ACCESSING CAPITAL FOR NATIVE CDFI GROWTH

Course materials sponsored through the CDFI Fund Capacity Building Initiative.

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CDFI Revenue Generation Strategies

All CDFIs need capital. Typically, we seek grant sources for operations and debt/investments for loan capital. We covered debt and equity in previous sessions. We are all familiar with grants. In this course we will focus on another source of revenue: earned income, or income from operations. As the availability of both private and public resources declines, CDFIs are looking more closely at ways to generate revenue to diversify their funding and sustain their operations.

A distinction should be made between earned income and revenue – revenue comprises all dollars in the door, whereas earned income comprises dollars coming in from the lines of business your CDFI is specifically engaged in, e.g., lending, training, development fees, servicing, rent, and other business activities.

Considerations for Developing Earned Income Strategies

1. What are you good at?

2. What do people need?

3. How have others addressed the demand?

4. If there is money to be made, why isn't someone already doing it?

5. What is fact, and what is hope? What have you documented/researched?

6. What is the total exposure if things go bad? Will this affect other lines of business? To what extent?

7. Do you have the dollars, staffing, capacity, and infrastructure to execute the strategy?

Distinguishing Revenue from Profitability

Profitability and revenue don't go hand in hand. Profitability should be achieved in three years or the venture may not be able to attract external funding. The example below shows the revenue, expenses, and profitability of three CDFIs. The example illustrates that profitability is not necessarily a function of revenue. Rather, it is the difference between revenue and expenses. Even though CDFI 3 has the highest revenue, it has the lowest profitability due to the high level of expenses. Profitability can be increased by cutting expenses.

CDFI Revenue v. Profitability Example

	CDFI 1	**CDFI 2**	**CDFI 3**
revenue	1000	10,000	100,000
expense	900	9500	101,000
profit	100	500	(1000)
profit/revenue	10%	5%	-10%

Ways CDFIs Generate Revenue

There is a wide range of strategies for CDFIs to earn income to contribute towards their profitability and asset growth. Corporate America typically assumes five ways to generate additional revenue:

1. More customers (expand your target market area or products)
2. More outreach to generate more customers
3. Increase conversion rate
4. Repeated sales (loans)
5. More sales (higher loan amounts per customer)

Much of this is applicable to CDFIs. The following list describes some of the most common strategies applied to CDFIs.

1. Interest Rates

The most obvious way for CDFIs to earn income is by charging interest on their loans. The income stems from the *interest spread* which is the difference between the interest rate charged for a loan and the lender's cost of funds. In order to benefit from this type of income, a CDFI must understand its cost of capital.

Interest Spread Example

	CDFI A	Cost of capital	CDFI B	Cost of capital
equity	1,000,000	0%	500,000	0%
debt	1,000,000	5%	1,500,000	5%
weighted cost	2,000,000	2.5%	2,000,000	3.75%

Once the cost of capital has been determined, the spread can be calculated. For example, *CDFI A's* weighted (or average) cost of capital is 2.5% because $1 million is equity obtained at no cost and another $1 million is debt at 5%. *CDFI B's* weighted cost of capital is more expensive at 3.75% because only $500,000 of its $2 million was no-cost equity.

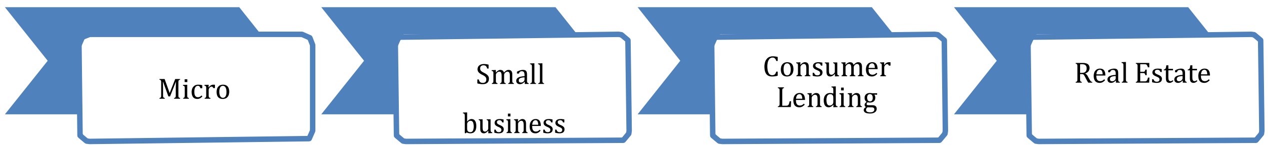
If *CDFI A* charged 8% for its loans, its interest spread is 5.5% (8% - 2.5% = 5.5%). *CDFI B,* on the other hand, only has an interest spread of 4.25% because its weighted cost of funds is higher (8% - 3.75% = 4.25%).

To increase interest income, a CDFI can either find less expensive capital or charge higher rates. Most CDFIs try to earn at least 2% to 4% over the cost their cost of funds.

Loan Pricing

A consideration for interest income is whether to further refine loan pricing by using a risk-based assignment of interest rates based on the type of loan or the various types of borrowers. In general, the riskier the type of loan, the higher the interest rate should be.

***Historical Risk Continuum by Loan Type** – Higher Risk to Lower Risk*



The chart below shows the average rates charged by the Leadership Journey cohort members compared to the CDFI industry as determined by the OFN's 2009 Side by Side study.

Interest Rates by Loan Type

Type of Loan	TLJ Cohort	CDFI Side by Side
Micro	From 5.25 to 13%	9.8% weighted average
Small Business	6 to 13%	6.9%
Housing to Developer	4.7 to 8.5%	5.6%
Housing to Individual	4 to 8.5%	5.5%
Non-profit	NA	6.7%
Consumer	9 to 16%	NA

Risk-Based Pricing

Risk-based pricing means a borrower who is determined to be a higher risk would pay a higher interest rate. Factors used to determine the risk of a borrower include credit score, employment status, income, and other outstanding debts, among other things.

2. Loan fees

Another way to generate revenue is from loan fees. Native CDFIs have historically charged below market loan fees making this a possible area for increased revenue. These fees may include: delinquency fees, application fees, origination fees, etc.

Fees by Loan Type

Type of Loan	Application Fee		Origination Fee	
	TLJ Cohort	Non-Native	TLJ Cohort	Non-Native
Microloan	None or $25	$25 to $50	1%	1-2%
Small business	None or $50	$50 to $100	1-2%	1-2%
Housing to developer	None	$100	1%	1-2%
Housing to individual	None	$25 to $100	1-2%	1-2%
Consumer	None, $10, or $25	N/A	None, $75, or 1%	N/A

Financing Fees

In order to lower the upfront costs to borrowers and to increase earned income, some CDFIs may offer to finance fees. It is important to consider the impact of financing the cost of fees to the borrower. In other words, CDFIs should be able to calculate what the effective interest rate is for borrowers if they finance a fee.

For example, if a borrower borrows $100,000 and there is a 1% origination fee, the borrower can either pay the fee up front, the borrower can pay for the fee out of the proceeds of the loan, or the borrower can finance the $100,000 plus the $1,000. The loan is a one-year loan at a nominal 5% rate. If the origination fee is financed, the earned income is higher.

Fee v. Earned Income Example

5% rate	loan amount	net proceeds to borrower	effective interest	monthly payment	CDFI earned
origination fee up front	100,000	100,000	5.12%	8,561	3,303
from loan proceeds	100,000	99,000	5.12%	8,561	3,303
finance fees	101,000	100,000	5.12%	8,646	3,326

3. New loan products

Another strategy to generate revenue is to offer new loan products that yield higher returns to the CDFI. Some possibilities to consider include:

- Mortgage
- Home improvement
- Construction/pre-development/development financing (short-term or interim)
- Home equity
- Line of credit
- Working capital
- Inventory/equipment
- Consumer
- Auto
- Education
- Credit cards
- Credit builder
- Factoring
- Energy efficiency improvements
- Community facilities

Discussing Price Sensitivity

In setting interest rates for these new loan products, a CDFI needs to be aware of its customers' price sensitivity. In the exercise below, we will discuss the range of possible loan products and determine for each one the price sensitivity (to interest rates) of the class of borrowers.

Price Sensitivity Exercise

On your own, rank the markets listed by interest rate sensitivity as highly, moderately, or mildly sensitive, and estimate what percentage of customers you would lose by raising rates by 1%. Discuss your results with your table.

Loan Product	Term (in years)	Rank as highly, moderately, or mildly sensitive	Estimate change in market when interest rate is increased by 1%
Mortgage	30		
Home improvement	10		
Construction	2		
Home equity	30		
Line of credit	1		
Working capital	3		
Inventory/equipment	10		
Consumer	3		
Car	5		
Education	15		
Credit cards	No term		
Credit builder	1		
Factor	1		
Energy improvements	Variable		
Community facilities	30		

4. Grants

Although grants do not necessarily increase a CDFI's self-sufficiency in the long term, they do increase dollars coming in the door. For example, when a CDFI is developing a new program, grant income can subsidize start-up expenses such as market studies or hiring new staff.

As a CDFI becomes more adept at pricing its services, it may even be able to further its revenue generating strategies through grants. This can be done by structuring grant-funded activities as fee-for-service. For example, if you are able to determine that your hard costs to deliver a credit counseling workshop are $500, you can earn a spread of

$250 by charging the grant $750 per workshop. You can also generate revenue by accurately estimating your administrative costs and charging the grant accordingly.

Another way to generate revenue through grants is to invest your grant funds subject to any restrictions in your grant agreement.

CAUTION – Conduct a cost benefit analysis of your grants. Be sure you are taking into consideration the staff and/or consultant time to prepare grant applications, comply with grant requirements, and compile and submit grant reports.

5. Other Strategies

Other strategies you can explore to generate revenue include:

- *Social enterprise* – This broadly encompasses ventures of nonprofits, civic-minded individuals, and for-profit businesses that can yield both financial and social returns. Some examples include:
    - Food ventures like community supported agriculture, commercial kitchens, value-added food products; and
    - Fee-for-service activities such as:
        - Fiscal agency
        - Servicing for other CDFIs, e.g. Individual Development Account servicing
        - Consulting services
        - Charging for development services.

- *Real estate development*
    - Single-family
    - Multi-family
    - Commercial
    - Mixed-use developments

- *Geographic expansion*
    - Expanding your service area to be statewide
    - Serving your tribal members nationwide

- *Out of the box ideas*
  - Agriculture – land purchase, trading development rights
  - Education reform – charter schools
  - Bond financing – community bonds
  - Equity pools – providing equity to relatively new businesses
  - Secondary markets – purchasing other loans for social or financial return

- *Business ownership*
  - Management company
  - Managing partner in a limited liability company (LLC)
  - Equity investor, partnership
  - Alternatives to equity such as:
    1. Royalties (a fee received by a 3rd party on the sale of an item), or
    2. Options/warrants (a contract between two people that gives the hold the right, but not the obligation, to buy or sell outstanding stocks at a specific price and at a specific date).
  - Affiliate – usually a non-profit venture that you don't really own but are affiliated with such as a food kitchen, day care, charter school, community garden, incubator, homeless shelter, credit union, etc.
  - Subsidiary – usually a for-profit venture such as commercial space, asset management

Review

Think back to the revenue generating strategy you proposed on page 8. Do you still think this is a viable strategy for generating revenue?

Consider the pros and cons of the following:

- Capital requirements
- Start-up costs
- Need for market research
- Pricing
- Length of time to become profitable
- Risks
- Board support
- Staffing
- Technical expertise
- Organizational capacity

Continuation of "Getting Your House in Order"

As we have discussed, before CDFI's can access new capital, you have to "get your house in order." In Part 1 of this course, participants conducted a self-assessment to determine readiness to access capital. Examples of areas you considered include:

- Three years of clean audits
- Three years of financial projections
- Operating budget
- Strong portfolio performance
- Adequate reserves
- Loan loss reserve
- Relevant board experience
- Staff capacity

Minimum Prudent Standards

In this module, we will discuss Minimum Prudent Standards (MPS) – what they are, what they mean, and how to change improve the ratios. We will look at the reason for the standards, why they are set at a certain level (and not another) and how an organization effectively change the components of their MPS ratios.

Minimum Prudent Standards are indicators, based on organization type, used by the CDFI Fund to evaluate the loan portfolio quality and the financial track record and projections of CDFIs applying for Financial Assistance or Technical Assistance.

The MPS standards include:

- Net Asset Ratio
- Current Ratio
- Deployment Ratio
- Self-Sufficiency Ratio
- Operating Liquidity Ratio
- Net Income
- Earnings Ratio
- Portfolio at Risk
- Loan Loss Ratio
- Loan Loss Reserves

The CDFI Fund provides the following charts to define MPS ratios.

Financial Ratio Minimum Prudent Standards (MPS) for Non-Regulated Entities

Measure	**Non-Regulated CDFIs**
Capital: Measures the Applicant's underlying financial strength and whether it has sufficient assets to cover unexpected losses. The capital ratio identifies the percentage of total assets unencumbered by debt.	**Net Asset Ratio ≥ 20%** Net Assets divided by Total Assets
Asset-Liability Management: Measures if the structure of debt is appropriate for the Applicant's financial products.	**Current Ratio = 1.25: 1** Current assets divided by current liabilities.
Deployment: Measures how much of the Applicant's available funds are lent out or invested.	**Deployment Ratio ≥ 50%**
Self-Sufficiency: Measures the percentage of operating costs a CDFI can cover with earned revenue.	**Self-Sufficiency Ratio = ≥ 40% (non-profit)** **≥ 70% (for-profit)**
Operating Liquidity: Measures whether the Applicant has sufficient cash to cover at least three months of operating expenses. The operating ratio reports the availability of cash to cover short-term operating expenses.	**Operating Liquidity Ratio= 1: 1** Cash and Cash Equivalents that are not restricted in a manner that prevents their use in satisfying obligations represented by operating expenses DIVIDED BY 25% of total operating expenses for the four most recently completed quarters.
Earnings: Measures whether the Applicant is earning sufficient revenue to cover its expenses.	**Net Income = $0** Gross Revenues (including grants or other contributions) less Total Expenses. For-profit Applicants should deduct total pre-tax expenses from Total Revenue.

Excerpt from the CDFI Fund application for Financial Assistance

Loan Portfolio Quality Minimum Prudent Standard (MPS) for Non-Regulated Entities			
Product Grouping	**Portfolio-at-Risk (PAR)**	**Annual Net Loan Loss Ratio**	**Loan Loss Reserves (LLR) Or Provision for Losses**
Affordable Housing-First Lien	≤ 7.00%	≤ 1%	Loan Loss Reserves are expected to be no less than half the actual Portfolio-at-risk and no more than one and a half times the actual portfolio at risk: .5 PAR ≤ LLR ≤ 1.5 PAR
Affordable Housing-Subordinate Lien	≤ 7.00%	≤ 3%	
Business	≤ 10.00%	≤ 5%	
Consumer & Micro-enterprise	≤ 12.00%	≤ 9%	
Overall MPS	≤ 15.00%	Narrative Only	

Excerpt from the CDFI Fund application for Financial Assistance

Strategies for Improving MPS Ratios

Many TLJ cohort members have used the Sustainable Mission Software or SMS. This software program allows CDFIs to project balance sheets, income statements, and cash flows based on user-defined assumptions. In addition, the software helps you to develop line of business projections, portfolio ratings, CDFI MPS metrics, and many of the ratios used in the CARS rating process.

You can use the SMS software spreadsheet (a portion of which is reproduced below) to look at each MPS ratio, change numbers, and see what happens to each ratio. Using the software can help CDFIs determine the best strategy to improve their MPS ratios.

MPS Ratios (Non Regulated)	Historic Data			
	Year 1	Year 2	Year 3	3-Year Historic Ratios
Net Asset Ratio	0.71	0.71	0.71	**0.71**
Total Financing Capital	$1,000,000	$1,000,000	$1,000,000	**$1,000,000**
Deployment Ratio	0.48	0.48	0.48	**0.48**
Net Income	$376,000	$376,000	$376,000	**$376,000**
Earnings Ratio	0.26	0.26	0.26	**0.26**
Self-Sufficiency Ratio	16.07	16.07	16.07	**16.07**
Operating Liquidity Ratio	26.67	26.67	26.67	**26.67**
Current Ratio	86.25	86.25	86.25	**86.25**

Strategies for Improving MPS Ratios Examples

Scenario 1 – Improving your Net Asset Ratio

A CDFI's net asset (NA) ratio is comprised of net assets divided by total assets – both of these come from the balance sheet. In this example, CDFI 1 has a NA ratio of 0.17, while CDFI 2 has a NA ration of 0.58. The MPS benchmark for NA ratio is $\geq$ 0.20. How can CDFI 1 boost its NA ratio?

	CDFI 1	CDFI 2
cash	100,000	100,000
loans	500,000	500,000
total assets	600,000	600,000
debt	500,000	250,000
net assets	100,000	350,000
NA ratio	**0.17**	**0.58**

CDFI 1 has two options. It can either increase its net assets or decrease its total assets. In this example, CDFI 1 could increase its net assets by increasing its cash by $25,000 through an unrestricted grant or earned income. The cash is a net asset as well as a total asset. By increasing both the numerator (net assets) and denominator (total assets), we push the ratio to 0.20.

	CDFI 1	more cash
cash	100,000	125,000
loans	500,000	500,000
total assets	600,000	625,000
debt	500,000	500,000
net assets	100,000	125,000
NA ratio	**0.17**	**0.20**

To decrease total assets, CDFI 1 could reduce its total assets by selling off its loan portfolio, for example. However, CDFI 1 should not sell its loans for less than 100 cents on the dollar because it will be unable to repay its debt obligations.

Scenario 2 – Improving Net Income

This example demonstrates the effects of CDFI 1 reducing its loan loss (LL) expense on net income, self-sufficiency, and earnings.

CDFI 1 has a loan loss reserve (LLR) or LL expense of $50,000. This represents a 10% LLR on a portfolio of $500,000. If we reduce this expense to 5% of the portfolio, we reduce expenses and increase profit (net income).

What should CDFI 1 consider before doing this? The organization must understand its historical loan loss (charge off). If its losses are running at 2%, a 10% LLR makes no sense. It may even be fiscally irresponsible because capital should be earning a return, not causing an inflated expense to the organization. On the other hand, if the organization is running a 20% loss, the 10% LLR percentage is not adequate, and the odds of a LLR reduction improving net income are low (like 50:1!).

Case Statements Presentations

Bernard Ross & Clare Segal, in their book, *The Influential Fundraiser*, point out that a good case statement needs to answer these five key questions:

- **What is the need?** Specify precisely what the need is, and who exactly will benefit when that need is met. Be sure to make the need manageable so that supporters will feel that they can make a difference. Global poverty is too big for an individual to get his arms around. But he may be able to save an individual or help a family.

- **What evidence is there that this is a pressing need?** Make it clear that the need is now, and that it needs to addressed soon. Include surveys, expert opinions, or statements from the beneficiaries.

- **How is your organization uniquely qualified to tackle this need?** While there may be several organizations that could tackle this issue, what is special about you? Is it your track record, the newness of your approach?

- **What will be the benefits of your action?** If you take action now, what will be the positive consequences, both major and minor? What can be guaranteed, and what is possible?

- **What are the negative consequences if you fail?** Sometimes this is the strongest motivator for donors, so lay out clearly the major and minor negative consequences if you do not act.

ADDITIONAL RESOURCES

1. *Community Development Financial Institutions: A Study on Growth and Sustainability*, Mary Reynolds Babcock Foundation, June 2011

2. ***CARS™ - COMPREHENSIVE RATINGS FOR CDFI INVESTMENTS***

3. *What Investors Want to Know About Your Loan Assets*, CDFI Fund Capacity Building Initiatives Resource Bank

Helpful Websites

- Society for Nonprofits – Fundraising Guide (www.snpo.org/funding/)

- CDFI Fund Capacity Building Initiatives Resource Bank (www.cdfifund.gov)