Reflections:

Lessons Learned from our Coastal Loan Fund

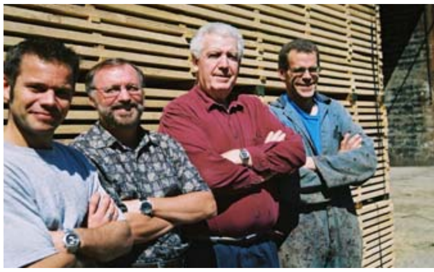
PHOTO / Judith Sayers, Former Chief of the Hupacasath Nation and President of Upnit Power Corporation

Introduction / Between 1999 and 2008, as an integral part of its *conservation economy* mission, Ecotrust Canada operated a loan fund to support small, triple bottom-line business ventures in remote coastal communities across British Columbia.

Over 10 years, the $4 million Coastal Loan Fund (CLF) made 87 mission-related loans, totaling $10.7 million dollars in lending activity. By classic metric measurement standards, the Fund created 696 full time equivalent jobs and leveraged over $40 million in additional loan capital. Operations were considered both e*fficient* and *effective*, with default rates and loan losses at the lower end of the range for comparable institutions in Canada.

As part of a wider organizational review in 2009, the Board of Ecotrust Canada made the difficult decision to wind up its lending activity and consider alternate ways to meet its objective to support the design and development of a triple-E economy in BC. Their decision was premised on three factors:(1) limited internal resources to underwrite the expansion deemed necessary to bring the Fund to scale; (2) the ongoing lack of financial instruments in the market to help mitigate risk; and (3) mission drift premised on the need to cover operating costs and remain financially viable. The Board and management agreed that, without significant growth, the loan program was in danger of becoming a financial burden on the charity and losing its mission advantage.

This abstract discusses some of the main lessons learned from 10 years of operating the loan program, and will be part of a longer paper examining case studies in order to translate lessons into policy tools. These reports, together with our wide range of experience in this field, are intended to support and advance discussions in Canada about the need for a comprehensive social finance program that is well designed, adequately supported by governments and that engages national and regional financial institutions as well as private capital sources to support social change.



Lessons Learned /

1. *Clarify mission impact expectations before creating financing vehicles*

Ecotrust Canada established its coastal loan fund (CLF) to invest in green businesses on the coast. The charity had two objectives: (1) to stimulate triple-bottom-line business development; and (2) to achieve a conservation economy in BC. These objectives proved too broad and too ambitious for the Fund's size, scope and type.

Too broad: The CLF was structured and endowed to provide financing through loans to small, remote, medium-risk businesses. In other words, the Fund occupied only a very narrow and specialized niche in the overall spectrum of social finance and in the field of community economic development. Although the organization's mission objective, 'to build a conservation economy', is very broad, its mission-fund was not structured to address all aspects of achieving it. Complementary initiatives, including industry sector restructuring, demonstration projects, institutional development and capacity building, could not access the CLF even though many needed social finance to succeed and offered sizeable investment opportunity. The Fund was also not structured to address higher risk activities in the community development field such as start-up financing, research/innovation, or market development. To draw social finance into the full suite of needs and opportunities associated with achieving its mission, a parallel strategy to engage venture capital, commercial banks and government was required. While the CLF did develop some of these financing partnerships, and leveraged capital much in excess of its own resources, the Fund's activity remained largely limited to co-financing for its target audience rather than building support across the full spectrum of needs associated with mission success.

Too ambitious: Transformative change is a slow, uneven and unpredictable process, often fraught with measurement and attribution challenges. In the context of transformation objectives, relatively conventional activity, in a niche market, over a 10-year time horizon, was simultaneously ambitious and limiting. Clearly articulated shorter term objectives, and designing a metrics system specifically for the Fund, would have increased the likelihood of understanding the true impact of this undertaking.

2. *Understand profitability scenarios & design for profitability expectations*

When the CLF was established, Ecotrust Canada expected 'net positive returns from fees and interest which it would redirect into operating revenue for the charity'. The reverse held true — Ecotrust Canada consistently subsidized the Fund's operations, with both staffing and financial support.

Profits: On the basis of earned income alone, no documented mission fund of comparable size in Canada or in the US has come close to fully recovering its operating costs, including the cost of capital. All other funds of like size and type have benefited from government subsidized capital and/or operating subsidies — neither of which was available to the CLF. Studies carried out by the Aboriginal Financial Institution network suggest that the real cost of capital (the interest rate required for a loan fund to break even), is in the order of 20 to 25%. The CFL was charging seven to 9% interest on its loans.

Profitability expectations: Establishing metrics that quantified progress towards mission objectives (cost-effectiveness), rather than simply measuring costs, would have aided in understanding the Fund's impact.

Profitability expectations were also found to create mission-drift pressure. There is a built-in trade off between profitability and mission risk. Pressure to reduce costs created an incentive to increase the number of large, low cost, low risk, *soft* mission loans at the expense of the small, costly and riskier *hard* mission loans. This dynamic has been observed in other similar mission-funds and remains one of the critical challenges in the micro-credit world.

3. *Analyze the fund size required to achieve mission impact & sustainability*

For every Fund there is a sweet-spot where the capital under management enables it to balance risk across the portfolio and cover operating costs. Ecotrust Canada estimated that, given its mission risk, a $20 million fund operating in an extended geography was needed to reach break-even.

Raising this level of capital into the CLF proved impossible due to the lack of support instruments. In other jurisdictions, instruments such as investment tax credits, or a contributed capital base with an interest rate buy-down for additional capital (available to ACCs in Canada), are known to encourage investment into funds of this size and type. These instruments were not available during the CLF's tenure.

The CLF did benefit, for about 45% of its loan portfolio over five years, from a federal government loan loss reserve through Western Economic Diversification. This absorbed part of the deficiency balance for loans that did not complete. The program considerably enhanced the capacity to respond to the need for higher risk mission loans and, while available, satisfied private investors that their capital was shielded from risk. When the federal program was cancelled, second round expansion financing was notably impacted.

4. *Consider the vehicle used to operate a Mission-Fund*

Current Canadian laws governing charities severely restrict their ability to operate a mission-related loan fund.

In order to operate its lending program on a profitable basis, Ecotrust Canada was required to incorporate a wholly-owned subsidiary corporation. This requirement substantially increased both the complexity and the cost of fund governance and fund management, and diluted the relationship between the loan portfolio and the mission activity of the charity. Ultimately, this dual structure resulted in a loss of synergy between the 'development' and the 'credit' sides of the organization.

Furthermore, because charitable funds could not be transferred to the lending subsidiary without market return expectations, the subsidiary was left with a zero net worth balance sheet that radically inhibited its ability to attract investors and expand to a break-even position.

5. *Plan for the costs of technical support, onsite development and research*

Mission lending requires more time and money than conventional lending.

Matching the right kind of social finance instrument to each initiative is key. With limited instruments available, Ecotrust Canada's loan fund was frequently called upon to fulfil functions not well suited to its size and scope, including R&D ventures and start-ups.

The organization addressed some of these needs by developing, within the charity, in-house technical and sectoral expertise; and it developed external partnerships to address others. Over time, this improved some business proposals to the point that they were able to access conventional financing.

PHOTOS / Loan fund clients

top left: Cumberland Wood, Lagoon Island Mariculture, and PCFCC

right: Tofino Bus and Atleo Air

6. *Reduce risk and enhance mission impact through co-investment*

It is clear that transitioning to more conventional forms of capital is enhanced by early stage investment and/or by partnered investment structured to mitigate risk.

The option of 'stacking' several types of financial support increases the likelihood that more conventional financing will find a deal attractive because risk has been mitigated. Ecotrust Canada has several examples where they used their own loan fund in this way, holding a less well secured position in a multi-party deal; or lending pari passu (equally) with other bankers; or by organizing grants to cover soft costs which can then be recognized as equity in a larger loan agreement. The CLF also frequently provided early stage financing coupled with technical support for two to three years and then transitioned clients to conventional financing once the business was more established.

7. *Integrate cultures of community development, sector expertise, communications and finance*

The model of internally integrating the expertise and approach of community development practitioners, industry sector experts and bankers may be Ecotrust Canada's single biggest innovative contribution in the field of social finance.

Ecotrust Canada has often 'married' its programming and its lending to create and/or support business endeavours to the stage where they can attract new financing. These living examples have helped clarify to the social sector the true value of a combined charity/lending model—where philanthropic investment is used to support innovation and lending is used to support business launch.

Combining the tools of planning, on-site technical support, industry sector expertise, direct business lending and partnerships with commercial sources of finance, has defined Ecotrust Canada's approach and created some excellent examples of what is possible. This said, knowledge of social finance failed, over time, to permeate equally across all parts of the organization and became increasingly segregated inside the CLF staff. In order to achieve deep integration across the organization, from programming through to lending, ongoing financial literacy training and selective hiring must remain a priority.

Conclusion /

The challenge of accessing capital for social good is as much centered on the incapacity of innovators and social entrepreneurs to communicate their needs and opportunities in a language that investors can understand, as it is the limitations of capital, including social capital, to understand and gauge the merits of innovation and the value of risk. Ecotrust Canada is well positioned to assist entrepreneurs to structure projects in a capital-friendly way, and to assist social capital providers that lack sectoral expertise, local knowledge and a 'foot on the ground' to assess opportunities worthy of investment. In the world of CLF-type funds, there is an urgent need to build the right incentives, and to determine the level of support required given mission risk, mission impact and desired outcomes.

Closely tied to this is the question of defining mission risk and impact metrics, developing benchmark measures of operating efficiency and identifying the most efficient support instruments. Numbers need to be supplemented with narrative, with longitudinal results tracking, and with detailed impact analysis; and success stories must be developed to maintain investor interest and maximize the impact of demonstration.

Published May 2011

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