Linking Institutional Investors to Communities

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Institutional investors such as public pension funds, insurance companies, foundations, and universities are increasingly allocating capital to *community investments*.[1] These investments have the dual purpose of earning high financial returns while spurring economic growth in underserved areas.[2] To date, public pension funds around the country have committed $11 billion to economic development investments.[3] Since 2000, market-rate, mission-related investments from foundations funded by program funds and endowment funds grew at a 19.5 percent compound annual rate.[4]

A growing body of research studies how institutional capital gets funneled into community investments. The primary challenge to growth of these investments has been that institutional investors try to place large amounts of capital into easily replicable financial instruments, whereas investments in underserved communities are generally small and specialized. Today, however, intermediaries are helping to overcome such barriers, and certain models have shown especially strong potential for ensuring community benefits—job creation, affordable housing, community facilities, and an improved environment.

Two Points of Connection

According to the research, two intermediaries are necessary to connect the institutional investor to the economic development area: the investment intermediary (or "investment vehicle") and the community intermediary (or "community partner").[5] Institutional investors do not have the time or expertise to actively manage investments in underserved areas. Investment vehicles intervene by using their financial expertise to pool assets into an investment fund and to lower transaction costs. The investment vehicle creates scale, which enables larger investments in the kinds of assets (fixed income, equity real estate, or private equity) required by institutional investors.

The community partner links the investment vehicle to the neighborhood and uses its local knowledge to identify investment opportunities, enlist the participation of partners such as developers, and assemble the support of civic leaders, government officials, and residents. Most important, it helps ensure that the investment yields benefits for the neighborhood and doesn't displace lower-income residents.

Investment Vehicle Business Models

Investment vehicles use a variety of operating models to link institutional investors to areas needing revitalization. One study identifies four approaches to the oversight of an investment fund: the Ownership Model, the Contractual Model, the Legislative Model, and the Fund Manager Model.[6]

The first two models hold the greatest promise because they have built-in connections to community partners. In the Ownership Model, a not-for-profit community partner organization, or "sponsor," owns the for-profit fund-manager subsidiary. In the Contractual Model, a not-for-profit community partner contracts with a well-established for-profit investment fund manager. The Legislative Model has been effective in Massachusetts but is not easily replicable because it requires a supportive legislature. The Fund Manager Model is effective in aggregating investment for institutional investors but may lack grounding in the community unless it affiliates with a community partner.

Community Partners' Toolkits

The five main categories of community partners are: (1) not-for-profit fund sponsors, (2) not-for-profit affiliates, (3) mission-driven lending intermediaries, (4) municipal governments and public officials, and (5) underserved businesses, including minority- and women-owned businesses. Not-for-profit fund sponsors and affiliates—in particular, community development corporations and community development financial institutions—are the strongest partners. Their mission is most closely aligned with the underserved areas, and they have a useful "toolkit" at their fingertips.

The toolkit holds the resources that help community partners structure community investments. First are *financial tools* that affect an investment's financial value, such as zoning and land encumbrances, tax credits, philanthropic grants, and other public and private incentives. *Social* and *political tools* are the community partner's ties with community stakeholders who can leverage resources and help get a development project approved. *Material tools* include land or facilities that are used to underpin an investment.

Illustrations from New England

Consider the two following cases: Urban Strategy America Fund (and its community partners in Boston) and Coastal Enterprises Inc.

The USA Fund is a for-profit real estate Fund Manager Model that takes a triple-bottom-line approach while bringing development expertise by way of the New Boston Developers group.

Coastal Enterprises Inc., a private, not-for-profit CDC and CDFI based in Wiscasset, Maine, works with community partners across New England and upstate New York. CEI provides financing and support to develop small businesses, natural resource industries, community facilities, and affordable housing. Like the USA Fund, it focuses on a triple bottom line. CEI acts as a community partner via the parent organization and as an investment vehicle via its three for-profit subsidiaries. They include two community development venture capital funds in addition to CEI Capital Management, LLC (CCML), which manages CEI's $129 million New Markets Tax Credit allocation.

Urban Strategy America Fund partnered with Lena Park Community Development Corporation to create Olmsted Green, now under construction. Photograph: USA Fund

The Role of the Investment Vehicle

Investment vehicles play three key roles. First, they work closely with community partners to source deals. CCML, for example, requires community partners to take the lead in sourcing deals but helps them by providing presentation materials and participating on investment road shows.

Second, investment vehicles structure an investment fund using complex financial engineering. The USA Fund, for example, provides preconstruction dollars and risk-adjusted equity to its community investment partnerships and helps secure approvals and public financing. In a typical deal, the USA Fund is responsible for obtaining third-party debt financing of up to 75 percent of project cost. Joint venture partners (developers and/or community partners) may provide up to 20 percent of equity through cash, third-party predevelopment expenses, or land contributions. In return, local partners receive a development fee commensurate with their development expertise; they may also receive a profit after equity investors get their preferred 12 percent return.

Finally, investment vehicles educate. Recognizing that they are in an emerging, niche industry, they inform potential investors, community partners, and other stakeholders about how the investments work and about typical returns. They also work to overcome market prejudices. For example, the New Boston Real Estate Fund developed proof of concept in a traditional investment fund. After that did well, New Boston was able to establish the USA Fund.

The Role of the Community Partner

Community partners play two key roles: sourcing deals and ensuring community benefits. Their deep local knowledge helps them find deals, resources, and partners to address local needs. They also may recruit local investors or invest in the projects themselves.

Their second critical role is related to the fact that they are more likely than the investment vehicle to be held accountable by the community. They know they have to deliver.

> **Community investments have the dual purpose of earning high financial returns while spurring economic growth in underserved areas.**

Olmsted Green, the USA fund's $144 million residential housing joint venture with Lena Park CDC in Boston's Mattapan neighborhood, illustrates the point. The CDC made sure that the community received benefits, including 287 workforce housing condominiums, 153 affordable rental units, 400 jobs in construction, 400 permanent positions, an energy-efficient design that included green public spaces, 83 units of senior housing, a 123-bed skilled nursing care facility, an urban farm, a Heritage House mental health center, and a job training center.

Additionally, community partners receive organizational benefits—for example, strengthened capacity and a new ability to seek out innovative and collaborative projects. Lena Park's participation in Olmsted Green gave it valuable experience in doing real estate development and helped cement its role in the community. Moreover, Olmsted Green is expected to provide a revenue stream that will subsidize Lena Park's health and human service activities.

Lessons Learned

Lessons learned from early adopters among institutional investors demonstrate that community investments yield both high financial and high social returns.

Nonetheless, deal flow remains a challenge, and the relative complexity of the investments makes it difficult for some potential investors to classify them. More research on the costs and benefits of the programs could encourage the use of public incentives to attract institutional capital. The return for government is outside help with economic development and poverty alleviation. Observers believe that as details of the financial and social returns of community investments are made available, the investments' appeal will broaden, and the industry will have an increasing impact on underserved communities.

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Endnotes

[1] This article is based on Anna Steiger, Tessa Hebb, and Lisa Hagerman, "The Case for the Community Partner in Economic Development" (discussion paper, Department of Public & Community Affairs, Federal Reserve Bank of Boston, November 2007). Another version appeared in the Federal Reserve Bank of St. Louis's *Bridges*, summer 2007.

[2] Related terms are *economically targeted investments*, *double-bottom-line investments*, *triple-bottom-line investments* (which seek financial, economic, *and* environmental benefits), *emerging domestic market investments*, and *urban revitalization*.

[3] That does not include broad in-state targeted investments. See Lisa Hagerman, "More than a Profit? Measuring the Social and Green Outcomes of Urban Investments" (working paper, Oxford University Centre for Environment, 2007).

[4] Sarah Cooch and Mark Kramer, *Compounding Interest: Mission Investing by U.S. Foundations* (Boston: Social Impact Advisors, 2007).

[5] Lisa Hagerman, Gordon Clark, and Tessa Hebb, *Investment Intermediaries in Economic Development: Linking Pension Funds to Urban Revitalization* (Cambridge, Massachusetts: Harvard Law School Labor and Worklife Program, 2007).

[6] Belden Hull Daniels, *Market Assessment and Investment Strategy for a Northwest Louisiana Community Development Fund, Shreveport, Louisiana* (Boston: Economic Innovation International Inc., 2004).