Expanding CDFI Coverage in Underserved Areas

Capitalization Strategies: Raising Debt and Equity for CDFIs

Michael Swack, Carsey Institute at the University of New Hampshire

February 23, 2016

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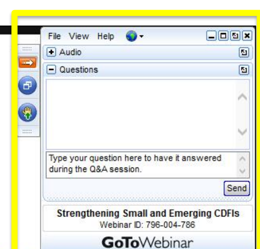
GoToWebinar

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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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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Goals for the Session

- Determine your needs for capitalization
- Identify sources appropriate to your needs
- Understand the pros and cons of various sources of capital
- Develop a basic capitalization plan

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Key Questions for your CDFI

- Is there a demand for your products?
- Are you capital constrained?
- How much are you trying to raise?
- Do you need debt or equity or both?
- What is your history of raising funds? What are your ratios? (Don't raise too much debt!)
- Do you need to raise reserves?
- What do investors look for before they invest?
- **One size does not fit all** – a capitalization strategy needs to fit your needs, and your particular situation.
- **Do you have a plan?**

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Sample Plan for Raising Debt and Equity

- **Goal**: To raise $5 million over the next 3 years to include 4.25 million in debt (blended rate of 2%) and $750,000 in equity.

- **Rationale for plan**: (e.g., Increased demand for funds, new product development, geographic expansion, etc.)

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Example: Capitalization Plan

Potential Sources	Amount	Notes
Equity	***$750,000***	
CDFI Fund	$500,000	Are we certified? Application deadlines?
CDBG	$100,000	Entitlement? Small Cities?
Local foundation (with PRI?)	$100,000	Possible sources? Established relationships with staff or board?
Private gifts/donations	$50,000	Any history with private donors? First steps?
Debt	***$4,250,000***	
Long term (5 years or more)		
Bank pool		Any existing pools? Local history?
Insurance Companies		Any local companies?
Private Individuals		Is this a good idea? Costs? Securities laws? Interest among board members?
Program Related Investments		Research local foundations
Religious		Start with board members
Short term (less than 5 years)		
Need line of credit?		Do you have an existing line of credit? Is it sufficient to meet possible short-term needs?
Religious institutions		Start with board members
Universities or other institutional lenders?		
Sell loans?		How will this affect earnings?

What are you raising money for?

- Affordable housing
- Small business and microenterprise
- Community services, such as child care, education, and health services
- Livable-wage jobs for low-income individuals
- Services to economically disadvantaged populations
- Asset-building for low-income individuals
- Sustainable development

Your uses will dictate the type of money you need to raise.

Sources of Capital: Private, Public, and "Alternative"

- Banks
- Insurance Companies
- Pension Funds
- Government – Federal and State (CDFI Fund, CDBG, HOME, EDA)
- Foundations – Program Related Investments
- Religious Institutions, Universities, other "alternative" or mission related investors
- Private individuals

Loan Fund Capitalization

How are Loan Funds Typically Capitalized?

- Unsecured Senior Debt; Subordinated Debt
- Secured Debt
  - Typically secured by loans receivable
  - Becoming more prevalent
- Equity (grants)
- Equity Equivalent investments

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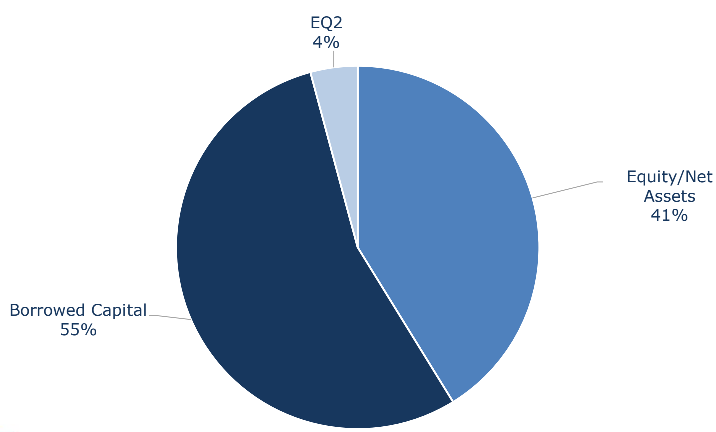
Loan Fund Capitalization



Source: OFN Member Survey, FY2013

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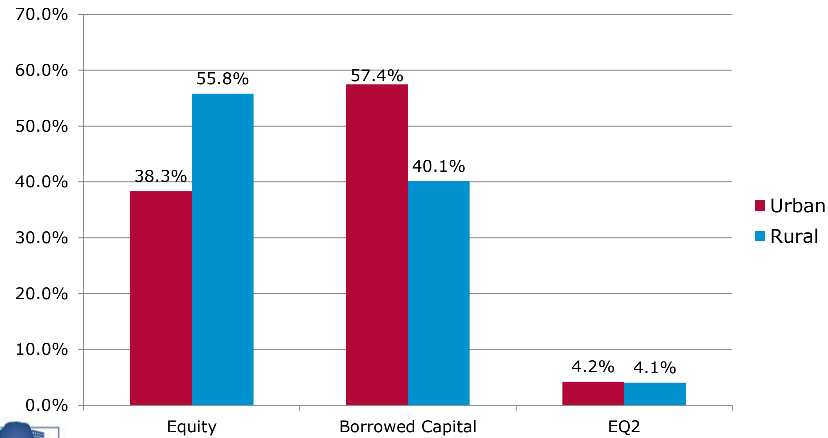
Capitalization By Loan Fund Service Area



Source: OFN Member Survey, FY2013

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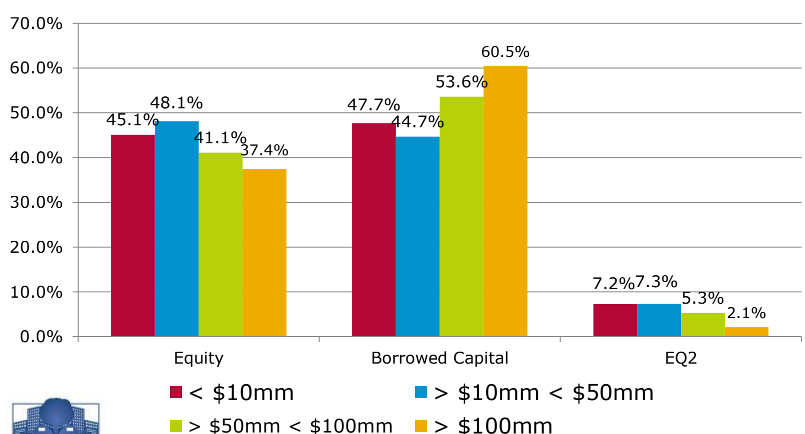
Capitalization By Loan Fund Asset Size



Source: OFN Member Survey, FY2013

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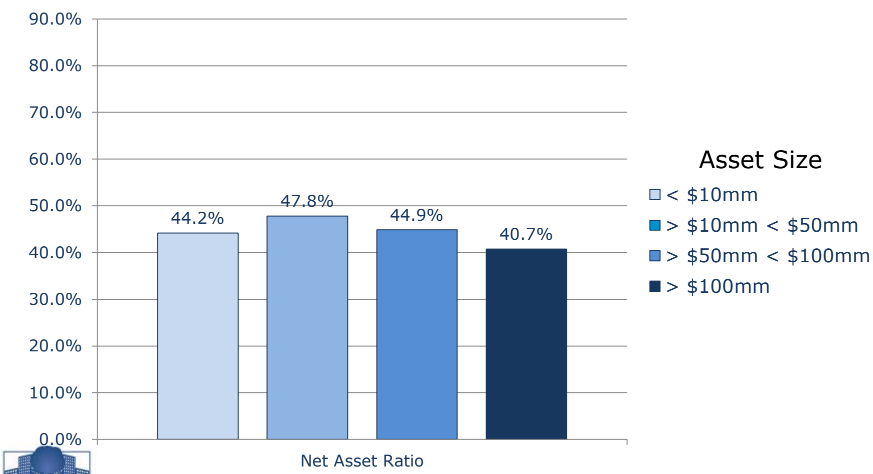
Net Asset Ratio By Loan Fund Asset Size



Source: OFN Member Survey, FY2013

Equity/Net Assets: Loan Funds

- Equity for non-profit loan funds = capital grants; retained earnings
- Hard to raise/not a lot of sources
- CDFI Fund has been the largest source of equity for the industry
- Lack of equity could hamper an ability of loan fund to grow and leverage
- Loan funds needs to determine appropriate equity/net asset %

Courtesy of: The Fundamentals of the Opportunity Finance Industry program.

Sources of Loan Fund Borrowed Funds

Source	% of Borrowed Funds
Banks/Thrifts/Credit Unions	29%
Federal Government	23%
Foundations	14%
Other	5%
State/Local Government	8%
Corporations	7%
Religious Institutions	5%
Individuals	3%
Non-Depository Financial Institutions	4%
National Intermediary	2%

Source: OFN Member Survey, FY2013

Average Loan Fund Cost and Term of Borrowed Funds

Cost of borrowed funds	Term of borrowed funds
2.4%	115 months

Source: OFN Member Survey, FY2013

Capitalization Trends: Loan Funds

- Community Reinvestment Act (CRA)'s importance varies depending on the policy environment and strength of regulatory enforcement
- Advocacy efforts have led to new and expanding sources of capital
  - SBA: SBA Community Advantage Program; SBA 504 program; SBA microloan program
  - Loan funds access to FHLB System
  - CDFI Bond Guarantee program
- More secured lending than in the past
- Investors have increasing focus on unrestricted net assets
- Loan funds need to focus more on longer-term balance sheet management

Debt: Characteristics of Bank Lending to CDFIs

1. Type of capital offered by banks to CDFIs = generally short-term, self-liquidating (fully-amortizing loans). Senior debt.
2. Banks do not provide equity, subordinated debt, or any other kind of patient money to CDFIs.
3. Banks generally lend for the short-term so as not to get locked into set interest rates (short-term, lines of credit).

Why Seek Bank Partners?

CDFIs seek bank partners for four primary reasons:

1. Liquidity—Almost all CDFI financing is non-conforming (does not meet typical bank criteria). As a result, productive CDFIs constantly face liquidity shortages.

2. Leverage—Because CDFIs seek to bring capital into underserved markets, many are willing to accept relatively higher risk to leverage more bank capital into a deal. CDFIs must use this limited capital strategically to encourage banks and other funders to participate.

3.

http://www.occ.gov/static/community-affairs/Summer-01.pdf

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Why Seek Bank Partners?

CDFIs seek bank partners for four primary reasons:

3) Access to technical financial expertise—CDFIs cannot afford to reinvent wheels, so they often rely on their bank partners' expertise. Many bankers enjoy the challenges of applying their professional talents to the non-traditional credit facilities that CDFIs often wrestle with.

4) Positioning CDFI borrowers for future bank relationships—CDFIs help season borrowers so that they can become traditional bank customers in the future. In some instances, CDFIs negotiate with banks up-front that the banks will ultimately purchase the CDFI's loans that are performing adequately.

http://www.occ.gov/static/community-affairs/Summer-01.pdf

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Bank Related Programs

- Goldman Sachs
  - CDFI Small Business Financing Initiative with Opportunity Finance Network:
  - http://www2.goldmansachs.com/citizenship/10000-small-businesses/index.html
- JP Morgan Chase
  - CDFI Collaboratives program intended to forge partnerships among CDFIs to help them build capacity
- Wells Fargo Diverse Community Capital
  - $75 million debt and grant program to CDFIs that focus on diverse entrepreneurs

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Examples of Financing Vehicles and Tools

- Bonds (State and Federal)
  - Bonds issued by state housing finance authorities to finance affordable housing
  - CDFI Bond Guarantee Program
- Loan Sales
  - Community Reinvestment Fund http://www.crfusa.com/Pages/Default.aspx
  - Impact Community Capital http://www.impactcapital.net/index.html
  - Community Development Trust http://www.cdt.biz/whatwedo.htm
- Loan Participations and Pools
  - Georgia, Florida and NH
- Credit Enhancements
  - Government guarantees (e.g., SBA loans which have a partial guarantee)
  - Third party guarantee (e.g., a foundation may guarantee repayment to certain lenders)

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“Alternative” Sources of Debt

- Program Related Investments from Foundations
- Institutional sources such as religious organizations, universities, and private individuals
- Government Sources

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Program Related Investments

Program-related investments (PRI) are loans originated by charitable foundations in which:

- The primary purpose is to accomplish one or more of the foundation's exempt purposes,
- Production of income or appreciation of property is not a significant purpose, and
- Influencing legislation or taking part in political campaigns on behalf of candidates is not a purpose.

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Program Related Investments

The following are some typical examples of program related investments:

- Low-interest or interest-free loans to students
- High-risk investments in nonprofit low-income housing projects
- Low-interest loans to small businesses owned by members of economically disadvantaged groups, where commercial funds at reasonable interest rates are not readily available
- Investments in businesses in deteriorated urban areas under a plan to improve the economy of the area by providing employment or training for unemployed residents
- Investments in nonprofit organizations combating community deterioration

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Sample Rate and Terms for Banks and PRIs

- Foundation PRI(low-cost, fixed rate)
  - 1- 4%; fixed rate, unsecured; 5-10 years
- EQ2 from banks
  - 1 - 3%, fixed rate; typical term of 5 years or longer, with rolling component, unsecured
  - Benefits bank's CRA (count towards lending or investment test)
- Bank Debt
  - Term loans (could be amortizing); less than 5 years (recent terms = 5-7 years at 2 to 3.75%
  - Lines of Credit which may convert to term loans
  - Variable or fixed rate
- Structured Capital Pools (often financial institution investors)
  - Variable rate based on LIBOR/prime
  - 1-5 year terms
  - Larger amounts available for a particular type of financing with pre-set requirements (i.e. LTV, DCR)
  - Secured by loan receivable

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Federal Government Programs

- CDFI Fund: see CDFI.gov or contact the CDFI Fund for more information about any of these programs.
  - CDFI Program
  - NACA Program
  - CDFI Bond Guarantee Program
  - Bank Enterprise Awards
  - Healthy Food Financing Initiative
- Community Advantage – SBA 7A program opened up for CDFIs
- SBA Micro lending
- USDA – business lending and equity programs

Raising Equity

- Investors
  - Are you eligible for investment?
- Grants
  - What are potential sources?
- Secondary Capital – EQ2
  - What is it? Do you qualify? What are the sources?

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What is an EQ2?

- Capital product for CDFIs and their investors;
- A financial tool that allows CDFIs to strengthen their capital;
- Structures, and leverages additional debt capital;
- A general obligation of the CDFI that is not secured by any of the CDFI's assets;
- Fully subordinated to the right of repayment of all of the CDFI's other creditors;
- Carries an interest rate that is not tied to any income received by the CDFI;
- Has a rolling term and therefore an indeterminate maturity.

Aeris*

- Rates CDFI financial strength and impact performance;
- Provides bird's-eye view into how investors underwrite and assess CDFI risk;
- Promotes a CDFI's commitment to transparency and rigorous performance standards;
- Simplifies due diligence process for investors;
- Investors currently more interested in whether CDFI is rated than the actual ratings.

See http://www.aerisinsight.com/

Standard and Poor's Rating

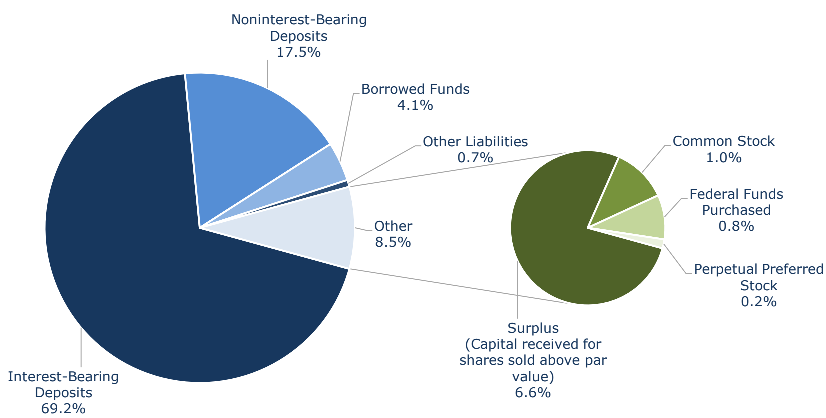
- New Entrant in Rating Loan Funds
- Loan Funds Rated to Date
  - Clearinghouse CDFI: For-profit loan funds
  - Housing Trust Silicon Valley: Not-for-profit loan funds
- Potential Access to New Capital Sources
  - Corporate Treasurers
  - State Treasurers
  - Impact Investors
- Emerging Trend: Too early to draw conclusions

Capitalization for Banks

Capitalization Trends: Banks

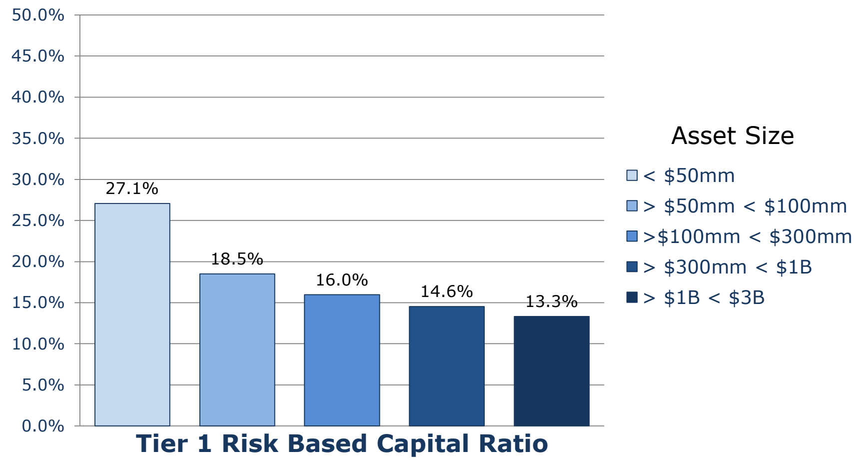
- After the financial crisis, regulators have increased scrutiny of banks' capital plans
- Regulators expect all banks to prepare and implement capital plans, which lay out how the bank will raise sufficient capital to support the bank's strategic plan and absorb losses
- It is becoming more difficult for CDFI Banks to raise capital
  - Growing competition from other banks and non-bank financial service providers has decreased small bank earnings
  - New regulatory requirements increase costs and limit or severely limit future growth of past sources of acceptable regulatory capital such as Trust Preferred Securities and various kinds of preferred stock
- Reduced earnings and growing compliance costs have led more banks to consider mergers and acquisitions

Bank Capitalization



Source: FFIEC call reports, Q1 2015

Tier 1 Risk Based Capital Ratio By CDFI Bank Asset Size



Source: FFIEC call reports, Q1 2015

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Equity: Banks

- CDFI banks face significant challenges in raising regulator approved equity capital from traditional capital markets due to lack of scale and the fact that only a small portion are publicly traded
- Sources of equity capital include:
  - Institutional investors, private equity (only for banks with assets over $1.5 billion; most institutional investors won't consider offerings smaller than $20 million)
  - Public offerings
  - Private Equity Funds
- Private investors require a clear exit strategy (e.g. an IPO or selling to a larger institution)
- Many CDFI banks opt to remain privately held in order to avoid becoming driven primarily by quarterly earnings and to maintain their mission focus and local control

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Capitalization for Credit Unions

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Capital Structure of Credit Unions

- Non-profit, member owned cooperatives
- Regulated and insured depositories
- Regulators require minimum Net Worth Ratio of 7% (equity/total assets)

Credit Union Balance Sheet

Regular Reserves		$55,000
Other Reserves		$5,000
Undivided Earnings	$10,000	
Total Equity		$70,000
Total Liabilities		$930,000
Total Assets		$1,000,000

Net Worth = 7%

- Median Net Worth Ratios:
  - 11.5% for all credit unions
  - 10.4% for CDFI credit unions

Source: NCUA 5300 Call Reports

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Net Worth: The Key to Growth

- Deposits are primary source of loan capital for credit unions
  - Ability to increase deposits determined by amount equity
- Permanent equity can only increase through retained earnings and grants
  - Credit unions cannot raise equity on capital markets or sell ownership shares to outside investors
- Slow, incremental growth of net worth a major constraint on growth for CDFI credit unions
- Financial crisis increased regulatory pressure to maintain higher net worth ratios
  - Greatest pressure on CDFI credit unions serving low-income markets, perceived by regulators to be higher risk
  - Some credit unions forced to reduce deposits to boost net worth ratio
  - Increased need for alternative capital to fuel continuous growth

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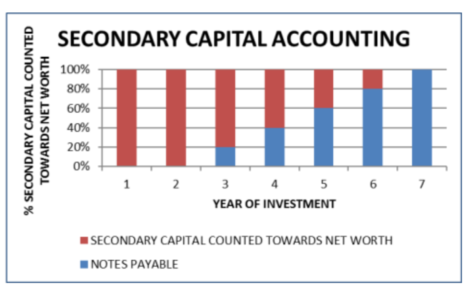
Capitalization Trends: Credit Unions

- Secondary Capital
  - Deeply subordinated loan that counts as regulatory net worth
  - Loans must be at least 5 years, typically interest only with balloon repayment at maturity
    - Portion that counts toward equity declines during final five years of loan
  - Low-income designated credit unions with secondary capital:
    - Increased primary capital
    - Increased efficiency and earnings
    - Grew faster than peers without secondary capital: assets, members, total loans
  - Federation is the largest private secondary capital investor.
  - In 2015, NCUA approves fully amortizing secondary capital loans to increase value for credit unions and reduce risks for Investors.

Source: NCUA Regulations Section 701.34



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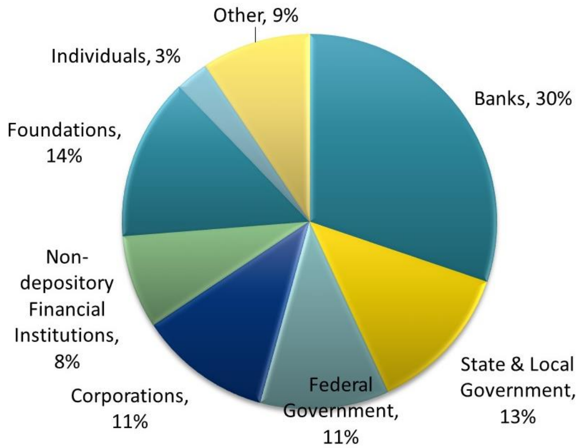
Capitalization for Venture Capital Funds

Capitalization Trends: Venture Capital Funds

- Typically capitalized 100% by equity investment interests in VC fund
  - Limited partnership interest in partnership or membership invest in LLC
- Investors are typically pari passu in fund, although some foundations will donate returns above a certain level on a PRI to associated not-for-profit for legal reasons
- Investor return dependent on success of fund's investments, less organizational expenses, fund costs, management fees, and carried interest
- Investment commitment is made up front, and returns are received as investments are exited
- CDFI Fund grants may go to associated not-for-profit to invest in fund alongside other investors

Sources of Capital for CDVC Funds



Source: Community Development Venture Capital Alliance

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Wrap Up: Capitalization Planning

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What is Your Plan?

- What are your goals?
- What are your most appropriate sources of debt?
- What are your most appropriate sources of equity?
- What is a reasonable timeline?

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Example: Capitalization Plan

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Questions?

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Expanding CDFI Coverage in Underserved Areas Webinar Series

- Upcoming topics include:
  - *March 22, 2016*: Customer Acquisition
  - *April 5, 2016*: Fundraising Strategies for your CDFI

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