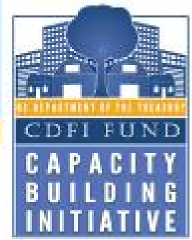
For CDFI lending programs, sources of capital may be as diverse as the types of projects that such capital supports. Though the U.S. Department of Treasury's CDFI Fund may be the capital source that unites CDFIs, there is considerable variety among others who may invest in or lend to each CDFI's program. Capital can come from governmental resources at federal, state and local levels. There are private sources drawn to different types of organizations and programs. Capital sources can differ depending on program, organizational form and culture, and scale of operations. Some small CDFIs may not borrow at all, relying instead on grant support from private and governmental sources. Some CDFIs that are banks or credit unions have very different access to credit.

Any new financing initiative requires the right fit between the capital source, market demand and borrowers needs. Though other chapters address program design, the product and the capital are intrinsically linked. Wrong capital can cause a program to fall on deaf ears. Pricing may be too high, terms too prescriptive or resources simply insufficient for the scale of demand. To develop a clear sense of demand, it is also critical to understand what matters most to - and works best for - potential borrowers. This is central to developing a capitalization strategy. It is essential to negotiate the right capital for the program and, similarly, the right program for available capital. This is a process that requires that the CDFI understands both the potential investors' and borrowers' needs.

In simple terms, investors in a CDFI's lending initiatives are motivated by some combination of 1) mission, 2) mandate, and 3) market. Each potential capital source comes with its own challenges and opportunities that must be considered when deciding how to capitalize a program. Until a few years ago, an investor or even a whole investor class could clearly fit within only one of these categories. The current economic environment and a variety of programs that have created government incentives for investing have changed that; a particular investor or source of capital may now be driven by a combination of all three motivators.

**Mission –** Many individuals, foundations and religious institutions are drawn to CDFIs by virtue of their mission. They seek the double-bottom line of both a social return and a modest financial return. These investors have typically provided low-priced capital with few restrictions. However, managing these investments can be challenging. Smaller investments can have fairly high management transaction costs. By virtue of the size of the investments and the range of investor involvement, this capital may sometimes become resource-intensive to manage. Many government resources are also driven by mission. When the U.S. Department of Education makes grants for charter school finance credit enhancement, it is fully motivated by the federal government's agenda and mission. A state or local government program may invest in CDFIs because it sees the CDFI as a means to enterprise development. Such mission-driven government resources may serve as equity (grant dollars) to attract private capital that has less risk and higher return expectations.

**Mandate –** The Community Reinvestment Act has traditionally been the first motivator for bank investment in CDFIs. In fact, it drove early investment in CDFIs. Bank capital attracted for CRA reasons is typically priced at much better than market rates. While better priced than market, this capital can be restrictive in terms of the types of projects it can support or even geography. In addition to banks, Government Sponsored Entities (GSEs) like Fannie Mae or Freddie Mac have also been largely driven by mandate. These GSEs have been a significant capital source for housing finance.




**Market –** Some investors fulfill their market need by capitalizing a CDFI's program. Such investors can play an important role in getting CDFIs to scale. The New Market Tax Credit program is the best example of a current market-driven resource. Those who invest in NMTC projects are doing so primarily because the project works for them on a market-driven basis. Where there is a market that is not idiosyncratic to mission interests or particular mandates, there is increased opportunity for scale. Market driven capital tends to provide for scale. Its main drawbacks for a CDFI tend to be underwriting requirements and pricing. CDFIs have also learned in recent years that 'market' is not a constant and that dependence on a single source of capital brings its own risks. For example, before 2008, charter schools were able to access the tax exempt bond market for facility financing. This particular capital market for charter schools dried-up with the economic downturn and has yet to recover completely.

A CDFI has to determine what fits its culture and organizational lifecycle with an understanding of the advantages and disadvantages of various capital sources and the motivation of potential investors. What fits the programmatic goals of a new initiative? In the ideal world, a program operator would be delighted to attract capital that optimizes flexibility of use, that is plentiful and that is low-cost, long term and patient. But in reality, each capital source tends to bring its own challenges and opportunities, tied to the characteristics and motivation of the investor/lender. We highlight just such trade-offs in each of the examples addressed below so a CDFI capitalizing its program can assess its own ability to manage such capital given the nature of its program. A key learning point for a CDFI capitalizing any new program is not just to raise capital but also to make a strong connection between capital and program. A wrong match can create an ill-fitted relationship between capital available and demand and leave a CDFI unable to meet the programmatic or financial goals of its business strategy.

## Improving Access to Fresh, Healthier Foods

Like with any new program, when planning the capitalization strategy for a financing program that serves the needs of healthy food retailers (urban supermarkets, rural grocery stores, farmers markets, food cooperatives), one must know the customers and their needs. Understanding demand is important to determining the right capital source. For example, if the primary goal of the healthy food retail program is developing farmers' markets, there will be a greater need for grant funding because of the nature of this type of business. Grocery store owners in small towns and rural communities may be interested in buying more energy-efficient refrigeration equipment to cut utility costs so they can remain competitive, in which case the USDA' s Rural Energy for America Program (REAP) could be a source of capital.

Outlined below are sources of capital that CDFIs may want to consider when launching a program to finance healthy food retailers or simply financing a project or two. Following this chapter are resource lists of both potential private and public grant and capital sources. Each program has to consider the types of investors that may be interested based on the programmatic niche and the geography of the program. Many of those highlighted here were particularly significant for the PA Fresh Food Financing Initiative experience.

*Financial Institutions*

Banks motivated by mandate and market can be an important source of capital for healthy retail programs, especially as access to healthy food continues to generate public interest. The primary source of capital for FFFI loans to Pennsylvania supermarket operators and developers was a $40 million credit facility in which national and regional banks participated. While this facility was negotiated prior to the

2008 meltdown of the financial services sector, strong bank interest in supermarket financing programs remains. In 2010, Goldman Sachs partnered with LIIF to create a similar $20 million credit facility to support the New York Healthy Communities, Healthy Foods. In July 2011, JP Morgan Chase and US Bank announced that they will allocate a significant portion of their New Markets Tax Credit (NMTC) investments to CDE and CDFI projects that increase healthy, affordable food availability in high-need urban and rural communities across the country. The leading benefit of these type of bank investments is the scale and related efficiency.

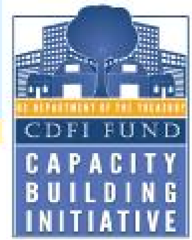
TRF and the banks participating in FFFI negotiated the terms and conditions for the five-year debt facility upfront, reflecting what mattered most to both parties. At issue in negotiations with these and any bank investors was risk, as expressed through 1) underwriting control, 2) price and 3) flexibility. For TRF, it was important to have the authority to underwrite borrowers without additional review by investors. For the investors, adequate credit enhancement was essential. The risk profile of these projects and these loans would not work in the bank's lending parameters without such enhancement. The use of the State's grant funds that could serve as credit enhancement was essential. Even so, the product remained fairly narrowly defined in term and purpose. Pricing and terms were less negotiable once the underwriting flexibility was assured. The grant funded loan loss reservemade it an attractive vehicle for bank investors that otherwise would not have taken the risk of such a portfolio directly. The challenge of such a facility is that a CDFI has to know it can attract sufficient demand that corresponds with the more limiting parameters of a bank facility.

*Foundation Program and Mission Related Investments*

Foundations are increasingly using Program Related Investments (PRIs) and Mission Related Investments (MRIs) to achieve their charitable objectives. Well-crafted PRIs and MRIs can be important sources of loan capital for CDFIs interested in launching a healthy food retail financing program. PRIs are typically investments from a foundation's grant-making budget and the capital is expected to be returned after an agreed-upon time. As mission-motivated investors, foundations generally structure their PRIs as below-market loans. PRIs can also include loan guarantees, lines of credit and equity investments. PRIs are considered charitable expenditures like grants and count toward the IRS requirement that philanthropic institutions use at least 5% of their endowments annually for charitable purposes. A PRI can be an essential source of low cost capital for a CDFI loan program. TRF's "core loan fund" has been critical in providing the flexibility to make loans that do not fit the parameters of a bank facility. TRF has used PRIs with other investments in our core loan fund to create very flexible debt capital for our healthy food-related projects.

On the other hand, MRIs are mission-driven investments funded by a foundation's endowment. MRIs may seek financial returns similar to conventional investments (stocks, bonds), while also producing social, environmental or educational impact. MRIs offer foundations the opportunity to better align their investment strategies with their mission.

As more foundations are drawn to food-related work, there may likely be opportunity for further food-related foundation investment. A CDFI ought to exercise caution, though, as a MRI/PRI can bring its own restrictions, too. They tend to work best when combined with other investors' capital. The foundation behind a MRI/PRI may have programmatic objectives which are similar but not identical to a CDFI's business and mission objectives. TRF has received a $2 million PRI in support of food access in the City of Newark, New Jersey. This PRI served as the very early capital in TRF's New Jersey food retail financing




program and was critical in spurring other institutions to invest. Yet, the PRI's limitations prevented TRF from using the dollars in other New Jersey cities where its first deals were located. Though a CDFI should only negotiate a PRI for which it believes it can manage the restrictions, it can still be slow to match projects with capital sources if they are too narrowly defined.

In another example, The California Endowment (TCE) chose to take a programmatic approach and fund a CDFI which will be responsible for underwriting projects in accordance with the foundation's own investment terms. TCE and other community, supermarket industry, and government partners have been working to create a California supermarket financing program. The California FreshWorks Fund (Fund) is scheduled to be unveiled in the first half of 2011 and will be administered by NCB Capital Impact, a CDFI. The Fund will be capitalized with a combination of debt and grant capital. Using an MRI, TCE is contributing $30 million in debt and $3 million in grant capital to finance healthy food retailers. In this particular instance, TCE's investment is also designed to get the program to scale as the foundation works with NCB Capital Impact to secure additional investors to create a $200 million fund that is comprised of 80% debt and 20% grant funding.

*State and Local Economic Development Agencies*

Most states and municipalities have economic development agencies (state authorities, government departments, non-profit corporations) whose mission is to promote job creation and retention within a specific geographic area by offering businesses low-cost loans, grants, loan guarantees or tax-exempt bond financing. Given their job creation potential, full-assortment supermarkets and grocery stores are excellent candidates for economic development programs. Retail grocery jobs are well-suited for unemployed and under-employed workers or those looking for part-time work because of other family obligations. On average 25 new jobs are created for every 10,000 square feet of retail grocery. Full-assortment supermarkets typically range from 25,000 square feet to 70,000 square feet.

State and local economic development agencies typically originate and service their own loans, but many are increasingly partnering with local CDFIs to leverage their capital or to service a business sector in which the agency has little or no experience or perhaps considers too risky. These partnerships can help economic development agencies address their job-creation goals efficiently and effectively. TRF formed such a partnership with the New Jersey Economic Development Authority to launch the New Jersey Food Access Initiative. Responding to growing requests for a supermarket financing program from several New Jersey mayors, NJEDA offered to provide the capital for transactions through TRF's program and served as a key sponsor of the program.

Many public sector or quasi-public agencies dedicated to economic development will have a sectoral approach – focusing on industrial businesses, or key technology clusters like the bio-sciences or export businesses, etc. Food retailing is not often on their radar as a job or business sector. Sometimes this is because of the job turnover in entry level of employment at supermarkets and the narrow career channel for advancement in large stores. Other times it is a focus on manufacturing that prevents them from seeing opportunity in the retail service sectors. NJEDA had a strong desire to support food access and the urban jobs that could be created in the field. They chose to not develop the expertise in the sector and instead formed a strategic partnership with TRF as its program delivery partner.

There are also many governmental and quasi-governmental economic development agencies that on their face appear to be unlikely investors in healthy food retail initiatives. For example, the Casino Reinvestment

Development Authority (CRDA) in New Jersey is an investor in the New Jersey Food Access Initiative. TRF had to seek many program rule waivers in order to fashion a use for the agency's funds. The typical user of CRDA funds borrows for a 30-year term and can afford to pay for a credit rating of the borrowing. TRF was borrowing for 10 years or less, and did not have the budget to pay large rating fees or other program borrowing costs imposed by CRDA. With careful negotiations, both CRDA and TRF were able to adapt the funds to a new, unprecedented use for the agency. It is important to note that negotiating with governmental and quasi-governmental agencies can be time consuming, particularly as agencies often have legislative or regulatory requirements which may not fit with the CDFI's program model. Such agencies also have greater reporting and compliance requirements tied to their investments. However, at a time when capital is scarce, more CDFIs may need to seek investments from these more atypical capital sources.

*State and Local Tax and Other Incentive Programs*

In addition to the federal New Market Tax Credit Program, many state and local governments provide incentives for the development of healthy food retail projects by offering tax breaks, zoning variances and land use density bonuses, or "Ombudsman" to expedite permitting and licensing processes. While not a source of capital for CDFIs attempting to establish a healthy retail financing program; these incentives, when combined with grant and loan capital, can help attract supermarket operators and developers to particularly challenging locations. Such incentives can also motivate market-based investors to engage in a project. Great examples of such local incentive programs are the New York City FRESH and the District of Columbia's recently passed FEED Initiative, which builds on the District's existing supermarket tax exemption and financing programs to create a package of incentives and assistance for new grocery store developments and for grocery store renovations in lower-income parts of the city. For example, the District created within the Office of the Deputy Mayor for Planning & Economic Development a "grocery ambassador" to help grocers navigate through the bureaucratic hurdles of opening new stores; granted density bonuses and other zoning variances for eligible grocery store developments; and set-up a fast-track permitting and review process for eligible grocery store developments.

*Loan Guarantee Programs*

An effective capitalization strategy should include credit enhancement tools. As mentioned earlier, TRF was able to create a $40.5 million debt facility, by pledging $8 million in state grant funds for a loan loss reserve. The federal and many state governments have loan guarantee programs in place which may be suitable credit enhancement tools for healthy food retail projects. On the federal level, two programs that CDFIs should consider are administered by the Small Business Association (SBA) and USDA's Business & Industry Loan Guarantee program (B&I).

The Small Business Administration's "7A" program offers a guaranty for the majority portion of small business loans, typically term loans for equipment, working capital and other fixed assets. For many years, there were few CDFIs that could meet the requirements to be an approved SBA 7A lender. Depositories and other regulated CDFIs were the usual players – unregulated CDFIs were routinely not approved. The SBA guaranty adds a level of compliance to loan servicing which can be expensive or alien to smaller CDFIs and those open to more flexible (non-standard) terms in their portfolios. Many CDFIs choose to use Colson Services for SBA loan servicing, as this subsidiary of JPMorgan Chase is also the master servicer for the SBA. Recently, the U.S. Small Business Administration announced its new loan program, Community Advantage, designed to allow CDFIs and other mission-driven lenders to originate SBA 7(a) loans (up to

$250,000). This new program may prove to be another good resource for CDFIs' food-related lending with its ability to provide small-sized equipment loans. Such loans can be used for a refresh of front-end equipment or for more energy-efficient refrigeration equipment.

The B&I program will guarantee loans for economic development and/or environmental projects in rural communities. These loan funds can be used for a wide range of purposes. A $6,900,000 B&I loan guarantee enabled Fiesta Foods to open a modern, 40,875 square foot, grocery store that caters to the needs of the large Hispanic population in a rural Oregon community. The B&I loan guarantee made it possible to provide permanent financing to take-out the construction loans, and it also helped with the term financing for furnishings, fixtures, and equipment for the store. Fiesta Foods offers amenities and grocery variety not often found in smaller ethnic markets, including a mix of locally-grown and processed food products from the states of Oregon, Washington, and Idaho. The project created 49 new jobs and an additional 6,700 square feet of retail space for lease to small business tenants.

Eligible B&I lenders include both traditional lenders (banks, savings and loans, credit unions, etc.) and "other non-traditional lenders," which may include CDFIs. 7 C.F.R. § 4279.29 http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title07/7cfr4279_main_02.tpl Non-traditional lenders may be approved by the USDA if they have the legal authority to operate a lending program and meet certain requirements regarding the strength of their loan and asset portfolio demonstrating a record of successful lending. A CDFI must apply to the local State Office for approval as a non-traditional lender under the B&I program. Eligible borrowers include businesses, individuals, Indian tribes, nonprofits or public entities.

The maximum guaranteed loan amount to any borrower is $10 million, although there are limited procedures for exceptions. The maximum percentage of guarantee is 80 percent for loans of $5 million or less, 70 percent for loans between $5 and $10 million, and 60 percent for loans exceeding $10 million. The primary drawback of the B&I is the inability to use the program to finance urban business enterprises. Eligible projects must be located in rural areas where the population does not exceed 50,000, and that community cannot be located immediately adjacent to an "urbanized" area. Because the rural definition for the B & I loan program is complex, CDFIs should work closely with their local USDA offices to make sure the project is located in eligible area.

## Conclusion

As CDFIs develop new programs, there is much to learn from various experiences to-date capitalizing healthy food-related programs. It is critical to understand the demand and the capital available and make sure that there is a programmatic fit between the two. The Financial Resources Catalogue prepared as part of the CDFI Fund's Capacity Building Initiative for Financing Healthy Food Options is a good starting place in that it provides additional ideas of what sources may be useful depending on the goals, objectives and structure of the healthy retail financing program that you wish to capitalize. In reviewing successful healthy food financing models, a combination of different kinds of capital (e.g., grant funding, grants that can be used as credit enhancement, debt capital, loan guarantees and New Market Tax Credits) have made for a successful healthy food financing program.