

# Equity of Opportunity Fund

A fund of searchers that provides capital and resources to grow durable businesses and provide good jobs in urban, low-income communities of the U.S.

## Challenge

Prosperity in the U.S. is not available to all. Economic growth of the last decade has been driven by one-fifth of U.S. zip codes. The most distressed places – defined in part by percentage of people living below the poverty line – have seen zero net gains in employment or business creation. While prosperous cities continue to attract investment and talent, financial capital and human capital are disinvested from distressed communities, home to 52 million Americans. The effects of this distribution are extreme and proven: poorer health outcomes, higher mortality rates, and strains on government assistance.

“Too many communities in our great nation feel passed over by economic growth and forgotten by our political leaders. We need a new formula for the public and private sectors to work together to generate new investments, new businesses, and new good paying jobs in places that have fallen behind.”

– Former U.S. Ambassador to the U.N.

## Opportunity

In 2018, there is a window of opportunity for private and public sectors to work together to stimulate employment and economic wellbeing in the urban subset of America’s low-income communities, ranging from Dorchester, Massachusetts to Stockton, California. The opportunity exists at the nexus of three observations.

First, established small businesses (fewer than 500 employees) are well positioned to build prosperity in America’s urban distressed communities. Small businesses have created 62% of net new private sector jobs over the last 25 years. Further, small businesses are a source of pride and identity for many communities, and they contribute directly to the local tax base.

Second, public and social sector stakeholders are ready to support small businesses. Policymakers have approved substantial tax incentives for place-based investments in low income communities through the Tax Cuts and Jobs Act of 2017. Anchor institutions, like hospitals and colleges, have untapped capital and are willing to deploy it creatively, especially when paired with local non-profit programming.

Finally, the search fund model provides a *direct* way to impact a small business and its community, but has not yet been leveraged by the impact investing community. A search fund is an investment vehicle that allows individuals to search for, acquire, manage, and grow a company. Funded “searchers” identify a healthy businesses to acquire:

- \$750k to \$1.5M EBITDA, valued at 3-5x
- Owner(s) seeking exit, often due to retirement or family transitions
- Low asset-intensity but high-employment generation
- Recurring revenues in niche sector, e.g. health services, restaurant payment software, pest control, equipment inspection, etc.

Traditional search funds are structured for a single searcher to acquire a single business, but investment efficiencies are possible for a *fund of searchers* to aggregate fundraising, diligence support, and operations principles across multiple searchers and acquisitions. This approach fits in with the Omidyar Network’s efforts to build a strong and diverse impact investing ecosystem.

## Solution

The Equity of Opportunity Fund (“the Fund”) hires experienced managers (“searchers”) to identify, acquire, and operate businesses in low income, urban communities for 7 to 10 years followed by exit. Traditional impact investors and local anchor institutes contribute capital while community partners provide programming support.

The Fund guides the investment process and supports searchers and portfolio companies in three key ways. These pillars lead to strong returns and direct benefits for employees, communities, and aligned investors.

## Key Pillars of the Fund

### 1 Incentive of Place

The Fund makes targeted investments in urban, low-income communities that are classified as “Opportunity Zones” by the IRS as outlined in The Tax Cuts and Jobs Act of 2017. Investors can temporarily defer taxes on their capital gains by reinvesting them into the Equity of Opportunity Fund. If the underlying investment is held for more than ten years, the capital gains from the sale or exchange of an Opportunity Fund can be permanently excluded from taxable income. Additionally, the Fund’s focus on distressed communities takes advantage of a perception arbitrage, whereby traditional investors perceive fewer opportunities than is reality. Underinvestment from traditional investors minimizes acquisition pricing inflation common with other investment strategies.

There are over \$2T in unrealized capital gains waiting to be invested through this strategy in over 81,000 small, transitioning businesses in Opportunity Zones. Plus, organizations like Kresge Foundation and the Ford Foundation have urban, equitable development priorities.

### Transitioning Small Business Example

Near Dallas, TX, a number of communities suffer from high poverty. Citywide Services was founded in one such community in 1968 and is the leading provider of commercial window washing services. The family business employs 50 people, many Veterans. The business has \$10M in sales, with opportunity to improve operations and expand regionally. The owners are keen to retire but have no succession plan.

### 2 Investment in People

People are a key pillar of the Fund’s investment strategy. Over the life of the Fund, the management team selects ten searchers based on criteria that balances competence and care. Searchers receive semi-annual training and access to network resources to implement a “Good Jobs Toolkit” that supports operational excellence and improved employment practices in portfolio companies. Additionally, the Fund cultivates a community network of government partners, anchor institutions, and non-profits who can support the inclusionary investment process in each of the target geographic clusters.

### Indicative Searcher

- 12+ years experience
- Transitioning milestone, e.g. career pivot
- Demonstrated operational and managerial competence
- Shared vision for business-community compact

### Sample Community Network in Dorchester, MA

- Community Investment Collaborative
- MIT Good Jobs Institute
- Boston Ujima Project
- Economic Development Corporation

### 3 Inclusionary Process

The Fund’s centralized Technical Assistance function collaborates with community networks and provides searchers access to proprietary resources that bring the impact thesis to life at each stage of the investment process.

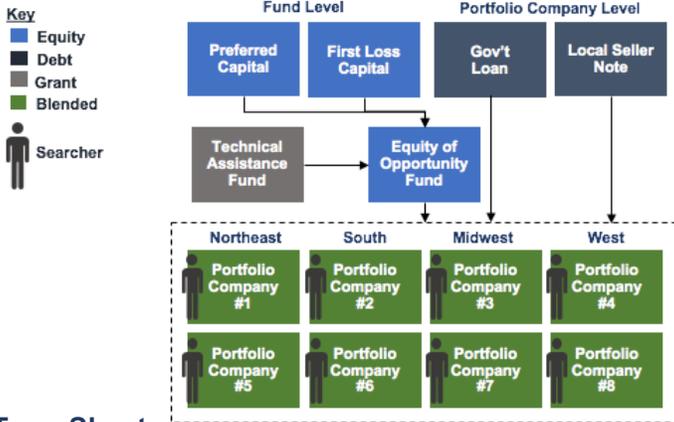
| Stage             | Sample resources   |
|-------------------|--|
| <b>Sourcing</b>   | Deal flow from cultivated community networks   |
| <b>Financing</b>  | Debt with guarantees from government partners, e.g. Small Business Administration, and favorable notes from sellers, integrated with fund’s equity |
| <b>Operations</b> | Grants and/or technical assistance from community networks to support feasibility studies or implementation of “Good Jobs Toolkit”                 |
| <b>Exit</b>       | Introductions to aligned mid-market funds  |

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## Fund Structure

The Fund innovates on the traditional search-PE model by integrating social mission, aggregating multiple searchers, unlocking untapped sources of capital, and developing a centralized support function that enables the place-based, people-first strategy.



## Term Sheet

|                      |   |
|----------------------|---|
| Fund Structure       | Fund of searchers (private equity)  |
| Fund Term            | 10 years (up to 3 optional 1-yr extensions)   |
| Target Fund Size     | \$16.6M (investment minimum = \$1M)   |
| Avg. Investment Size | \$2.08M   |
| Target Geography     | Urban US opportunity zones  |
| Target Investors     | Foundations, family offices, and anchor inst.   |
| Target Leverage      | 50% D/V ratio<br>(25% = gov't loan, 25% local seller note)  |
| Target IRR           | 24% (net management fees)   |
| Fee Structure        | 2% annual management fee<br>30% carry (20% to searcher, 10% to GP)<br>7% preferred return with catch-up for searcher & GP |

## Key Assumptions

### Fund Level

- 10 recruited searchers
- \$120k/yr salary
- \$50k/yr travel and broken deal costs per searcher
- 80% of searchers acquire
- 1.5 yrs average search length
- \$200k/yr salary per Fund FTE (2) and \$50k/yr Fund expenses covered by management fee
- Additional FTE covered by grant-funded Tech. Assistance Fund

### Portfolio Company Level

#### At time of acquisition:

- \$5M average annual revenue
- 20% EBITDA margin
- Acquire at 4x EBITDA multiple
- \$150k deal costs

#### Operating scenarios:

- Annual revenue growth: -5%, 10%, 20%
- Annual EBITDA margin expansion: 0%, 0.25%, 0.5%
- Exit EBITDA multiple: 3.5, 4, 5

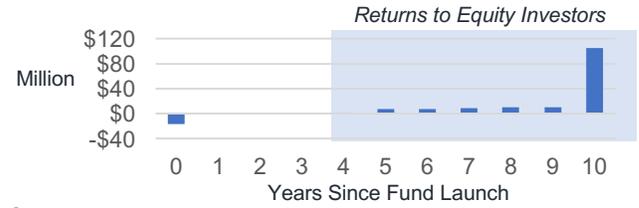
## Capital Stack & Returns

Debt is raised from partners at the acquisition-level. Equity is distributed from the Fund. Grant supports development of centralized function to execute the fund pillars for maximum impact and scale.

| Type                | USD M  | Financing Org.               | Return               | Net IRR |
|---------------------|--------|------------------------------|----------------------|---------|
| Senior Notes        | \$8.3  | Government                   | 6%                   | -       |
| Junior Notes        | \$8.3  | Company sellers              | 8%                   | -       |
| Preferred Equity    | \$15.4 | Foundations and family funds | 7% + 70% carry       | 24%     |
| First Loss Equity   | \$1.0  | Anchor institutions          | 5% capped            | 5%      |
| Common Equity       | \$0.2  | GP                           | Catch-up + 10% carry | 10%     |
| Tech. Assist. Grant | \$3.0  | Foundation                   | None                 | -       |

## Equity Cash Flow

The simplified, base case below represents the cash flow available to equity holders after company-level debt repayment, across eight acquisitions, for distribution according to the fund capital structure.



## Impact

Impact measurement relies on assessments of the following outputs through annual surveys to companies, employees, and community partners at the fund (\*) and portfolio company (\*\*) levels.

| Output                  | Target      | Towards Outcomes      |
|-------------------------|-------------|-----------------------|
| Jobs*                   | 1.2 – 2.0k  | Improved Livelihoods  |
| Wage Growth**           | 0 – 20%     |                       |
| Minimum Wage Multiple** | 2.0         | Empowered Employees   |
| Training Hours*         | 19.2 – 32k  |                       |
| Employee Satisfaction** | Qualitative | Durable Businesses    |
| Sales Growth**          | 0 – 20%     |                       |
| EBITDA Expansion**      | 0 – 0.5%    | Resilient Communities |
| “Good Jobs” Roadmap**   | Qualitative |                       |
| New Investment Capital* | 10M         |                       |
| Partners Engaged*       | Qualitative |                       |

## Scalability

The Fund will scale in three ways: (1) Concentrate investment in four geographic clusters to develop strong relationships with place-based investors who can invest in a second, larger fund, (2) Actively share knowledge iteratively to inspire growth and collaboration as the pioneer of the impact search fund field, and (3) Communicate successes to position the Fund as a go-to vehicle for Opportunity Zone investment across the nation, as state governments assess implementation paths.

## Risk Assessment

| Risks   | Mitigation   |
|---|--|
| <b>Incentive of Place</b>   |  |
| <ul style="list-style-type: none"> <li>• Implementation uncertainty of Jobs Act</li> <li>• Availability of deal flow in target communities</li> </ul>                 | <ul style="list-style-type: none"> <li>• Model financial returns without Opportunity Zone tax incentives</li> <li>• Select target communities based on population and business density</li> </ul>            |
| <b>Investment in People</b>   |  |
| <ul style="list-style-type: none"> <li>• Recruitment of committed and aligned searchers</li> <li>• Implementation of Good Jobs Toolkit</li> </ul>                     | <ul style="list-style-type: none"> <li>• Align searcher incentives (carry) and select best Opportunity Zones</li> <li>• Include operational experts, not just investors, as advisors</li> </ul>              |
| <b>Inclusionary Process</b>   |  |
| <ul style="list-style-type: none"> <li>• Management of acquired companies by searchers</li> <li>• Varying motives between community partners and investors</li> </ul> | <ul style="list-style-type: none"> <li>• Secure favorable advisory period from seller after acquisition</li> <li>• Build formal feedback loops for community partners and Fund to balance motives</li> </ul> |

## Sources & Appreciations

Sources: Economic Innovation Group, Bureau of Labor Statistics, Small Business Administration, U.S. Department of the Treasury, Richard Ruback & Royce Yudkoff (HBS), Stanford Search Primer (2016), Boston Small Business Plan; Appreciations: Luke Seidl (Veris Wealth Partners), Pete Joubert (CrossBoundary Energy)