Expanding CDFI Coverage in Underserved Areas

Exploring New Models for CDFI Coverage through Formation of New or Affiliated CDFIs

Kerwin Tesdell, Community Development Venture Capital Alliance

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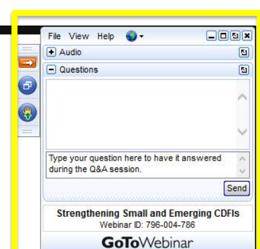
GoToWebinar

CDFI Fund's Capacity Building Initiative

- The Capacity Building Initiative will greatly expand technical assistance and training opportunities for Community Development Financial Institutions (CDFIs) nationwide and significantly boost the ability of CDFIs to deliver financial products and services to underserved communities.
- Industry-wide training will target key issues currently affecting CDFIs and the communities they serve.



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What is the *Expanding CDFI Coverage in Underserved Areas* Initiative?

- The series will provide specialized training and technical assistance to certified and emerging Community Development Financial Institutions (CDFIs) seeking to expand their reach into underserved communities that currently lack a CDFI presence.
- The workshops include content that is applicable to all CDFI organizational structures, including loan funds, credit unions, banks, and venture capital funds.

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3

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4

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Training Partners

COMMUNITY DEVELOPMENT BANKERS ASSOCIATION

Federation
Credit Unions United to Serve the Underserved

CDVCA COMMUNITY DEVELOPMENT VENTURE CAPITAL ALLIANCE

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About the Training Partners

- **Community Development Bankers Association (CDBA)** is a national trade association of the community development bank sector. CDBA is the voice and champion of banks and thrifts with a mission of serving low and moderate income communities.
- **Community Development Venture Capital Alliance (CDVCA)** is a network of community development venture capital funds, which provide equity capital to growth businesses in low-income communities to create good jobs, productive wealth, and entrepreneurial capacity.
- **National Federation of Community Development Credit Unions (NFCDCU)** is a national association for community development credit unions providing capital, advocacy, technical assistance, training to support innovative services for low-income consumers.
- **Opportunity Finance Network (OFN)** is a leading national network of community development financial institutions (CDFIs) investing in opportunities that benefit low-income, low-wealth, and other disadvantaged communities across America.

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Overview

- Factors to consider when creating a new CDFI affiliate or subsidiary
- Not-for-profit and for-profit corporate structures
- Formation strategies
  - Create de novo, acquire, and evolve
- The risk/return spectrum

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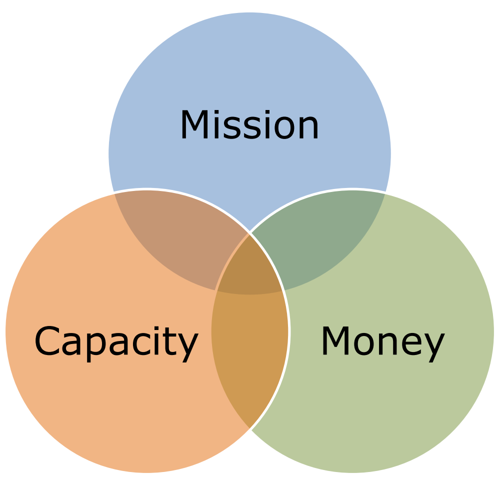
Today's Topic

- Goal: To understand the decisions that need to be made regarding structure, formation strategy, and risk/return spectrum when creating a CDFI affiliate or subsidiary.

- Assumptions are that before pursuing a strategy to create a new entity, the organization has already:
  - Conducted a market analysis
  - Determined that there is unmet need in the market
  - Evaluated that the new products or services will require a new affiliate or entity to address need
  - Explored whether partnership models could serve the need

The Formation Decision



The Decision: Mission

- How does the mission of the sponsoring organization relate to the mission of the new subsidiary or affiliate?
  - Identify needs of your community
  - Clarify current strategy vs. long-term mission
  - Consider phased or all-at-once development
  - Decide impact of corporate form
    - Not-for-profit vs. for-profit
    - Regulatory oversight
  - Consider commitments to funders, lenders, and investors

The Decision: Capacity

- Organizational capacity
  - Identify most important customers and value proposition for expansion
  - Determine leadership capacity required for expansion
    - Board
    - Senior management
    - Staff
  - Explore potential for partnerships, outsourcing, pro bono services

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The Decision: Money

- Identify resources to finance new and expanded activities:
  - Determine funding needs
    - Equity, debt, operational subsidy
  - Develop an effective fundraising strategy
    - Gauge prior and new funders' interest in new activities
    - Determine impact of new activities on new funding for old activities
    - Assess whether new activities complement or compete for funding

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The Decision: Capital Structure

- Capital structure and regulatory issues
  - Match capital structure and risk of new activity
    - Mitigating or segregating risk
    - Creating subsidiaries and affiliates
  - Determine opportunities/risks of associating not-for-profit and for-profit activities
  - Identify impact if different regulatory environment for new activities

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Corporate, Subsidiary, and Affiliate Structures

Subsidiaries and Affiliates

Four types of structures:

- For-profit corporations
- Not-for-profit corporations
- For-profit subsidiaries
- Not-for-profit affiliates

Corporate Structures

- Differences between *for-profit* and *not-for-profit* (501(c)(3)) corporations
- For-profit/not-for-profit decision driven by:
  - Regulatory requirements
  - Return expectations and comfort level of capital providers
  - Signaling to market

Subsidiaries

- For-profit subsidiaries
  - Control relationship
  - Stewardship of mission
  - Opportunity to raise investment capital
  - Ownership and division of profits
  - Segregation of risk
  - Effect on mission
  - Culture clash
  - Effect of regulation for regulated depositories
    - E.g., for banks, make a subsidiary of bank holding company rather than bank.

Affiliates

- Not-for-profit affiliates
  - Control relationship
  - Opportunity to raise grant funding
  - Opportunity to provide subsidized products and services
  - But get a good tax-exempt organizations lawyer!
  - Effect of regulation for regulated depositories

Formation Strategies

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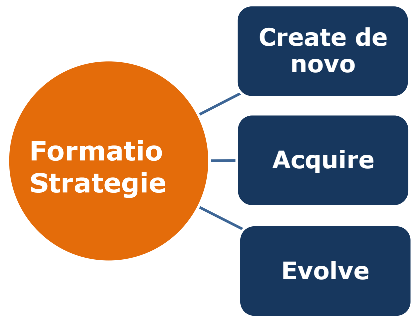
Formation Strategies

- Key decision points
  - Create de novo
  - Acquire
  - Evolve



Formation Strategies

- Create de novo
  - Able to create what you want
  - Segregate risk
  - Proper staffing and supervision from outset
  - But may be more difficult

Formation Strategies

- Acquire
  - Not starting from zero
    - Acquire organizational and staff capacity
  - May lower regulatory hurdles
  - May make financial sense, if price is right
  - But potential cultural clash

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Formation Strategies

- Evolve
  - Often easier
  - Build slowly on existing strengths—test waters
  - Build track record in new field
    - Potentially to create de novo organization in future
  - But may not provide proper infrastructure or staffing
  - "Half-way" mentality may lead to failure

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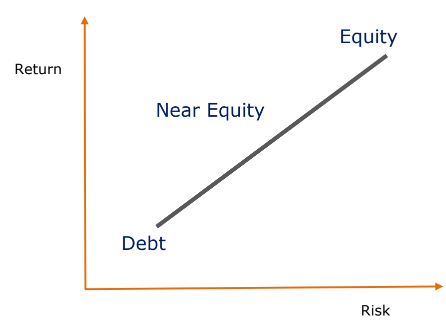
Risk/Return Spectrum

25

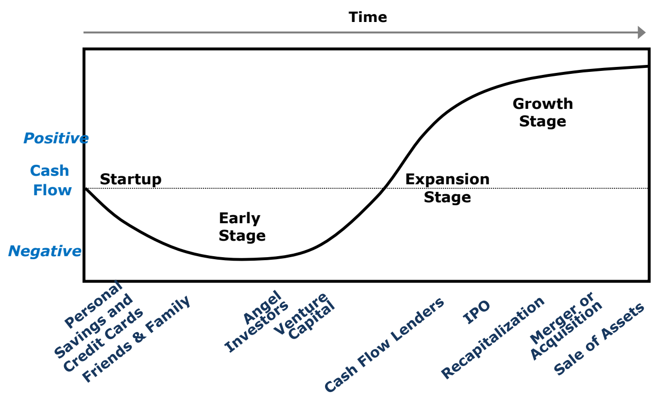
Debt, Equity, and Hybrids

Risk-return profile for types of financing



26

Debt, Equity, and Hybrids



Debt, Equity, and Hybrids

- Characteristics of **debt** financing products:
  - Fixed returns, even if company performs well
  - Low risk: Top of capital stack
  - Added protection: Collateral, subordination, guarantees, debt-equity ratio, amortization
  - Control: Typically arms-length, loan covenants
    - Concern about lender liability and cost of oversight
  - Orientation: Don’t lose any

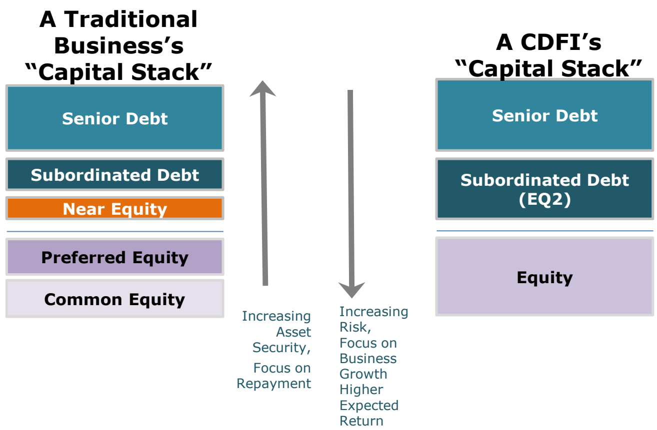
Debt, Equity, and Hybrids

- Characteristics of **equity** financing products:
  - Returns variable: Dependent on company performance
  - High risk: Bottom of capital stack, typically no collateral, repaid through exit
  - Added protection/control: Board seats, power of purse, may take over company
    - Acceptance of "lender liability"
  - Preferred or common
  - Orientation: Swing for the fences, and expect strikeouts

Debt, Equity, and Hybrids

- Characteristics of **near equity** financing products:
  - Deeply subordinated "mezzanine" debt
  - Debt with royalties
    - Loan with high or low interest rate, plus royalty payments calculated as a percentage of sales or profits
    - No exit necessary
  - Debt with warrants
    - Loan with warrants to purchase stock attached
    - Security of debt, but exit necessary
  - Convertible debt
    - Loan convertible to equity at option of lender/investor
    - Security of debt, but exit necessary

Debt, Equity, and Hybrids



Questions?

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Expanding CDFI Coverage in Underserved Areas Webinar Series

- Upcoming topics include:
  - *February 23, 2016*: Capitalization Strategies: Raising Debt and Equity for CDFIs
  - *March 22, 2016*: Customer Acquisition
  - *April 5, 2016*: Fundraising Strategies for your CDFI

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