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
Baltimore, MD

June 16, 2015

CDFI FUND CAPACITY BUILDING INITIATIVE

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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

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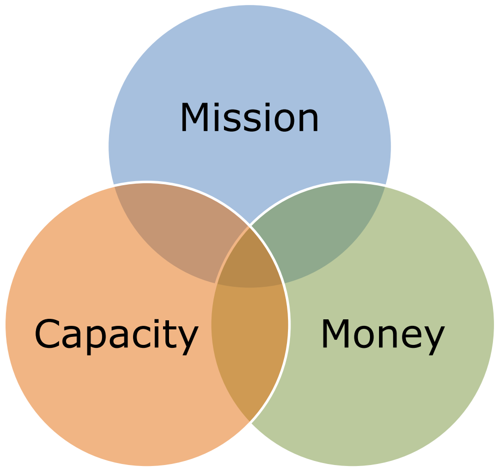
The Formation Decision



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

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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

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Corporate, Subsidiary, and Affiliate Structures

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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

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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

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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!

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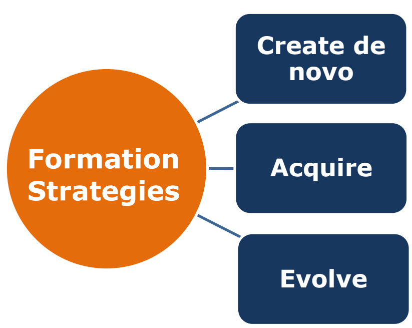
Formation Strategies

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

Questions?

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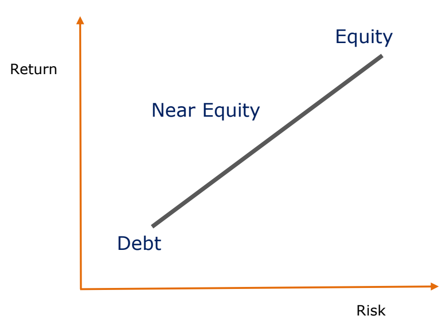
Risk/Return Spectrum

Debt, Equity, and Hybrids

Risk-return profile for types of financing



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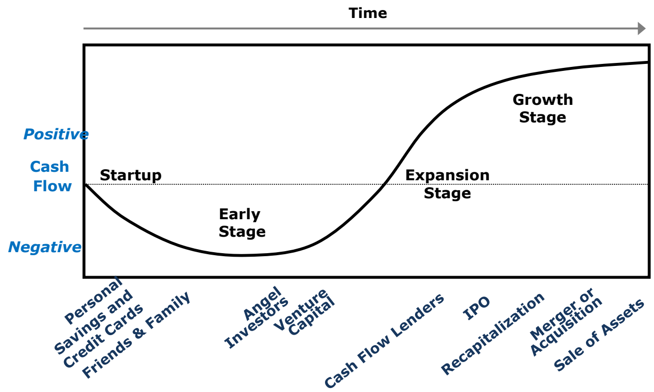
Debt, Equity, and Hybrids



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

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Debt, Equity, and Hybrids

- 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

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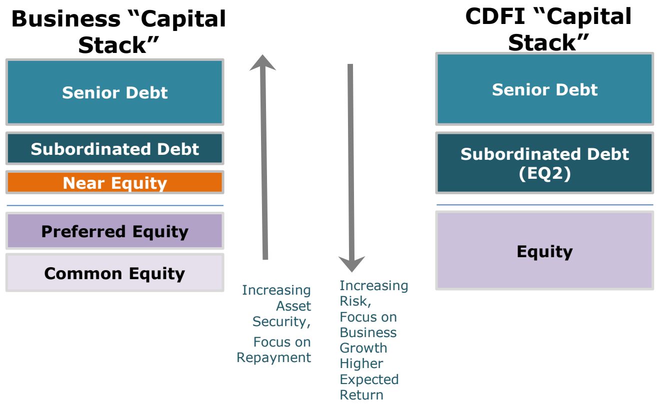
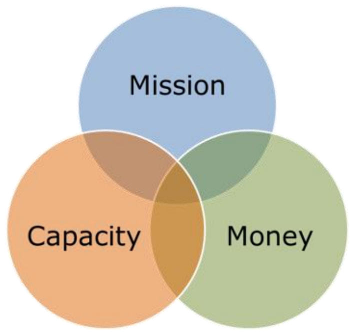
Debt, Equity, and Hybrids



Questions?

Small Group Discussions

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



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