A Path to Conventional Equity for CDFIs

Working Paper

November 16, 2022

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Funded By:
JPMorgan Chase, The Rockefeller Foundation, Goldman Sachs, and Deutsche Bank

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Background

Community Development Financial Institutions (CDFIs) have been lending and investing in low-income communities nationally for over 30 years and have established an impressive track record. The 1,300 CDFIs have total assets under management of $228 billion. CDFI performance over the period has been characterized by sound lending, low loss rates, and relatively low leverage—all of which contribute to their low risk financial profile. Over multiple economic and financial cycles, CDFIs have shown a tendency toward counter-cyclicality in terms of demand: in down-cycles, the need for their services accelerates as gaps in credit availability expand and capital availability decreases in low-income communities. CDFIs would be able to grow, expand their lending capacity, and serve their customers much more effectively if they could access equity from the conventional public equity markets. This is not currently possible due to a series of mostly technical market factors. If these technical factors could be addressed, conventional equity investors would be presented with an excellent opportunity to invest in well managed and strong performing loan portfolios that generate cash returns and experience steady and stable growth. There would be the additional benefit of providing essential investment to low-income communities, businesses, and individuals, and aligning with federal efforts on behalf of these constituencies.

This proposal takes a segment of the CDFI industry—non-profit loan funds with approximately $15 billion in assets on the balance sheet—and tackles each of the technical obstacles. Successfully implemented, the effort would result in direct access to the public equity markets on an unsubsidized basis and open the equity door to smaller and newer CDFIs and eventually a large segment of CDFI banks and credit unions.

Origins

The CDFI Equity Project was funded in 2020 by JPMorgan Chase, the Rockefeller Foundation, Goldman Sachs, and Deutsche Bank. The Project was based on concepts of aggregation, portfolio analysis and linked financing structures discussed at the Financial Innovations Roundtables and developed by the Center for Impact Finance. Ten CDFI loan funds participated in the project: Capital 4 Change, Capital Impact Partners, Chicago Community Loan Fund, Craft 3, Local Initiatives Support Corporation, Low Income Investment Fund, New Hampshire Community Loan Fund, Opportunity Finance Network, Pacific Community Ventures, and ROC USA. The Project benefitted substantially from pro bono legal, accounting, and analytical assistance from Orrick, Herrington & Sutcliffe; CohnReznick; and AERIS.

Concept

Create an equity platform that raises common and preferred equity in the capital markets and uses the proceeds to provide preferred equity to a pool of aggregated CDFI loans. The aggregated CDFI loans remain on the balance sheets of the CDFIs that originate and service them.

The Assets

The purpose of the proposal was to aggregate and provide equity to finance loans originated by a group of CDFIs invited to participate in the project. Invitations were based on the quality of their operations, financial and impact performance, established track record, their lending, and their interest in raising equity. The process of aggregation involved the following:

1. **Survey**. The participating CDFIs submitted a four-page Survey that resulted in collection of information and data on (i) their current portfolios, funding mechanisms, and financial statements; (ii) the unit cost of their origination and lending activities; and (iii) 10-year forecasts of how the CDFIs expect to use the proposed facility by type of loan, rate, term, and attributes of their borrowers. The responses from the Survey populated the fields, were aggregated and were summarized via the "Roll-Up" software.

2. **Roll-Up Software**. As part of the CDFI Equity Project, software was developed to facilitate the aggregation and segmentation of the CDFI lending assets. Called "Roll-Up," the software captures the loan purchase activity of each CDFI's new program-created Special Purpose Vehicle (SPV) on a loan-by-loan basis and rolls it up into: (i) complete financial forecasts of each SPV; (ii) a financial forecast of the aggregate SPVs; and (iii) a complete financial forecast of the proposed equity platform. The software is set up so that the finance staff at the participating CDFIs—and at the equity platform—can run scenarios based on actual loans for the purpose of generating budgets, forecasts, scenario development, stress testing, and financing strategies.

3. **Segmentation**. The loans had to be mission-based loans for low-income individuals, businesses, and communities. They could be existing or newly originated by the CDFIs and could be of any purpose, rate, term, or underwriting standards agreed to by the stakeholders. The loans fell into six general classes: Single Family Residential, Multifamily Residential, Small Business, Community Facility, Commercial Real Estate, and Other (principally, lending to other CDFIs). These loans were automatically segmented by originator, location, asset class, rate, term, key underwriting attributes, borrower credit, and other criteria for the purposes of portfolio management and funder requirements. This was accomplished through the financial modeling (Roll-Up) software. The data were all posted to the Roll-Up, which was the source of the budget/actual data for portfolio management reporting.

4. **Outcomes**. The primary forecast from the Surveys showed: $964 million in SPV portfolio loans outstanding in the 10th year, on $1.95 billion in loan volume over the 10-year period. The initial breakdown of the portfolio by asset class was: Single Family-0%, Multifamily-53%, Small Business-18%, Community Facility-6%, Commercial Real Estate-17%, and Other (primarily loans to CDFI organizations)-6%. The average size of the loans being funded would be initially $841,000, the average term 107 months, and average fees at closing would amount to $15,400.

Financial Instrument

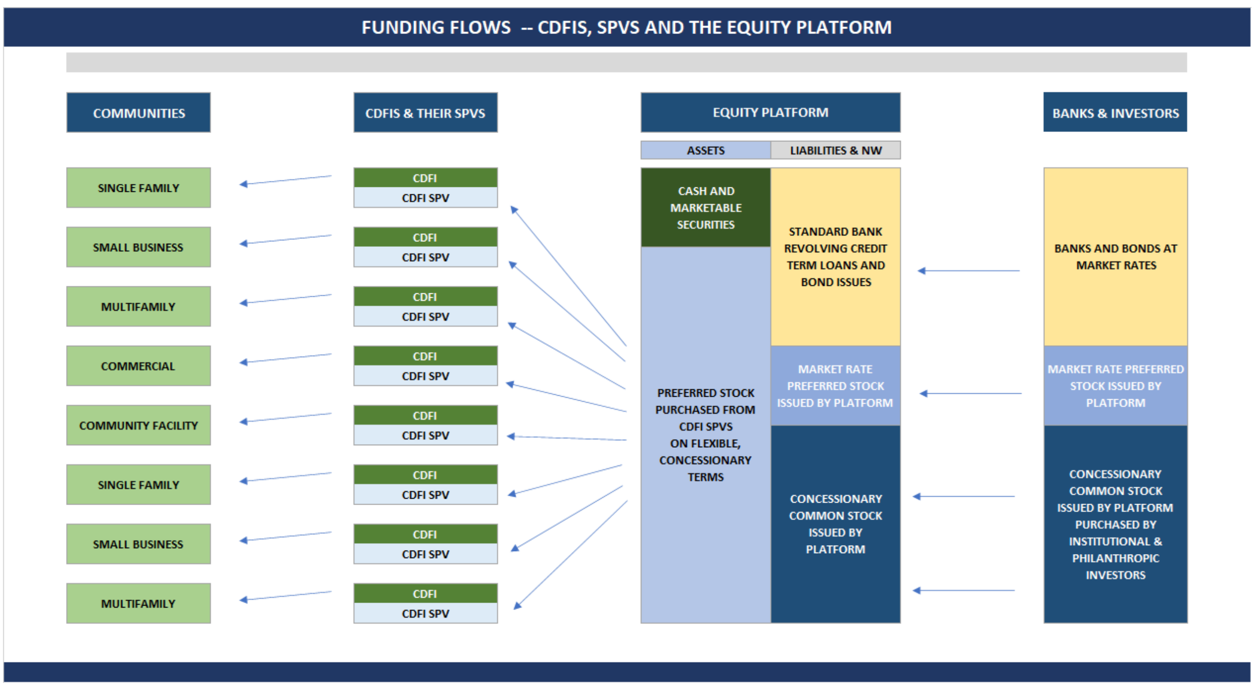
Preferred stock was deemed the most suitable form of equity for CDFIs due to (i) modest asset growth expectations; (ii) minimal investor voting rights—if any; (iii) fixed and established dividend rate; (iv) flexible terms and conditions; and (v) extensive use by financial institutions and financial institution investors familiar with preferred stock. *Preferred stock could open the door to the capital markets*. Once the preferred stock instrument achieved an investment grade rating, the CDFI industry access to capital would expand broadly in both the public and private preferred and common equity markets.

Financial Structure

The CDFI Equity Project calls for two structural steps:

1. The creation of a for-profit special purpose vehicle (SPV) at each CDFI for the purposes of receiving equity.
2. The creation of an equity platform (Platform) that raises equity in the conventional capital markets and uses the proceeds to provide the preferred stock to the SPVs.

The chart below shows how the funds flow from the conventional lending and investing public into the CDFIs, and from the CDFIs to the communities they serve:



The Platform is capitalized with (i) market-rate bank debt and bonds; (ii) market-based investment grade "plain vanilla" preferred stock; and (iii) concessionary common stock. The proceeds of the funding from the lenders and the investors are used by the equity Platform to invest in preferred stock issued by the CDFI SPVs. The SPVs upstream the cash to their CDFI parents as part of the purchase of loans from the parents. The CDFIs use the proceeds from the SPV preferreds to capitalize new loans in their communities.

CDFI SPV Structure

As part of the program, CDFIs create SPVs to provide a for-profit entity that issues the equity instrument and receives the cash. In the proposed structure, the CDFI parent creates a 100% owned SPV for this purpose. The SPV organization has the following key attributes:

1. There is an operating agreement between the CDFI parent and its SPV that governs the lending and administrative operations and transactions between the CDFI and its SPV. The CDFI appoints the leadership (executive director, and/or general or managing partner), identifies staff, outlines authorities, and conducts oversight via a structure determined by the CDFI.
2. The originating, servicing, and administrative functions are conducted by existing CDFI staff in the normal course of business. The costs incurred in their SPV activities are identified and reimbursed to the CDFI on a reasonable and consistent basis using established agreed upon terms and requirements.
3. There is a modest set of additional costs associated with the SPV, primarily in the form of auditing, legal issues and requirements, analysis, oversight, and meetings. It is recommended that a board of five including two non-CDFI personnel be established to demonstrate the arms-length nature of the transactions.

In order to assure stability, consistency, and value retention, the SPV works within specific financial guidelines:

1. The SPV is restricted to purchasing loans originated by the CDFI, and the loans represent at least 95% of SPV assets.
2. Total equity is not to be less than 30% of total SPV assets, and common equity of the SPV is not to be less than 50% of the preferred stock outstanding.
3. The SPV has a direct and discreet relationship with the equity Platform: There are no joint and several obligations with other participating CDFIs or their SPVs. There is no pledge of collateral.

In order to reduce the cost of underwriting, administration, and fund-raising, the SPV gets delegated authority to purchase and fund loans: the loans it purchases are funded by the issuance of SPV preferred units which are automatically purchased and funded by the Platform at a rate of 20 cents on the dollar. Operations are conducted as follows:

1. The SPV purchases loans originated and selected by the CDFI at book value on an arms-length basis. Purchases are done once each quarter.
2. Platform purchases of SPV preferred units are performed quarterly at the same time the SPV purchases the CDFI loans.

In addition to the upstreaming of the proceeds to the preferred interests and the reimbursement for operational expenses, the CDFI may take distributions from the SPV as long as the minimum equity percentages are maintained (See “Managing Risk” below). It is essential to remember that the creation of the SPV is specifically for the purpose of channeling equity into the non-profit CDFI loan fund. It is effectively, start to finish, a series of paper—or more accurately stated, electronic—transactions.

CDFI SPV Process

In the chart on page 7, the CDFI BEFORE columns on the left show what the CDFI looks like if it books a $1,000,000 loan in the normal course of business, without the benefit of the Platform:

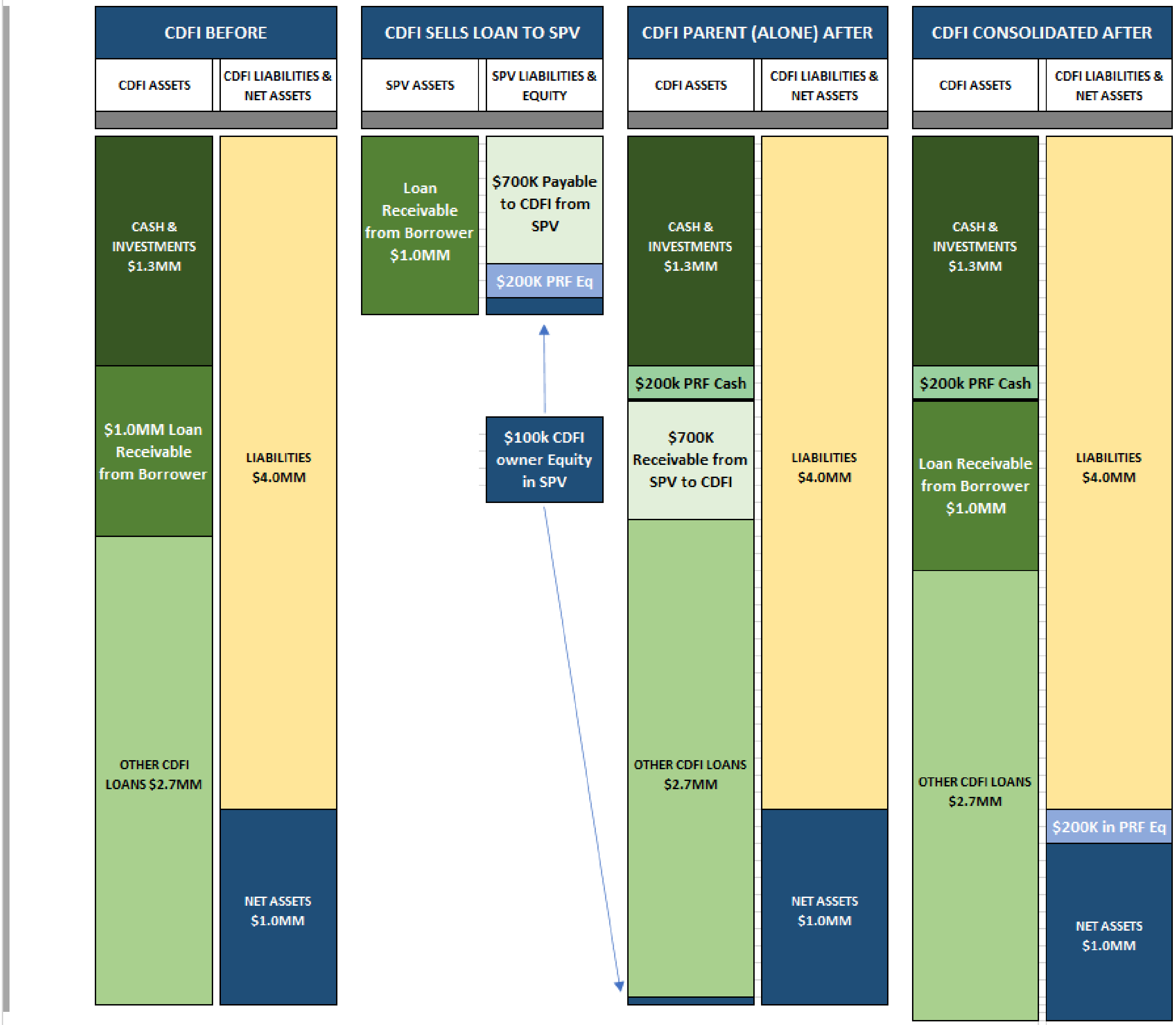
1. The CDFI reduces its cash account for $1,000,000 and conveys it to the borrower.
2. The CDFI increases its Loan Receivable account by $1,000,000, raising it to $3,700,000.

The next three columns show how the Platform improves both liquidity and capital for the CDFI AFTER for both the Parent Alone and Consolidated CDFI:

1. The CDFI sells the $1,000,000 loan to its 100% owned SPV (2nd Column).
2. The SPV issues $200,000 of SPV Preferred units to the equity Platform and receives 20% of the book value of the loan in cash—$200,000, which is upstreamed to the CDFI Parent (2nd Column).
3. The CDFI injects $100,000 in common equity into the SPV. This may be in cash or in other earning assets (2nd Column).
4. The SPV issues a $700,000 Note Payable to the CDFI to complete the transaction (2nd Column).
5. The CDFI on a Parent-Alone accounting basis now shows $200,000 of additional cash, so its Cash & Investment account goes up to $1.5 million from $1.3 million (3rd Column).
6. The CDFI Parent now has a $700,000 Note Receivable from the SPV and a $100,000 equity investment in the SPV. Together with the $200,000 in cash from the Preferred, this amounts to $1,000,000, equal to the amount of the loan that was sold to the SPV (3rd Column).
7. On a Consolidated basis, when the 100% owned SPV is consolidated into the CDFI's books, the intercompany accounts are eliminated leaving the final Consolidated Audit for the CDFI with $200,000 more in cash and $200,000 more in equity.

The results: the Cash and Investments to Total Assets ratio goes from 26% BEFORE to 30% at the AFTER Parent Alone column and 29% at the AFTER Consolidated column. The ratio of Total Liabilities to Equity goes from 4:1 BEFORE to 4:1 at the AFTER Parent Alone, and 3.3:1 at the AFTER Consolidated.

In sum: the CDFI ends up with $200,000 more cash, $200,000 more equity, more lending capacity, as well as the capacity to make more effective use of its grant capital. It also gains the potential to increase leverage in the future as a result of the reduced debt to equity on a consolidated basis.



Cash & Investments	$1,300,000	$0	$1,500,000	$1,500,000
Loans	$3,700,000	$1,000,000	$3,400,000	$3,700,000
Equity Investment	$0	$0	$100,000	$0
Assets	$5,000,000	$1,000,000	$5,000,000	$5,200,000
Liabilities	$4,000,000	$700,000	$4,000,000	$4,000,000
Preferred Equity	$0	$200,000	$0	$200,000
Common Equity	$1,000,000	$100,000	$1,000,000	$1,000,000
% Cash & Investments to Assets	26%	0%	30%	29%
Total Liabilities to Equity	4.00	2.33	4.00	3.33

The Key Platform Function

Note: the terms and rates below were drawn from market research conducted during 2020−2021 on preferred stocks in the banking industry, mortgage REITs, and private funds for subordinated and quasi-equity vehicles. The terms and conditions were not proposed to investors at the time. They do not reflect current conditions; they are shown here as examples of how the Platform works.

The Platform is structured to be attractive to the lenders and preferred investors at inception. It is over-capitalized, highly liquid, and pays *interest* and *preferred* dividends at a higher rate than warranted by the risk. This is due to the need to minimize the risk profile associated with a start-up equity fund.

The *common* equity interests (*interests* instead of stock when the platform is an LP) of the Platform are initially provided by private investors on concessionary terms—specifically, a low dividend yield and no liquidity over the short to medium term. Because of the size of the common equity on the balance sheet (never less than 40% of total assets) these concessions enable the Platform to accomplish two critical objectives: (i) adjust yields and redemptions downwards for the SPV Preferreds to better suit the needs of the CDFI constituencies; and (ii) adjust yields and redemptions upwards to suit the risk/reward appetites of the investors in the Platform Preferreds. This mediation is reflected in the chart below.

TERMS AND CONDITIONS	PLATFORM PREFERRED	ON SPV PREFERRED
Investor is:	Accredited or Institutional Investor	The CDFI Equity Platform
Dividend Yield	6.00%	6.00%
Cumulative/Non-cumulative	Cumulative	Cumulative
Redemption / Repurchase	5% Quarterly starting in 1Q Year 2	10% every 5 years
Minimum % Common to Preferred	200%	50%
Minimum Cash % to Total Assets	15.00%	2.00%
Minimum Cash % to Total Debt	33.00%	3.00%

The crucial fact here is that the Platform pays investors the same rate on its preferred interest as the SPVs pay the Platform on their SPV preferreds—6%. Though distributions on both are cumulative, the Platform must redeem its interests at a rate of 5% per quarter or 20% per year to ensure liquidity for its private investors. However, because the bulk of the Platform funding consists of common equity interests on concessionary terms, the platform can purchase preferred interests from the SPVs that require redemptions of only 10% every 5 years. Bottom line: the preferred equity that the CDFI SPVs get is more patient than that which the Platform obtains. The Platform's concessionary common interests also enable the SPVs to be far more highly leveraged and maintain much lower liquidity—both essential needs for the CDFIs in pursuit of their low-income lending mission. Despite the disadvantages to the Platform of the preferred terms it gets, it still generates profits and makes distributions to its investors. This is due entirely to the conservative capitalization and the concessionary rates on the Platform's common units. These common units are purchased by institutional and foundation investors motivated by the prospect of sustainable equity and unsubsidized equity growth for the CDFI sector over time (see Capitalization on page 11).

This crucial support mechanism is designed to decline in applicability as the quality and track record of the SPV loan and preferred portfolio performances are demonstrated: the more tested the assets and the model, the less the over-capitalization and liquidity constraints are required by investors. One of the main reasons that the investment grade ratings on the Platform preferreds is a primary objective is that the rating will lower the cost of the preferred, and free the Platform from the tight liquidity (redemption) requirements. Together with the lower unit cost of operations, this will (i) spark an improvement in margins, (ii) enable the Platform to raise the common dividend, and (iii) enable the Platform to enhance profitability by moderately leveraging. Once the Platform common is issued in the public market, it is possible for the CDFI SPVs to obtain or issue non-cumulative perpetual preferred stock on a flow basis.

This positive mediation between the requirements of public market investors (which the Platform engages) and the financing needs of low-income constituencies (which the participating CDFIs engage) is one of the chief benefits of the proposed structure. It is the central mechanism by which investor constraints are converted into patient capital for CDFIs, *and it is the primary innovation of this proposal.*

Managing Risk

There are three fundamental sources of risk in the Platform portfolio:

1. The SPV Preferreds are junior to all liabilities of the CDFI and its SPV.
2. The loans in the SPV are not pledged.
3. The delegation of credit authority to the SPV (and CDFI) produces a potential for moral hazard: the dumping of bad loans into the SPV portfolio.

These risks are mitigated by the following:

1. *Selection of CDFIs*. All participants are rated highly by AERIS (the rating agency that specializes in evaluating the financial condition management and impact of CDFIs).
2. *Structure of the SPVs*. As noted above, the SPVs are limited to investing in CDFI loans (no less than 95% of total assets), Debt not to exceed 70% of total loans, and Net Worth not to be less than 10% of total loans.
3. *First loss position*. The CDFI which owns the SPV 100% must keep a minimum of 50% of the value of the SPV preferreds in SPV equity.
4. *Credit Benchmarks*. The loans that the CDFI sells to its SPV must comply with certain benchmarks established at the beginning of each year by the Platform's Advisory Council—as approved by the General Partner or Managing Board. The benchmarks for size reflect considerations about concentrations by asset type, originator, and location. Benchmarks for credit include term, debt-to-income, debt-to-equity, interest coverage, and similar indicators.
5. *State-of-the-art predictive loan and loan portfolio monitoring system*. The system is highly automated and accurate. It generates trends by loan type and by lender and can be used by the participating CDFIs as well as the Platform for discerning and remedying impending impairment.
6. *Federal Agency presence*. The proposed investment in the Platform by federal agencies that provide resources to the CDFI sector discourages the misuse of the platform by CDFIs.
7. *Regular Credit Audits.* A comprehensive credit audit protocol for the SPV portfolios.
8. *Early Warning and Graduated remedies*. The Platform will take steps to mitigate excessive risk early in a CDFI SPV portfolio by (in order):

- Raising the dividend yield of the SPV's preferred units to reflect the higher risk
- Requiring the 10% equity injected by the CDFI to be in cash or marketable securities
- Closing of the equity window
- Conversion of the preferred interests to debt

One of the strategic innovations is that federal agencies that provide programs to low-income constituencies can invest in a form of non-voting common stock or common interest (in the LP stage). They may also take official roles in the operational functions: the proposal recommends that the CDFI Fund put its CDFI market resources to work in the Market Advisory Committee, and that the SBA (Small Business Administration) share its data capture and predictive modelling system with the Platform. The presence of the Agencies will also likely add credibility with investors. Discussions have been initiated with the CDFI Fund and are to be initiated with the SBA. Both capabilities could significantly reduce the cost of operating the Platform. They could also reduce the costs of market definition and risk management for the CDFIs. Discussion with the USDA (Department of Agriculture), HUD (Department of Housing and Urban Development), and the housing finance agencies is also recommended.

Strategy

A large number of scenarios were run on the Platform as a Limited Partnership (called "Source LP") as well as on the individual and aggregate loan portfolios of the SPVs. Some general observations include:

1. The optimal (stabilized) size of the Platform comes in around $200 million or more in assets (SPV preferred equities), with anything under $100 million probably not sustainable.
2. The use of a 70-20-10 Debt-Preferred-Common ratio for financing loans sold to the SPVs when combined with an asset restriction (loans, cash, and marketable securities only) effectively controls the leverage and protects the SPV preferred from excessive risk.
3. The 20% maximum preferred interest advance to the SPV enables the higher cost of the preferred to have a lower impact on the blended cost of funds for the SPV and CDFI.
4. Changes in loan volume at the SPV level have a greater impact than changes in rate, as do changes in the term and amortization of SPV debt. Because the CDFI/SPV's average maturity of debt and equity capital is being extended it is possible to extend maturities of the loans they make—and thereby accommodate the higher blended cost without altering the size of the borrower payment.
5. A leveraged fund with a 50/50 split between bank debt and a combination of preferred and common interests that favors common at a rate of 2:1 over preferred is feasible. In the 2020−2021 rate environment such a structure would enable the bank debt and the preferred interest to be obtained at market rates, while the below market rate common could become market rate in time.

The implementation of the CDFI Equity Project is sensitive to market conditions. During 2020, market appetite for innovation and risk was high and rates and yields low—ideal conditions for implementation. Present conditions are not similarly ideal. Implementation, however, is a multi-year proposition. There are two major reasons: (i) the challenge of creating a de novo equity platform in the public market calls for an interim step—initial funding provided through a partnership structure in the private market; and (ii) the absence of essential data on the valuation of CDFI loan and organizational assets in liquidation obviates a near-term investment grade rating for Platform preferred. Both obstacles can be reasonably addressed. This proposal embraces an interim structure that calls for a Limited Partnership at the Platform level

(Source LP) that is capitalized in the private market instead of a C-Corp capitalized in the public market. The five key components of the strategy are:

1. The Platform invests in the preferred units issued by the CDFI SPVs. The preferred units issued by the SPVs carry more flexible terms than the preferred units issued by the Platform which are purchased by private market investors (See the Key Platform Functions above).
2. In order to obtain an investment grade rating for its preferred units (or their equivalent), the Platform demonstrates the quality of CDFI credit to potential public as well as existing private investors. This is accomplished through: (i) the performance of the market-based preferred units it issues to private investors; (ii) the performance of the flexible preferred units the CDFI SPVs issue that are purchased and managed by the Platform; and (iii) the performance of the aggregated CDFI portfolio the CDFIs manage on behalf of their SPVs.
3. By using up-to-date market research, asset segmentation, and automated risk management technologies, the costs of running the Platform drops relative to the size of the portfolio. This enables the concessionary common equity of the Platform to raise dividend rates to a market level over time.
4. At or near the point at which an investment grade rating can be arranged for the Platform's preferred equity, Platform management begins demonstrating the potential for market rates and terms on the common by raising the common dividend. When the dividend and rate of growth reach market acceptable levels, most (if not all) of the SPV funding activity moves from the LP to a C-Corp capitalized entirely in the public market. The range and type of CDFI participant is expanded.
5. When CDFIs achieve sufficient scale, they can individually issue preferred stock similar to that of the Platform directly to the public market.

Capitalization

No similar kind of transaction has been identified. However, project finance for infrastructure provides a good model. The CDFI Equity Project proposal calls for three sets of discreet funding, which can be altered over a period of time depending on the outcomes of the first stage and achievement of specific objectives.

1. The *bank debt* should be relatively easy to arrange as it carries market rate and terms, and banks are already familiar and experienced with CDFI assets and operations.
2. Obtaining investment grade *preferred stock* from conventional public investors and calibrating it for CDFIs is the chief strategic objective. The big challenge is getting an investment grade rating. In the interim, preferred funding can be arranged in the private market, albeit with higher rates and strict liquidity requirements.
3. The key to the success of the Platform is the *common stock/interest* support. In order to make the preferred stock that the Platform issues attractive to conventional investors, it is necessary to have the common stock carry rate and liquidity concessions for a number of years. Solicitation for the initial common equity will be primarily among foundations and institutional investors known to the CDFI industry. These investors will be motivated by desire to prime the pump for independent and sustainable equity growth for the CDFI industry. They will also be motivated by the potential for a market return on an excellent and highly valuable public mission. Under the

current scenario, the common equity is designed to accomplish market rates and terms over time—prospectively within 7−10 years.

The optimal approach would be to arrange at inception facilities that fund the minimum sustainable size of the Platform—$100 million. A stack of 50/10/40 in common/preferred/bank debt presents a reasonable starting point. Since the biggest variable for the Platform is the extent to which the CDFIs will use it, commitments from the CDFIs must be arranged. Commitments to sell more than a set minimum of loans to their SPVs over a 2–3-year period will largely govern the magnitude of the financing at inception.