Expanding CDFI Coverage in Underserved Areas

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

Forming New and Affiliated CDFI Entities
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Overview

• Factors to Consider in Creating a New CDFI or Developing a New Activity
• Not-for-Profit and For-Profit Corporate Structures
  – Subsidiaries and Affiliate
• Formation Strategies
  – Create De Novo, Acquire and Evolve
• The Risk/Return Spectrum
• Small Group Discussions
The Decision: Mission

• How does the mission of the sponsoring organization relate to the mission of the new CDFI?
  – 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

The Decision: Money

• Identify resources to finance new and expanded activities:
  – Determine funding needs
    • Equity, debt, operational subsidy
  – Develop effective fundraising strategy
    • Prior and new funders’ interest in new activities
    • Impact of new activities on new funding for old activities
    • New activities complement or compete for funding
The Decision: Capital Structure

• Capital structure and regulatory issues
  – Match capital structure and risk of new activity
    • Risk mitigation or segregation
    • Creation of subsidiaries and affiliates
  – Determine opportunities/risks of associating not-for-profit and for-profit activities
  – Identify impact if different regulatory environment for new activities

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

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!
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

• 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
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

Questions?
Risk/Return Spectrum

Debt, Equity, and Hybrids

Risk-return profile for types of financing
Debt, Equity, and Hybrids

- **Debt**
  - 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

• Equity
  – 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

• Near Equity
  – 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

Business “Capital Stack”
- Senior Debt
- Subordinated Debt
- Near Equity
- Preferred Equity
- Common Equity

CDFI “Capital Stack”
- Senior Debt
- Subordinated Debt (EQ2)
- Equity

Increasing Risk, Focus on Business Growth Higher Expected Return
Increasing Asset Security, Focus on Repayment

Questions?
Small Group Discussions

- Apply the criteria to one of the institutions you would like to form (one institution per group)