THE KRESGE FOUNDATION

TESTIMONY BEFORE THE SMALL BUSINESS SUBCOMMITTEE ON ECONOMIC GROWTH, TAX, AND CAPITAL ACCESS

OF THE UNITED STATES CONGRESS

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Introduction

Chairwoman Velázquez, Ranking Member Chabot, and members of the Committee:

Thank you for the invitation to discuss how Opportunity Zones can address concerns in the small business economy. As you know, one of the fundamental goals of this incentive is to address disparities in access to capital for small- and medium-sized businesses located in low income communities. The Kresge Foundation's mission to expand opportunities in American cities with a focus in low-income communities strongly aligns with this goal.

In my role, I lead our nationally-focused Social Investment Practice, managing an impact investing portfolio of nearly $350 million and more than 80 transactions. Our role at Kresge is to examine why traditional forms of capital do not reach the people and communities that need it most and to create innovative financing tools that breakdown those capital barriers – all in the hopes that along the way, we unlock new sources of funding that expand opportunity.

As a charitable, private foundation, we are not subject to capital gains tax and therefore not an eligible investor for Opportunity Zone tax benefits. We raise no third-party capital, provide no for-profit consulting, accept no fees for speaking engagements, and otherwise have no economic stake in Opportunity Funds beyond what I will describe below. Our sole interest in the Opportunity Zone legislation is ensuring that, overall, this tax incentive provides meaningful benefit to the people and communities we serve.

At Kresge, we remain hopeful that this new incentive has the power to bring untold volumes of capital to disinvested communities across the country. However, we also remain deeply concerned about the trajectory of this industry and the complete lack of transparency and accountability in this newly formed market, which could inadvertently exacerbate growing economic inequality across the country.

Background on Kresge

The Kresge Foundation was founded in 1924 to promote human progress. Today, Kresge fulfills that mission by building and strengthening pathways to opportunity for low-income people in America's cities, seeking to dismantle structural and systemic barriers to equality and justice. Using a full array of grant, loan, and other investment tools, Kresge makes grants and investments of around $150 million annually to foster economic and social change.

Central to our work is the ability to draw on an array of versatile, flexible grantmaking and social investing tools. Kresge awards operating support, project and planning grants to advance the strategic objectives of its six programs. Our Social Investment Practice works across Kresge's six programs to complement grantmaking with loans, deposits, equity investments and guarantees. These funds often address funding barriers, draw other investors to the project and make capital available in otherwise disinvested communities. Typical projects include investments in health care technology, affordable housing, social service providers, Community Development Financial Institutions, social impact bonds, and real estate to advance economic development.

Kresge's engagement with Opportunity Zones

In June 2018, we partnered with the Rockefeller Foundation to release a request for letters of inquiry (LOIs) for managers establishing new Opportunity Funds. Kresge's initial purpose in issuing this LOI was to learn more about how potential managers planned to raise and deploy capital in designated Opportunity Zones. We sought potential partnerships with emerging fund managers who were seeking to deploy capital in a manner that aligned with our individual program goals and that furthered the stated goal of the Investing in Opportunity Act (the "IIOA") — reducing economic inequality.

Unlike other tax incentives designed to incentivize investment in low-income communities, the IIOA, as passed, did not include a provision for long-term impact reporting – an element we saw as necessary and important. Kresge, therefore, sought partnerships with not only mission-aligned fund managers, but also those who were willing to publicly evaluate the impact of investments over time.

We believed that in the early days of any new market there is an opportunity to define market norms, what products will come forward, and who they will benefit. We believed private philanthropy was in a unique position to help define this new market as one that not only delivers returns to investors but also creates, and does not extract, value from low-income communities. We received 141 official responses, many more than we expected.

There was a broad diversity among the submissions. Some were organizations we've worked with that would be expected to participate in community development programs of significance. But perhaps more strikingly, we saw responses from entities less familiar to us including large corporate banks, small rural communities, insurance companies and everything in between. Given that large sample, we gleaned a few early take-aways:

1. **Uncertainty about Who Will Invest**: Few managers were able to paint a clear picture of exactly who the actual investors will be, what they'll be looking for as they consider funds, and what they will expect in terms of return.

2. **Uneven Regional Representation:** Although the applicants came from a wide swath of the country, there was a predictable clumping. Lots from coastal cities and urban centers. Few from the deep South or Appalachia. Interestingly, there was a high level of interest from the Southwest.

3. **Real Estate is King:** It was no surprise that most aspiring managers focused on real estate. On one hand, this is not a bad thing – most of the communities in Opportunity Zones need this type of development. However, this was not the fundamental intent of the legislation, which placed high emphasis on financing for operating businesses, venture, and private equity.

4. **Measurement is Murky**: The request for inquiries placed an emphasis on managers articulating how their funds would benefit communities and how they will know whether they've met their mark. Yet the responses contained precious little of this kind of impact analysis and metrics; more often, the managers focused on readily quantifiable outputs, such as units of affordable housing produced, or jobs created.

5. **No Clear Exit:** Managers had few theories about how or when they expect investors to exit funds. This was particularly pronounced for those seeking to invest in small- to medium-sized business. These businesses are chronically illiquid and fund managers were unable to identify scalable solutions to provide an exit to opportunity fund managers.

The Opportunity Fund Incubator

Another significant takeaway from the LOI process was how many emerging fund managers lacked the capacity to even raise a fund. Most of these organizations were strong mission-driven actors steeped in their communities, but which lacked the technical know-how to raise, deploy, and manage a private equity fund. In response, we partnered with Calvert Impact Capital to create the Opportunity Zone Incubator, which provides support and technical advisory services to mission-driven managers seeking to build and launch Qualified Opportunity Funds. Through this partnership, we provided the following services to new Opportunity Fund managers:

1. Identify and build their investment strategy based on the demand in their communities;
2. Determine the feasibility of a mission-driven, marketable Qualified Opportunity Fund;
3. Develop the appropriate fund structure that is responsive to the market demand and fits the requirements of the Opportunity Zone legislation and regulations;
4. Draft the fund's main documents, including a term sheet and offering memorandum;

5. Model the economics of the strategy at the project and fund level to understand the terms and investment profile; and
6. Develop an investor outreach strategy and gather initial feedback from the relevant investor community.

Of the five mission-aligned funds we supported through the Incubator, one is launching its fundraising now and will exit the incubator successfully.

Guarantee Support for Fund Managers

While pleased with the Incubator, we remained concerned that the Opportunity Zone marketplace would be dominated by large, private or institutional fund managers managing hundreds of millions or billions of dollars in capital with no commitment to impact, transparency, or accountability. In the absence of a federal mandate, we acted to incentivize early movers in the space to voluntarily adopt best practices more likely to lead to positive social outcomes.

We partnered with two established private equity fund managers, Community Capital Management and Arctaris to provide a total of $22 million in balance sheet guarantees to their new Opportunity Funds. In exchange, they committed to adopting certain fund-level commitments around transparency, accountability, and impact, all consistent with principles outlined by the U.S. Impact Investing Alliance. We are happy to share those covenants with anyone who is interested; they are posted on our website at Kresge.org. These covenants are largely based on the reporting framework of the New Markets Tax Credit program and are widely accepted by large institutional investors nationally. In addition to serving as a good framework, the collection of these datapoints will also provide Congress and the public with data that can be compared against a dataset generated by a large and well-established program (NMTC) focused largely in the same Census tracts. While by no means conclusive, the ability to compare investments by two Opportunity Fund managers of some scale should provide insight as to how this incentive performs compared to another government program in terms of social impact.

How Opportunity Zones can address the concerns in the Small Business economy

First, it's important to clarify a very common misconception that leads to a flawed understanding of Opportunity Zones. Because the incentive carries many of the hallmarks of traditional community development tools such as the New Markets Tax Credit or the Low-Income Housing Tax Credit, it's tempting to think of it as another government "program." Members of this committee will know it is no such thing. This is a private tax incentive that has created a private marketplace with scant government oversight. There are few restrictions on what this market can invest in, and every investment carries the same innate tax benefits. It is up to the market participants to decide how this market will function. Given that structure, Opportunity Zones certainly can address many of the concerns of the Small Business economy. The more important question is, will the market participants choose to?

To answer that question, it's important to understand the incentives of the three market participants: 1) Investors, 2) Fund Managers, and 3) Business Owners/Developers.

1) For investors, OZ creates a new incentive **to invest capital gains**, in the form of equity, into designated communities for at least five years and with much greater reward for holding for 10 years.
2) For fund managers (in most cases), the typical private equity incentives exist, wherein a fund manager **seeks to maximize investor profit** in the hopes of generating a significant "carried interest" return in the fund.
3) Business Owners/Developers are incentivized to **locate or grow their business** or **significantly improve real estate holdings** in Opportunity Zones and to keep those business holdings for at least five years, with added benefit in holding for 10. In exchange, they seek capital on better terms than what the market would provide (if at all).

Starting from the position of the small business owner in an Opportunity Zone, we can assume they have struggled at some point to access capital to grow their business. Businesses in these census tracts face a chronic barrier to capital. In particular, raising equity for a small business is incredibly challenging, as most small businesses source early equity from "friends and family." For disadvantaged communities and people of color, raising capital from this group of investors is virtually impossible. Opportunity Funds could help incentive new investors to enter this market. However, I remain concerned there is a mismatch between the needs of small business owners and the incentives in place for investors and fund managers. Three primary concerns come to mind.

First, there is the matter of scale. Of the Opportunity Fund managers who have opted to publicly disclose their existence, the vast majority require a minimum investment of $250,000 and are targeting a total raise in the hundreds of millions of dollars. Conversely, if you examine the average size loan for equity substitutes like online lenders or SBA microloans, the vast majority are less than $100,000 per borrower. How you define "small business" is important, but based on the readily available data, I am concerned that most fund managers will seek investments far larger than the capital needs of most small businesses.

Second, there is the issue of liquidity. If we assume an Opportunity Fund manager seeks to invest their fund's capital into a small business in the form of equity, that fund is now a part owner of the small business. The original owner may invest that capital under the agreed upon terms, whether it is to buy new equipment, develop a new product, expand a facility, etc. This could be extremely beneficial to the small business in the short to medium term. However, at the end of the investment period (assume 10 years), if the Opportunity Fund wishes to exit, it's unclear what vehicle would allow that to happen. Hopefully the business has grown substantially — increasing revenues, growing its balance sheet, and hiring more people. At the end of the decade-long period, the business could go to its local bank and seek to take out a loan to pay-off the Opportunity Fund. This is the ideal outcome, but it's not entirely consistent with what we know about small businesses in the U.S. While some businesses start small and grow into large enterprises, the majority remain relatively small. That is due in part to the capital barriers they face. Other businesses do not reach scale because they don't seek to; instead, they fill a niche market, or they are simply out-maneuvered by competition. For these businesses, an equity tool might not be the best solution to their capital challenges and is unlikely to bring real value.

Third, there is the issue of substitution. While investing in small businesses under a venture capital framework (businesses that offer very rapid growth) certainly provides the greatest benefit to Opportunity Zone investors, it also offers the greatest risk. Venture capital is notoriously risky with most investments losing money. Alternatively, real estate, with noted exceptions, has over time provided a very stable long-term rate of return. In addition, because the Opportunity Zone incentive is based on investing in specific geographies, the compliance risk for any investor largely centers around the underlying investment remaining in a designated Census tract for the entire investment period. But operating businesses grow and contract. They hire people, buy new equipment, service customers from multiple states, buy new buildings and merge. From a compliance perspective, real estate investments offer far less compliance risk for an investor at a reasonable return. The Treasury Department has worked to clarify certain regulations that will make it easier to invest in operating businesses. However, real estate will continue to offer a lower risk profile to investors for the foreseeable future. Assuming this, it's unclear why an investor would seek to invest capital in a small business in an Opportunity Zone, absent the rare "unicorn" growth company, when the same tax benefit supports a lower-risk real-estate investment.

Conclusion

There are many excellent organizations working to address the concerns I have brought forward. The U.S. Impact Investing Alliance has proliferated a set of voluntary impact principles for fund managers to adopt. Many CDFIs such as LISC, Enterprise Community Partners, the Community Reinvestment Fund, and Cinnaire are hoping to raise Opportunity Funds focused on both financial return and community impact. There are dozens of for-profit and nonprofit actors trying to approach this work the right way. And of course, for this incentive to be sustainable, investors must make a reasonable return. But the people who live in these places, whose neighborhoods, livelihoods and futures will be most affected by this investment, have every right to expect the very same reasonable social returns in their communities. If Opportunity Zones do not lead to better lives for the people who live in them, then I question the point of this incentive.

This leads me to my final point. It is economic theory bedrock that markets that are not transparent are not efficient. More importantly, they can be dangerous, as we learned from the 2008 financial crisis. We are amid a large-scale social experiment on millions of low-income Americans by highly incentivizing unregulated investments into their communities and prioritizing the appreciation of capital over social impact. Members of the American public will never know where OZ capital comes from, where it is being invested, and who benefited from that investment. Due to the lack of disclosure at both the fund and transaction level, it will be impossible to answer those questions.

We have been here before. When Congress created the Fair Housing Administration and later the mortgage income tax deduction, all data suggested that homeownership and wealth creation grew significantly. It wasn't until Congress passed the Home Mortgage Disclosure Act that we saw the truth — the rampant redlining, discrimination, concentration of poverty, and community erosion created by that well-intentioned incentive. We do not know now, and we will never know, whether or not Opportunity Zones will address the concerns of the small-business community. There will certainly be examples, both positive and negative, of Opportunity Zones doing just that. But without data, we can’t know which example the norm is, and which is the exception. We need real disclosure and not just that attached to the investor tax return, where it is not subject to public disclosure.

To fill that gap — not adequately but as well as we can without real reform — Kresge has supported journalists across the country interested in writing about Opportunity Zones. We funded a nonprofit to create a list-serve of now 95 journalists across the country from every medium, including television, magazines and newspapers. These journalists are sharing stories, sources and data to piece together what is happening across the country in Opportunity Zones. We plan to expand this work through 2020 and will remain a resource to any and all parties who seek to ensure that Opportunity Zones expand opportunities for people across the country.

Thank you for your time and the opportunity to address this committee.