



# REPORT

**DATE:** For the Agenda of December 13, 2002 **Item 105**

**REPORT NO.:** HCR02-100

**SUBJECT:** San Diego Capital Collaborative Feasibility Study (Citywide)

## SUMMARY

**Issue:** Should the Housing Commission accept the completed feasibility study that recommends the establishment of the San Diego Capital Collaborative, a for-profit family of funds governed by a non-profit umbrella organization?

**Recommendation:** That the Board accept the feasibility study (Executive Summary provided in attachment) on the San Diego Capital Collaborative, that will be formed to provide equity capital for funding affordable housing projects.

## BACKGROUND

The Reinvestment Task Force (RTF) is a quasi-public agency established by a City and County of San Diego joint resolution in 1977. The RTF's purpose is to monitor and impact banking practices in the region in concert with the federal Community Reinvestment Act (CRA) and to develop strategies for reinvestment. It has a successful record of creating lending intermediaries for small business credit needs. In addition, it has assisted in the formation of numerous Community Development Corporations that do job development and affordable housing development. In recent years it was the lead agency to establish the first Community Development Financial Institution in the country totally funded by lender investments. The RTF is charged by the City and County to link private/public and community strategies to benefit low-income communities throughout the region.

The RTF is overseen by a committee that is co-chaired by a San Diego City Councilperson and a member of the Board of Supervisors, and it includes five lender representatives, five non-profit organizations, and representatives from three cities in the County. The RTF encourages lenders to use CRA to support the following needs: home purchase loans in low-income communities, construction and long-term financing for affordable housing



construction, access to small business credit in low-income neighborhoods, community development investments for area lending intermediaries, and access to grant funds from lenders for area non-profits involved in housing and economic development. In 2001 this activity generated \$1.932 billion in reinvestment throughout the County.

The Comprehensive Credit Needs Assessment study produced by the RTF in October of 1999 identified an unmet equity capital need. In May 2001, as part of the business plan, the RTF proposed to evaluate the feasibility of establishing an equity capital fund for San Diego. From May of 2001 through September of 2002 the RTF received funding from the County, City, Washington Mutual Bank, Wells Fargo Bank, Bank of America, California Federal Bank, San Diego National Bank, and Fannie Mae totaling \$165,000, to develop a work program for an experienced consultant. An Advisory Committee was established to oversee the process and to advertise, interview and recommend a candidate to the RTF and the Housing Commission.

Economic Innovation International and its local San Diego partner, Economic Research Associates, were hired and a contract was executed in July of 2002. Economic Innovation International is a management-consulting firm specializing in strategic economic action in this country and overseas. Over the past 32 years, the firm has created more than \$50 billion of privately capitalized development funds to accomplish public purposes in North America, Europe, and the Pacific Rim. In thirty-seven States and eleven countries, Economic Innovation has invested in market-driven, performance-based development funds to create measurable wealth and high-quality jobs for residents of low and moderate-income neighborhoods. The RTF Advisory Committee reviewed a draft feasibility study on September 17, 2002. Revisions were suggested and have been appropriately incorporated into the final document. The full RTF reviewed and endorsed the report and directed RTF staff to establish the not-for-profit umbrella corporation, the San Diego Capital Collaborative.

## **DISCUSSION**

The document being presented to the Housing Commission recommends that the RTF proceed with the development of a "Smart Growth" Fund and also recommends establishment of the "Mezzanine Fund" in partnership with Neighborhood National Bank and the Certified Development Corporation. "Mezzanine" is a fixed rate subordinated expansion capital loan with some form of equity component. These flexible instruments may involve warrants, coupon rates, exercise price, and other means of convertibility. The Smart Growth Fund will invest equity in commercial, industrial and mixed-income housing and workforce housing, and focus on mixed-use projects that can be made commercially viable, but are not yet sufficiently attractive to private developers and investors to benefit low and moderate-income populations. The Mezzanine Fund will provide an appropriate form of high-risk finance or subordinated debt with near-equity features to growing small

firms that need access to higher risk capital than commercial banks can provide, but are not yet growing fast enough to be able to employ venture capital profitably.

Phase I in the development of the San Diego Capital “Collaborative” has three principal elements:

- 1) Establish the overall fund development strategy for the Collaborative. This strategy will govern the evolution of the Collaborative as it builds a San Diego family of funds throughout the first decade of the 21<sup>st</sup> century.
- 2) Design a strong, self-sufficient umbrella organization that has the capacity to:
  - ❑ create the Smart Growth Fund and the Mezzanine Fund, the first for mixed-use commercial, industrial and mixed-income housing development (including support for public, not-for-profit and related uses and amenities appropriate for sustainable mixed use development), and the second for small business finance;
  - ❑ assist and oversee implementation of the two funds , and
  - ❑ monitor and report on the success of the funds in producing measurable outcomes with regard to the “three *Es*” of sustainable economic development—*Economic* returns, *Social Equity* returns and measurable *Environmental* returns. These translate as (1) financial returns to investors, (2) job and wealth creation for low and moderate income residents of target neighborhoods, and (3) measurable contributions to a self-sustaining environment. Together, these three sets of measurable returns are referred to as the “triple bottom line” returns.
- 3) Assess the market for the first fund.

Economic Innovation International will draw on their experience with the three preceding California Regional Families of Funds to build a financially self-sufficient, not-for-profit San Diego Capital Collaborative.

The proposed fund development strategy for the Collaborative is based on a 60-day initial review that included the RTF, its Advisory Committee and over 40 interviews with key investors; for-profit and not-for-profit developers; public sector, neighborhood and other community stakeholders. This review led to the recommendation of the Smart Growth Fund as the first fund (keystone) of the Collaborative.

The compelling market conditions and policy initiatives that lead Economic Innovation International to make this recommendation include acute market needs throughout the County for (1) new, improved and rehabilitated housing at all income levels to reduce, rather than increase sprawl; (2) new policy initiatives for smart growth, transportation investment, affordable and inclusionary

housing; and (3) unique resources within the banking and foundation communities that create special opportunities for smart growth in the San Diego political economy.

### **Smart Growth Fund**

The study proposes a Smart Growth Fund of both for-profit and below market not-for-profit and public sector resources as an integrated group. This will create a properly structured and closely connected not-for-profit and for-profit management capable of one stop financing for mixed-use development and mixed-income housing. Recent policy initiatives in the San Diego region remove barriers to smart growth, and encourage affordable housing in all neighborhoods of the City, thus creating a more attractive market for the success of the Smart Growth Fund. Some of the drivers for smart growth in the region include; transportation corridors, major employment centers, decommissioned military bases and California designated Enterprise Zones.

These drivers present the potential for further smart growth development in the region. Moreover, the long-term practice of impact fees in the San Diego region encourages smart growth development. This fund will place a premium on choosing a fund management team with extensive experience financing commercial, industrial and mixed-income housing to employ both market and below market financial and management resources.

The steps to implement the Smart Growth Fund include: establishing the management and legal structure of the not-for-profit umbrella corporation, the San Diego Capital Collaborative, as Special Member; identifying a proven fund management team; identifying potential investors; and closing the Fund.

### **Mezzanine Fund**

The study also proposes financing of the Mezzanine Fund to address the needs of growing small companies as identified in the 1999 Credit Needs Assessment. This will be the fund in the Small Business Finance section of the San Diego Capital Collaborative. Additional components of the Small Business Finance are also suggested, including an expansion or evolution of Emerging Technologies Loan Fund, which is overseen by the City of San Diego Economic Development Division, and models to expand technology and biotech companies from North County to lower cost neighborhoods of the City and South County.

The internal rate of return (IRR) history of smart growth funds and business equity funds targeted to low and moderate income urban emerging markets is nearly three decades old. One of the oldest of these, the Massachusetts Capital Resource Company, has consistently produced high teens to low twenties returns since its founding in 1977, even though sixty percent of the \$500 million capital invested has been targeted to disadvantaged areas. The specific models upon which the Mezzanine Fund will be based have produced similar returns. The privately capitalized smart growth funds in

California are only five years old. Returns to date have substantially exceeded the expected mid to high teens outlined in prospecti to investors. Most historic workforce and affordable housing fund experience is substantially lower because of the high added cost (seven to ten percent) in the lost time and effort dealing with requirements of federal housing tax credits and the required fifteen year holding time.

The market assessment concludes there is more than sufficient deal flow to support a \$25-\$40 million for-profit San Diego Smart Growth Fund. It is this level of potential deal flow that will attract a proven fund manager who will, in turn, attract investors committed to the San Diego Smart Growth Fund. Thirty years of experience confirm that development funds like this often operate best in “contrarian” markets. Times of market contraction often create the best development opportunities and private funds created for a public purpose are often unique in their capacity to appreciate in contrarian markets. Local governments will benefit from the San Diego Smart Growth Fund by creating a new source of equity capital for low-income communities. This funding will allow low-income areas to revitalize.

Special efforts will be made to recruit and select a fund management team with a proven capacity to (1) operate in commercial, industrial and mixed income housing markets in low and moderate income areas; (2) work with market and below market resources; and (3) work well with the Collaborative to ensure that key smart growth developments contribute to a changing development paradigm in San Diego.

Other potential funds and tasks for the Capital Collaborative after the two keystone funds are in operation include formalizing a relationship with the existing California Environmental Redevelopment Fund as a part of the Smart Growth Fund.

Respectfully submitted,

Approved by,

Jim Bliesner  
Reinvestment Director

Elizabeth C. Morris  
Chief Executive Officer

**Signature on File  
with Original Document**

Attachment: Executive Summary

Distribution of the full report is limited due to its length. A copy is available for review at the Housing Commission’s 1625 Newton Avenue office and the Office of the City Clerk, 2<sup>nd</sup> floor, 202 “C” Street. You may also request a copy of the report by calling 858-694-8729.