Chantier de l'économie sociale Trust

A UNIQUE PRODUCT FOR THE DEVELOPMENT OF SOCIAL ECONOMY ENTERPRISES

Chantier
de l'économie sociale
trust

Information about financing rates and conditions presented in this document is not meant to replace the Chantier de l'économie sociale Trust's investment policy. This brochure is to be used only as an example to illustrate the impact of Trust financing on a social economy enterprise.

THE CHANTIER DE L'ÉCONOMIE SOCIALE TRUST

The impact of financing on an enterprise

THE KEY TO SUCCESS – APPROPRIATE FINANCING

As is true of any business, social economy enterprises need funds to start up, expand, diversify their activities or modernize their facilities. Different financing strategies and various sources of financing exist to meet these needs: lenders, investors, grants, social capital and internal sources (accumulated surplus). Faced with this range of financing possibilities, how do you choose what is most appropriate for your business? First, you must determine the structure and composition of your business' capital and its ability to meet your financial commitments.

An enterprise in the start-up or expansion phase is necessarily confronted with financing needs that cannot be covered simply by the surplus generated in its regular operations. The enterprise must rely on outside financing. The greater the financial need, the greater the need for negotiated financing.

This is the situation social economy enterprises face throughout their development. Debt financing is not enough; they must have access to funds to support their capitalization, thereby allowing them to develop while limiting the risk on their long-term viability. They need sufficient and affordable capitalization funds to continue developing.

The **Chantier de l'économie sociale Trust** meets the capitalization needs of collective enterprises and gives them the support they need for their expansion, development and start-up projects, in tandem with other available sources of financing.

CHOICE OF CAPITAL STRUCTURE

The money that finances a business is called capital. The capital structure of a business comprises the distribution of the different sources of capital with which it is financed. In Figure 1, we see the financial position of a social economy enterprise. This illustration shows that the enterprise's assets are financed by a capital structure based on three major sources: loans, development capital and owner's equity (an NPO's net assets or a cooperative's equity).

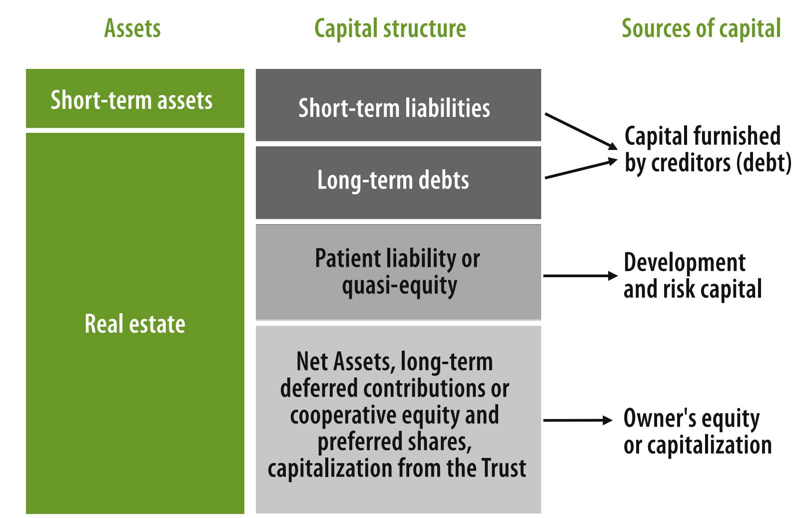

Figure 1: Capital structure of a social economy enterprise

The three types of capital are mainly distinguished by the required security, flexibility of capital repayment, and financial cost.

Credit financing

Capital provided by creditors consists of short-term financing in the form of a line of credit authorized for an enterprise's daily operations (working capital), and supplier credit (accounts receivable). As for long-term debt, this takes the form of term loans and mortgages from a financial institution for the purchase or renovation of a building and other assets (computer and office equipment, office, machinery, etc.). Loan duration is generally from three years (equipment) to as long as 15 years (building). The financial risk for the lender is minimized by a security on the property, which influences the rate of return.

Development capital financing

Development capital, also known as quasi-equity in social economy circles, usually requires no security and involves no specific rights over the enterprise's assets. With quasi-equity, capital repayment is more flexible, with terms ranging from 5 to 7 years. Returns are usually higher than those demanded by a financial institution, since no security is required. This form of capital is offered by the Réseau d'investissement sociale du Québec (RISQ), Filaction, Investissement Québec, CLDs, CDECs, and SADCs.

Owner's equity or capitalization financing

This financing is mainly obtained through the enterprise's accumulated surplus, a cooperative's members (shares held by members and third parties), government bodies (grants), philanthropic investors and donors. Generally no security is required, and with this type of financing there is no obligation to repay the capital in the medium and long term. Sometimes there is a cost to remunerate the investor (dividend or interest).

The more of its own funds an enterprise possesses, the more financial leverage it has to finance its development and growth using the previously mentioned sources of financing.

Thanks to its 15-year repayment moratorium, the financing offered by the Chantier de l'économie sociale Trust is considered as capitalization for the enterprise.

Balancing debt and capitalization

Let's look at the example in Figure 2 of a social economy enterprise with $250,000 in total assets. Its financial structure breaks down as follows: funds from outside sources based on debt (45%), quasi-equity (20%) and owner's equity or capitalization (35%). The enterprise in question is viable with this capital structure, in other words, there are sufficient funds generated to cover its financial commitments.

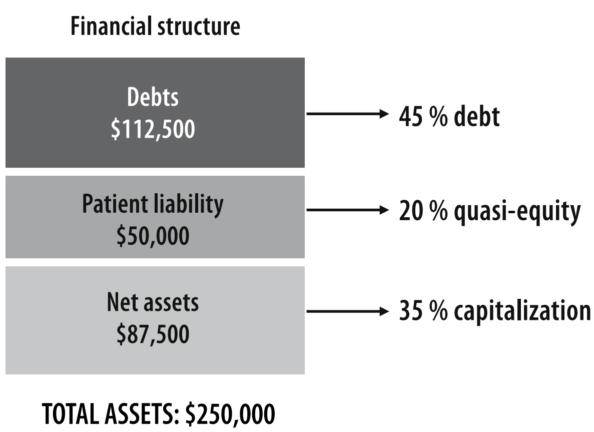

Figure 2 – Example of financial structure before project financing

THE IMPACT OF A FINANCING CHOICE

We will now illustrate the impact on the enterprise's financial structure of $50,000 in additional financing:

- If we add $50,000 of financing to the debt in the form of a term loan, the enterprise's indebtedness ratio rises from 45% to 54%.

- If we add $50,000 of development capital, the quasi-equity ratio is 33% instead of the 20% ratio before financing.

- Last, if the additional financing comes from the **Chantier de l'économie sociale Trust in the form of operations patient capital**, the enterprise's capitalization ratio now represents 46% of its total assets, while its debt now represents only 38% of the total assets. This places the enterprise in a better position to negotiate any additional financing it may need for its growth or operations.

Figure 3 presents the impact on the financial structure of these different financing scenarios and some financing conditions (term and interest rate).

Figure 4 shows the debt servicing cost of the 3 scenarios. It shows the funds the enterprise must generate to repay capital and interest for the first, third and fifth year and accumulated cash expenditures after 7 years and 15 years.

In Figures 3 and 4, taking into account the possible offer, and for purposes of comparison, we used a five-year term loan to illustrate the impact of debt financing with respect to operating fund needs. It must however be noted that, in contrast to the Trust's term, such a short term implies a five-year capitalization/decapitalization cycle that would demand constant fundraising on the part of the enterprise.

As we can see, the cash flow burden throughout the 15 years is lower when the enterprise uses the **financial products of the Chantier de l'économie sociale Trust. This gives the business more financial latitude to handle unanticipated events or expand its development.** On this topic, it should be stressed that during the years following the completion of a start-up or expansion project, the enterprise must exercise careful management of its cash flow and adjust its project parameters to the rude shocks of reality (overestimation of revenue or underestimation of expenditures, contingencies, etc.).

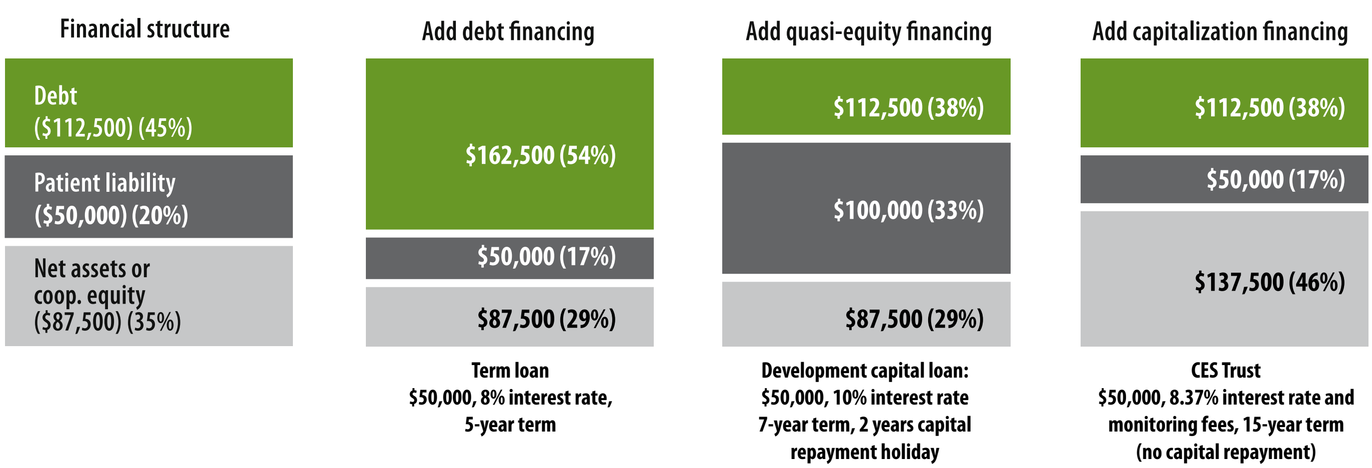

Figure 3 – Impact on financial structure of additional financing of $50,000

Financial structure	Generated funds needed to repay capital and interest			Accumulated expenditures in	
	Year 1	Year 3	Year 5	7 years	15 years
Debt (mortgage)	$12 166	$12 166	$12 166	$60 829	- $
Patient liabilities (development capital)	$5 000	$12 748	$12 748	$48 245	$73 741
Capitalization (CES Trust)	$4 185	$4 185	$4 185	$20 925	$29 295

Figure 4 – Comparative chart showing financing of $50,000 and its impact in terms of cash needs

ADVANTAGES OF THE FIDUCIE DU CHANTIER DE L'ÉCONOMIE SOCIALE TRUST IN THE FINANCING OF A REAL ESTATE PROJECT

More and more social economy enterprises are acquiring real estate infrastructures with a view to constituting collectively owned property. Vacation camps, youth hostels, eco-museums, recreation and community centres, local multiservice centres, cultural infrastructures, and group real-estate (office space) are all examples of property owned collectively by their members. It has been observed that a collectively managed real estate property strengthens social economy enterprises organizationally in terms of their recognition and stability. It is clearly to the advantage of social economy enterprises to own their own premises.

In this section, we want to demonstrate the positive impact on a real estate project of the Chantier de l'économie sociale Trust's real estate patient capital with a 15-year capital repayment holiday.

We take the example of a group of social economy enterprises that wants to acquire an office building. The objectives of this group are twofold: first, to stabilize rental space at the most affordable cost possible, and second, to take advantage of real estate's leveraging power.

Here is a very brief outline of the project's main parameters:

Project parameters	Financial instruments (Financing conditions)
Overall cost: $3.35M Value of building: $2M No. sq. ft. rental space: 30 000 Annual rent indexation: 2.5% Annual indexation of building's value: 2%	**Mortgage loan :** 10% interest rate, repayment of capital and interest over a 10-year term and 15-year amortization period **Chantier de l'économie Sociale Trust :** real estate patient capital 8.37% interest rate and follow-up, 15-year term (with no capital repayment) **Other sources of financing :** grants, other contributions and investments of local funds $1.85M

We will now examine the impact on rental cost of joint financing from the Chantier de l'économie sociale Trust and a mortgage lender. For demonstration purposes, we will analyze only the rent portion, expressed in $ per sq. ft. of rental space, that is directly affected by variations between these two sources of financing. It goes without saying that the total rent cost includes other financing and operational costs.

Here, the mortgage loan and the Chantier de l'économie sociale Trust investment represent $750,000 each, for total financing of $1.5M for the real estate project.

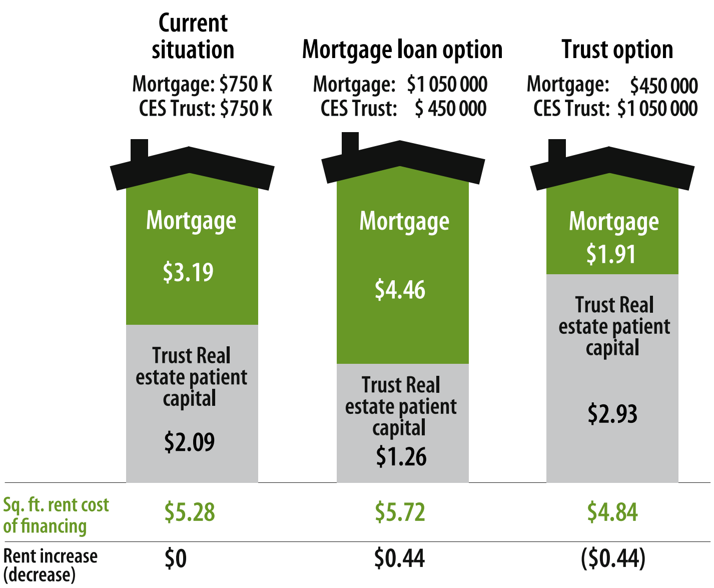

Figure 5 – Three situations

As seen in the first column of Figure 5, a $750,000 mortgage loan generates a cost of $3.19 per square foot of rental space. The same amount, invested by the Chantier de l'économie sociale Trust, generates a $2.09/sq. ft. rental cost, giving a total rental cost of $5.28 per square foot.

The next two columns illustrate the impact of financing on square foot rental cost when $300,000 is transferred to a mortgage loan or to Chantier de l'économie social Trust financing. So, if we increase the mortgage loan by $300,000, the resulting rental increase will be $0.44/sq. ft. compared to the initial premise. However, if we opt to increase the Trust's investment by $300,000, the rental cost will be $4.84/sq. ft., or a reduction of $0.44 compared to the current situation. The Trust option thus meets the group of businesses' objective to stabilize rental space at the most affordable price possible. .

With respect to the second objective, which is to use the leverage obtained through real estate ownership to consolidate its development (through the acquisition of another building or in other ways), a business could want to maximize the mortgage loan in order to repay the borrowed capital as rapidly as possible.

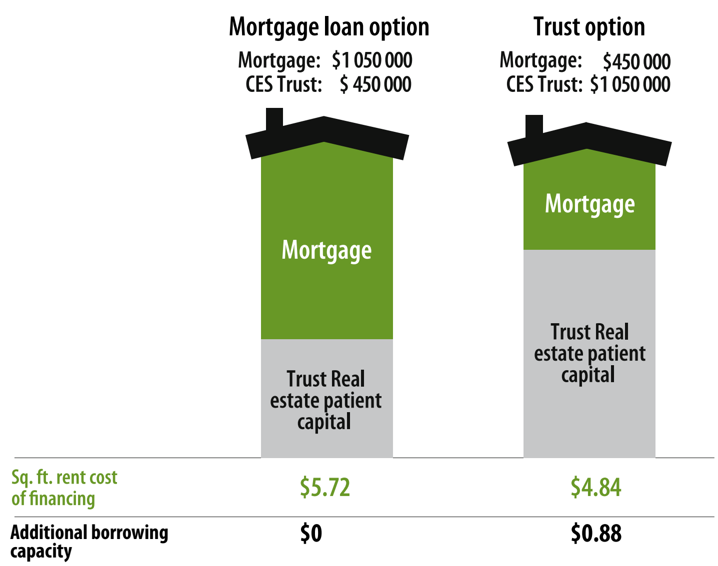

Figure 6 – Maximum borrowing capacity generated

Looking at Figure 6, we see that the total difference between the Trust option and the mortgage loan option is $0.88/ sq. ft. ($5.72 versus $4.84). If users decide to maximize their leveraging power, it is because they have the financial latitude to pay the rental cost ($5.72/sq. ft.). They could pay this rent and opt for the Trust financing. They would then free up $0.88/ sq. ft., or an annual sum of $26,400 ($0.88 x 30,000 sq. ft.). With this sum, it becomes possible to obtain a mortgage loan of $232,000 as early as the second year of operation. On the other hand, opting for the mortgage loan will indeed result in more rapid capital repayment and will create greater equity-based borrowing capacity, but they will have to wait for 10 years before they reach this level (+/- $232,000). It is also important to note that this equity-based borrowing capacity would entail a rent increase (for the current or a future project) to pay for the loan, whereas with the Trust option, the loan cost is integrated into the existing rental price.

As we can see, the **Chantier de l'économie sociale Trust's financial products enable the promoter group to use the building as financial leverage much more rapidly.**

Impact of the Chantier de l'économie sociale Trust on overall interest cost

Lastly, given the characteristics of the products offered by the Chantier de l'économie sociale Trust, you would likely think that the advantages (reduction of self-generated revenue needs to service debt and accelerated leverage power) would translate into much higher total interest costs for the enterprise.

Figure 7 shows that the reverse is true: the advantages are in no way cancelled out by excessive interest expenditures. We see here that with the classic scenario of a 15-year mortgage loan, a $1.5M loan generates annual debt service costs of $191,239 or total interest payments over the period amounting to $1.4 M. Seeking to reduce its debt service burden, a business might wish to extend its repayment period to 20 or even 25 years, but that would necessarily mean an increased interest charge of potentially $2.5M. However, if the enterprise decides to divide its financing equally between a standard mortgage product and a Trust investment (scenario 4), it could obtain the benefit of a debt service cost resembling that of a 25-year loan ($160,479) while actually paying total interest close to that of a 20-year loan. With this scenario, the enterprise meets its twofold objective of lowering annual cash expenditures while keeping interest costs within very acceptable limits. This is true regardless of the loan amount, as seen in Figure 8, where we present the 4 scenarios with a loan of $100,000. Here, we should explain the interest rates used in each of these scenarios. Remember the two basic business financing rules: one, the higher the funder's risk, the higher the return rate; and two, the length of the investment affects the return rate because the longer the term, the higher the funder's risk. For long-term loans, a premium is added to compensate the lender for possible fluctuations in interest rates.

The interest rate of the Chantier de l'économie sociale Trust is fixed for the duration of financing, ensuring repayment stability for enterprises. In the case of a mortgage loan, however, the rate may fluctuate upward or downward in the course of 15 years. In practice, enterprises opt for either a variable or fixed rate for periods lasting from one to five years. No economist can predict exactly what the interest rate will be in 5 or 10 years. The early 1980s saw rates as high as 22%! To offset rate fluctuations throughout the financing period (15 years), we chose an average rate for a 10-year term for the mortgage loan so that the financial products could be compared the basis of a similar risk factor.

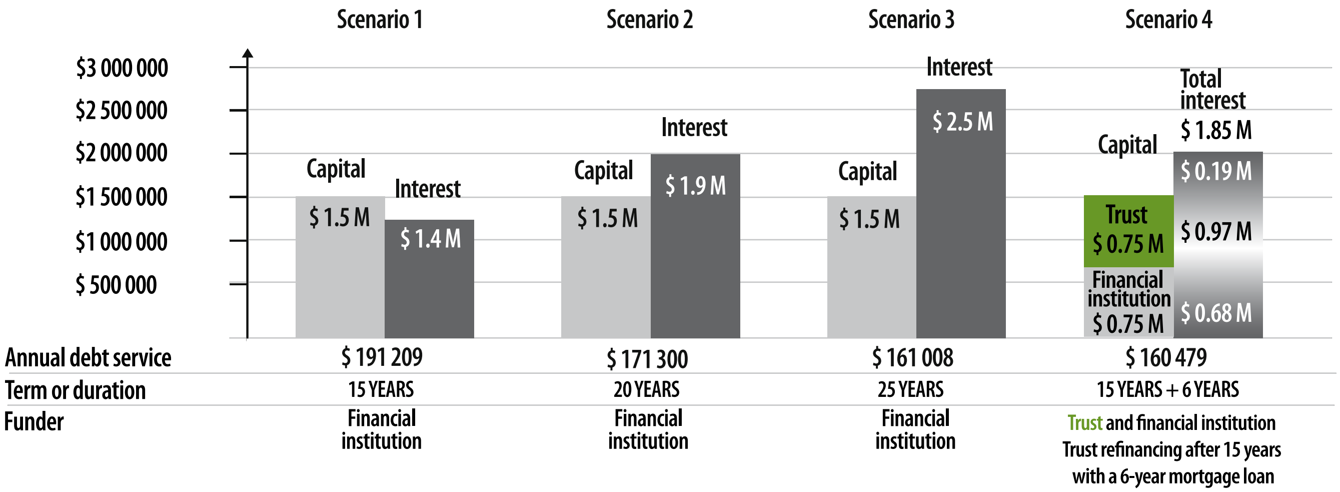

Figure 7 – Four scenarios of $1.5 M financing

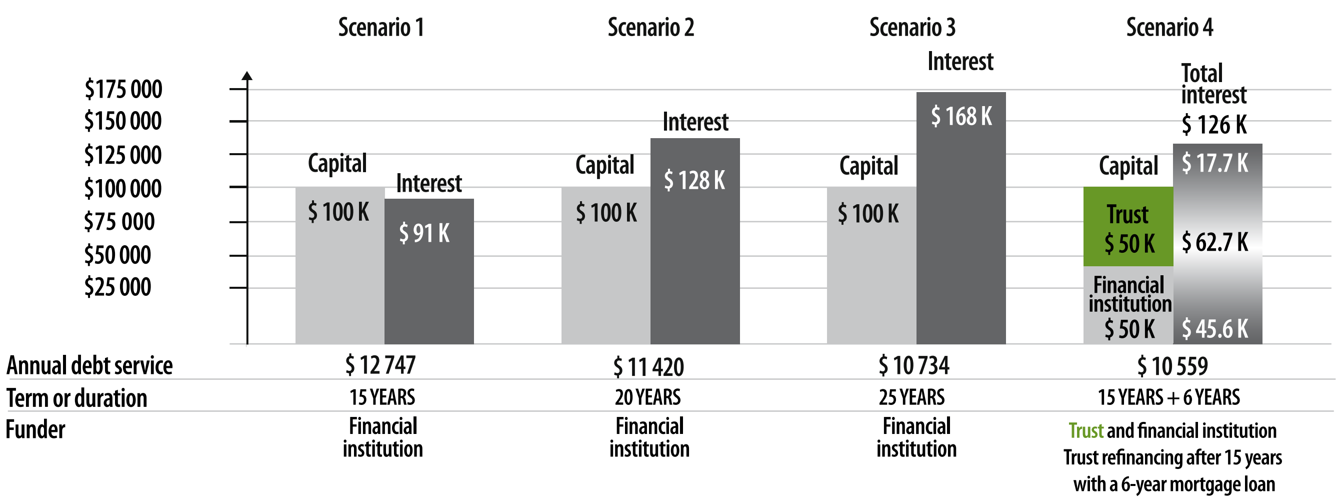

Figure 8 – Four scenarios of $100,000 financing

These are the reasons we believe that the products of the Chantier de l'économie sociale Trust are a very powerful vehicle for the capitalization and development of social economy enterprises.

Développement économique Canada pour les régions du Québec
Canada Economic Development for Quebec Regions

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