



Fundamentals of the Opportunity Finance Industry – Certificate in Community Development Finance

University of New Hampshire
Carsey School of Public Policy
Durham, NH

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University of New Hampshire
Carsey School of Public Policy

OPPORTUNITYFINANCE
NETWORK 

Day Two

- Analyzing CDFIs
 - CAMEL Analysis
 - Capital, Asset Quality, Management, Earnings and Liquidity
 - Financial Analysis of CDFIs
 - Sample financial exercise
- Lunch & Site Visits to Local Borrowers
 - Underwriting a CDFI borrower, including impact and financial analysis

Evaluating CDFIs vs. Projects

	CDFI	Project
Investor Security	Generally unsecured	Secured with real estate, fixed assets, other
Operations	Operating results; spread business; reliability of revenue sources	Income; debt coverage ratios; cash-flow
Leverage	Capital structure; asset ratios; seniority	Loan-to-value
Management	Management & board	Historically focused on project management
Repayment	Portfolio quality; asset-liability matching	Cash-flow; take-out financing; collateral value



Evaluating CDFIs

- Analyze Financial Strength and Performance through CAMEL
 - **C**apital (capital structure and capitalization)
 - **A**sset Quality (performance and practices)
 - **M**anagement
 - **E**arnings (structure and performance)
 - **L**iquidity (financing and operating)

Key Information for Analysis

- 3 years of audited financials
- Most recent interim financial statements
- Historical & current portfolio performance
- Peer comparison report – *Side by Side*
- Loan, investment and other policies
- Business plan and/or strategic plan
- Staff & board list and bios of management
- Board and committee minutes
- Conversations with management and board
- Aeris™ Report
- Key Operating Metrics

Key Components of CDFI Financial Analysis

- Understand corporate structure of CDFI
- Understanding financials:
 - 3+ years of audited statements
 - Most recent interim statements
 - Spread financials, and understand trends and ratio
- CAMEL Analysis
 - Explain changes/trends
 - Financials need to “jive” with what CDFI management discusses

Corporate Structure

- How do you assess the risk if the CDFI is comprised of multiple corporate entities?
 - What entity?
 - What is the relationship of that entity to other entities in the corporate structure?
 - The information is for what entity?
 - Audited statements
 - Interim statements
 - Other information
- How do off balance sheet activities relate?
 - New Market Tax Credits subsidiaries
 - Other subsidiaries

Statements of Financial Position & Activity

Balance Sheet Items	Income Statement Items
Assets •Cash/Restricted Cash •Loans Receivable & Equity Investments •Loan Loss Reserve •Real Estate/Fixed Assets	Revenue •Earned Income •Contributed Revenue
Liabilities/Net Worth •Notes Payable	Expenses •Financing Expenses •Operating Expenses
Net Assets •Unrestricted •Restricted	The "Bottom Line" •Net Operating Surplus (Deficit) •Change in Net Assets

CDFIs Manage Two Kinds of Funds

- Operating Funds
 - Earned income
 - Operating grants
- Financing Capital
 - Debt capital (various)
 - Equity or net assets
 - Restricted donations, surpluses designated
- Differentiate between operating funds and financing capital on financials

Capitalization

- Capital structure
 - % debt; % equity
- Characteristics (restrictions) of net assets
- Characteristics of debt (term, rate, maturity, senior vs. subordinate)
- Security of investment
 - Are some investments secured vs. unsecured?
- Diversity, predictability, and sources of capital
- Historic growth in CDFI's capital
- Capitalization strategies
- Contingent liabilities

Capitalization

	Debt	Subordinated Debt	Equity
Loan Fund	Unsecured loans Secured loans	Sub debt EQ2	Net Assets (non-profits), Equity
Venture Fund	Unsecured loans Secured loans	Sub debt	Equity
Credit Union	Deposits Shares	Secondary Capital	Equity
Bank	Deposits (primary) Unsecured loans		Equity



Capitalization

- Equity Equivalent Investments (Loan Fund)
 - Subordinate debt with equity-like features
 - Usually longer-term with roll-over feature
- Secondary Capital (Credit Union)
 - Subordinate debt with long terms available to credit unions with low-income designation from NCUA
 - A portion can count towards net worth ratio (helps to leverage deposits)

Capital: Understanding Net Assets

- **Unrestricted**
 - No donor-imposed limitations or internally generated (from surplus)
 - Maybe used for operations or financing
 - May be restricted by Board for future use
- **Temporarily Restricted**
 - Restricted for specific time period or use by donor
 - May be for operations or financing
 - May be “released” per donor terms, converting to unrestricted
- **Permanently Restricted**
 - Restricted in perpetuity by donor
 - For capital (cannot be “released” or spent)

Sample Footnote

Temporarily Restricted Net Assets as of 12/31/14

	<u>Purpose</u>	<u>Restriction Expires</u>
\$50,000	General Operating	12/31/13
\$50,000	General Operating	12/31/14
\$100,000	Public Policy-Operating	N/A
<u>\$500,000</u>	Capital	N/A
\$700,000		



Net Assets Characteristics

- **Board Designations**

- Can designate net assets for various purposes
- Typical to designate unrestricted net assets as capital
- Helps CDFI management, investors, and funders understand intent of funds
- Other purposes: operating reserve, LLR endowment
- Can be undesignated at any time

Ratio Analysis - Capitalization

- **Loan Fund**

- Net Asset Ratio
- Unrestricted Net Asset Ratio
- Alternative Net Asset Ratios that consider net assets available to protect lenders

- **Credit Union**

- Net Worth Ratio

Net Asset Ratio

- Measures the percentage of a CDFI's total assets that are equity or net assets
- Equity protects senior debt investors from losses, helps reduce a CDFI's average cost of capital, and enhances a CDFI's flexibility.

Net Asset Ratio = Total Net Assets ÷ Total Assets

\$21,987,234 ÷ \$104,617,612 = 21.0%

Unrestricted Net Asset Ratio

- Measures percentage of a CDFI's total assets that are in the form of unrestricted net assets.
- Shows how much flexibility the CDFI has to use its assets for financing or operations.

UNA Ratio = Total UNA ÷ Total Assets

\$10,432,220 ÷ \$104,617,612 = 9.97%

- Alternative calculation may include temporary and permanently restricted NA available for financing.

Net Worth Ratio (Credit Union)

- Primary measure to determine credit union's financial strength
- >7% – well capitalized; >6% – adequately capitalized
- Includes equity + Portion of secondary capital
- Typically much lower ratios than unregulated institutions

$$\text{Net Worth Ratio} = (\text{Equity} + \text{Portion of Secondary Capital counting for Net Worth}) / \text{Total Assets}$$

Sample Rate and Terms

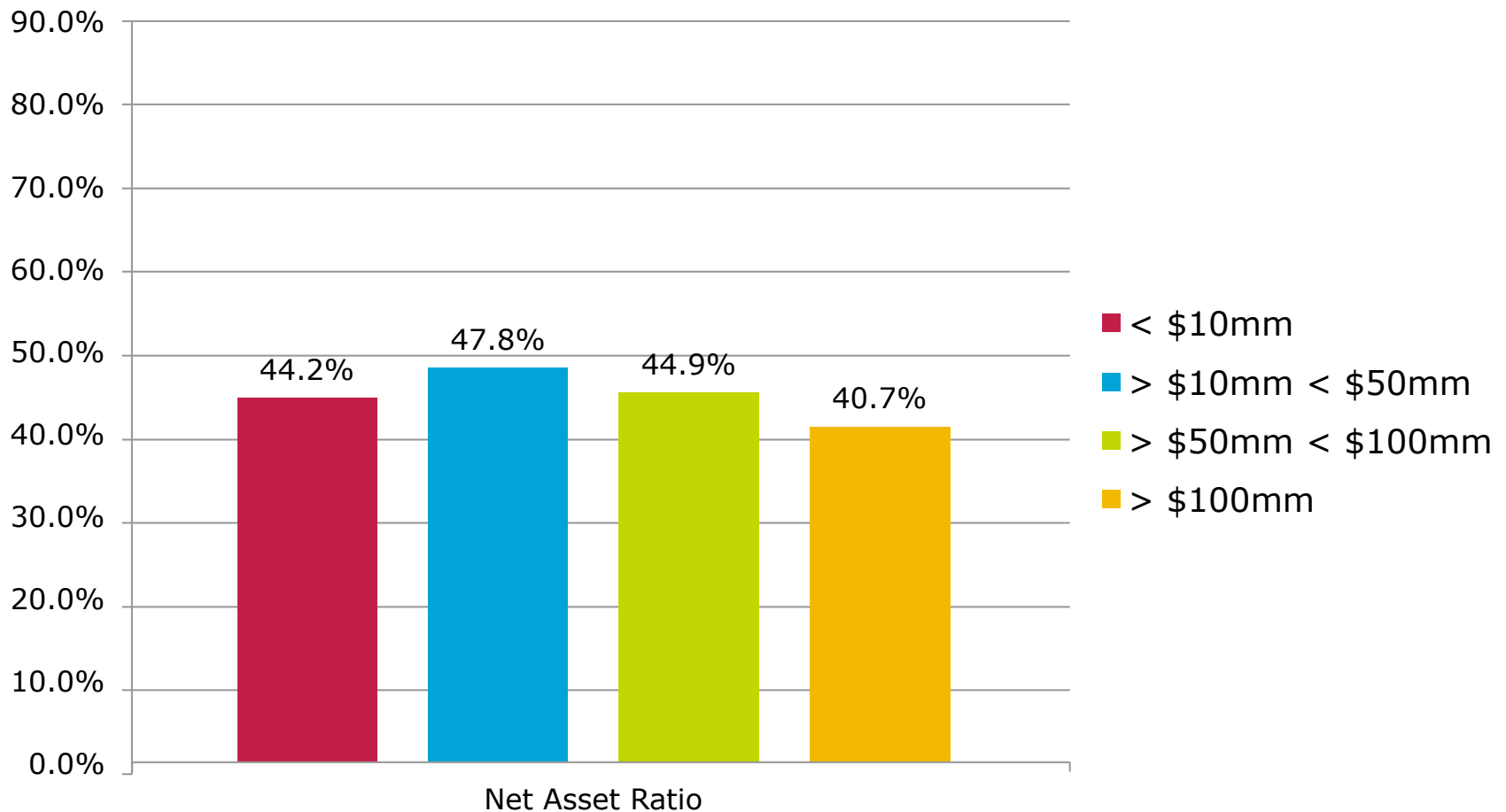
- Foundation PRI (low-cost, fixed rate)
 - 1- 4%; fixed rate, unsecured; 5-10 years
- EQ2
 - 1 - 3%, fixed rate; typical term of 5 years or longer, with rolling component, unsecured
 - Benefits bank's CRA (count towards lending or investment test)
- Bank Debt
 - Term loans (could be amortizing); less than 5 years
 - 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

Cost of Borrowed Funds By Loan Fund Service Area

Loan Fund Service Area	Average Borrowed Funds	Cost of Borrowed Funds	Term of Borrowed Funds	Average EQ2	Cost of EQ2
Urban	\$ 21,077,814	2.63%	83	\$ 1,574,742	2.25%
Rural	\$ 8,494,924	2.59%	151	\$ 840,707	2.15%



Net Asset Ratio By Loan Fund Asset Size



Asset Quality

- Understanding asset composition and quality are at the heart of the analysis process
 - Loan Process and Decision-Making
 - Asset Composition
 - Portfolio Performance
 - Portfolio Management

Asset Quality

- **Asset Composition**

- What types of loans does the CDFI make?
- Loans Receivable
- Cash and Investments
- Other Assets

- **Loan Process & Decision Making**

- Credit analysis and underwriting
- Policies and practices for approvals
- Credit & collateral file documentation
- Documentation of exceptions

Asset Quality

- **Portfolio Performance**

- Delinquency and write-off levels and trends
- Loan types, terms, concentrations
- LTV and lien position as % of total portfolio

- **Portfolio Management**

- Policies and practices for monitoring & managing portfolio
- Reports enable appropriate analysis
- Problem loan management
- Practices with regard to restructures
- Documentation, quality, valuation of collateral
- Analysis, management of risk, and relation to loan loss reserves
 - Risk Ratings – criteria and adjustments
 - Factor collateral valuation into adjustment of reserves

Asset Quality

- **Exposure to Contingent Liabilities**
 - Many different structures
 - Guarantees
 - Participations
 - LLCs and other entities
 - NMTC recapture risk
 - What is recourse back to the CDFI?
 - Other risks (i.e. legal, reputation)
 - Does CDFI have sufficient reserves for off-balance sheet activity?
 - Do they properly disclose off-balance sheet activity?

Ratio Analysis

- Allowance for Loan Loss Ratio
- Past Due Ratios
 - Loan Funds: >30 days & > 90 days
 - Credit Unions: > 60 days & > 180 days
- Net Charge-Off Ratio
 - Net of Recoveries

Allowance for Loan Loss Ratio

- Measures the Allowance for loan losses (ALL) as a percentage of a CDFI's gross loans.
- ALL acts as insurance reserves for potential problem loans. They are an estimate of loans (or portions of loans) that may prove to be uncollectible.
- The net impact of the ALL is to discount the value of the gross portfolio based on likely repayment and to smooth losses on the income statement

ALL Ratio = ALL ÷ Gross Loans Outstanding

\$2,405,319 ÷ \$85,589,275 = 2.8%

Past Due Ratio >30 Days

- Measures the dollar amount of delinquent loans as a percentage of a CDFI's gross loans outstanding.
- Demonstrates potential problem loans in the portfolio. Consider in conjunction with the ALL Ratio and Net Charge-off Ratio.

**Past due >30 Days Ratio = Past Due Loans
>30 Days ÷ Gross Loans Outstanding**

Net Charge-off Ratio

- Measures the net amount of loans written off as a percentage of a CDFI's gross loans outstanding.
- Ratio will fluctuate year-to-year based on portfolio performance.

Net Charge-off Ratio = Net Charge-offs ÷ Gross Loans Outstanding

\$53,109 ÷ \$ 85,589,275 = .06%



Calculating Charge-offs

- Formula to calculate charge-offs
- Start with the loan loss reserve for the prior year, add in the current year loan loss expense and subtract the loan loss reserve for the current year

$$\text{Charge-off} = \text{LLR}(\text{beg}) + \text{LLR Expense} - \text{LLR}(\text{end})$$



Sample Portfolio Performance

	FY 13	FY 14	FY 15
31-60 days past due	0.7%	0.7%	0.9%
61-90 days past due	0.3%	0.5%	0.8%
>90 days past due	0.9%	2.6%	2.8%
<i>Total past due %</i>	<i>1.9%</i>	<i>3.9%</i>	<i>4.6%</i>
<i>Net Charge off %</i>	<i>0.5%</i>	<i>0.3%</i>	<i>0.1%</i>
<i>Impaired loans %</i>	<i>5.6%</i>	<i>1.3%</i>	<i>2.3%</i>
ALL%	2.9%	2.2%	2.8%



CDFI Portfolio Quality Rivals Conventional Financial Institutions

Average Past Due	%
>90 days	1.5%
>30 days	4.1%
Average Net Charge-Offs	%
Net Charge-Offs	0.7%

Data provided by OFN's "CDFI Market Conditions Report"

Portfolio Definitions and Reporting

- Important to have consistency of portfolio definitions within your organization and across the industry
- Paper published by Performance Count helps set standards for definitions

"CDFI Portfolio Reporting, Definitions, Accounting Treatment, and Reporting Guidance"

Portfolio Definitions and Reporting

- When terms have same / similar meanings, Performance Counts recommends a term for CDFI industry use.
- Example:
 - **Past Due loan** – any loan where principal and/or interest is past due according to the scheduled repayment terms specified in the loan documents
 - Recommended terms not to use which have the same or similar meaning: **delinquent loan, PAR**

Portfolio Definitions and Reporting

- *Recommend all CDFIs use the following terms in to described portfolio performance:*
 - *Current loans*
 - *Past due loans (31-60; 61-90, >90 days)*
 - *Non-accrual loan*
 - *Impaired loan*
 - *Troubled Debt Restructuring (TDR)*

Proposed Supplemental Loan Quality Portfolio Reporting Chart

Loan Quality Report

Principal Amount (\$)	Total Portfolio	Non-Accrual (Subset of Total)	Impaired (Subset of Total)	TDR-optional (Subset of Total; Subset of Impaired)
Current	\$4,925,000	\$0	\$25,000	\$25,000
31-60 days past due	\$100,000	\$0	\$0	\$0
61-90 days past due	\$200,000	\$0	\$0	\$0
>90 days past due	\$275,000	\$275,000	\$275,000	\$275,000
Totals	\$5,500,000	\$275,000	\$300,000	\$300,000

Note: Each category (Non-accrual, impaired, and TDR) is a subset of the total portfolio. Loans are often included in more than one category, so that the columns can not be added together. All TDR loans are also impaired. All non-accrual loans are impaired. Not all impaired loans are non-accrual or TDR.

*If there are loans that are >90 days past due and not on non-accrual, the CDFI may want to note why the CDFI chose not to put the loan on non-accrual.

Investing Idle Funds

- Most CDFIs have Investment and Cash Management Policies that guide idle fund investing
 - Mostly very conservative practices
 - Preservation of capital is most important goal; high quality
 - Predominantly MMFs & fixed income
- Some CDFIs have negative and/or positive mission screens as well.

Management

- Strategy
 - Regular planning process; history of achieving goals
- Governance
 - Appropriate expertise and structure
 - Evidence of fiduciary oversight
 - Succession planning for CEO, key management
- Management and Staff
 - Depth, experience, and tenure
 - Rational staffing structure
 - Professional development
- Infrastructure and Information Systems
 - Quality of information systems, including reporting capability
 - Internal controls

Earnings

- History and trends of operating results
 - Change in unrestricted net assets (or net income) to assess operating performance
- Characteristics of revenues and expenses
 - Composition and reliability of earned and unearned (grant) revenues
 - Composition of expenses (financing vs. operating)
 - Ability to reduce expenses and maintain core financing activities if revenues fall short
 - Should not use financing capital (e.g., CDFI Fund grants for financing) to cover operating expenses
- Strategies for sustainability, self-sufficiency, efficiency, etc.

Self-Sufficiency Ratio

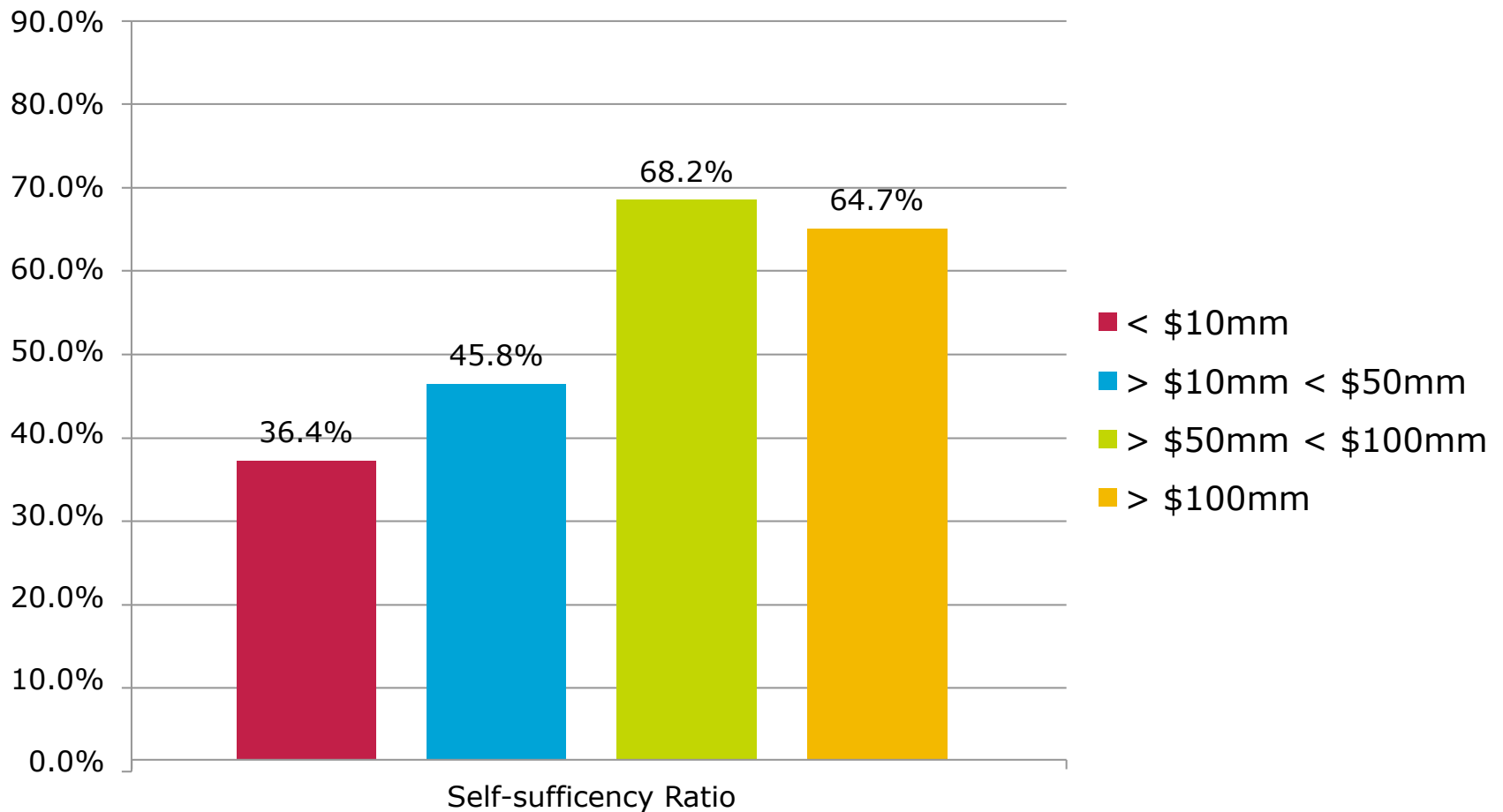
- Measures the extent to which a CDFI is covering its expenses through earned income
- Higher self-sufficiency allows CDFIs to be more independent in program growth and priorities
- Adjusted expenses excludes pass-through grants and one-time non-operating expenses

**Self-Sufficiency Ratio = Earned Income ÷
Total Adjusted Expenses***

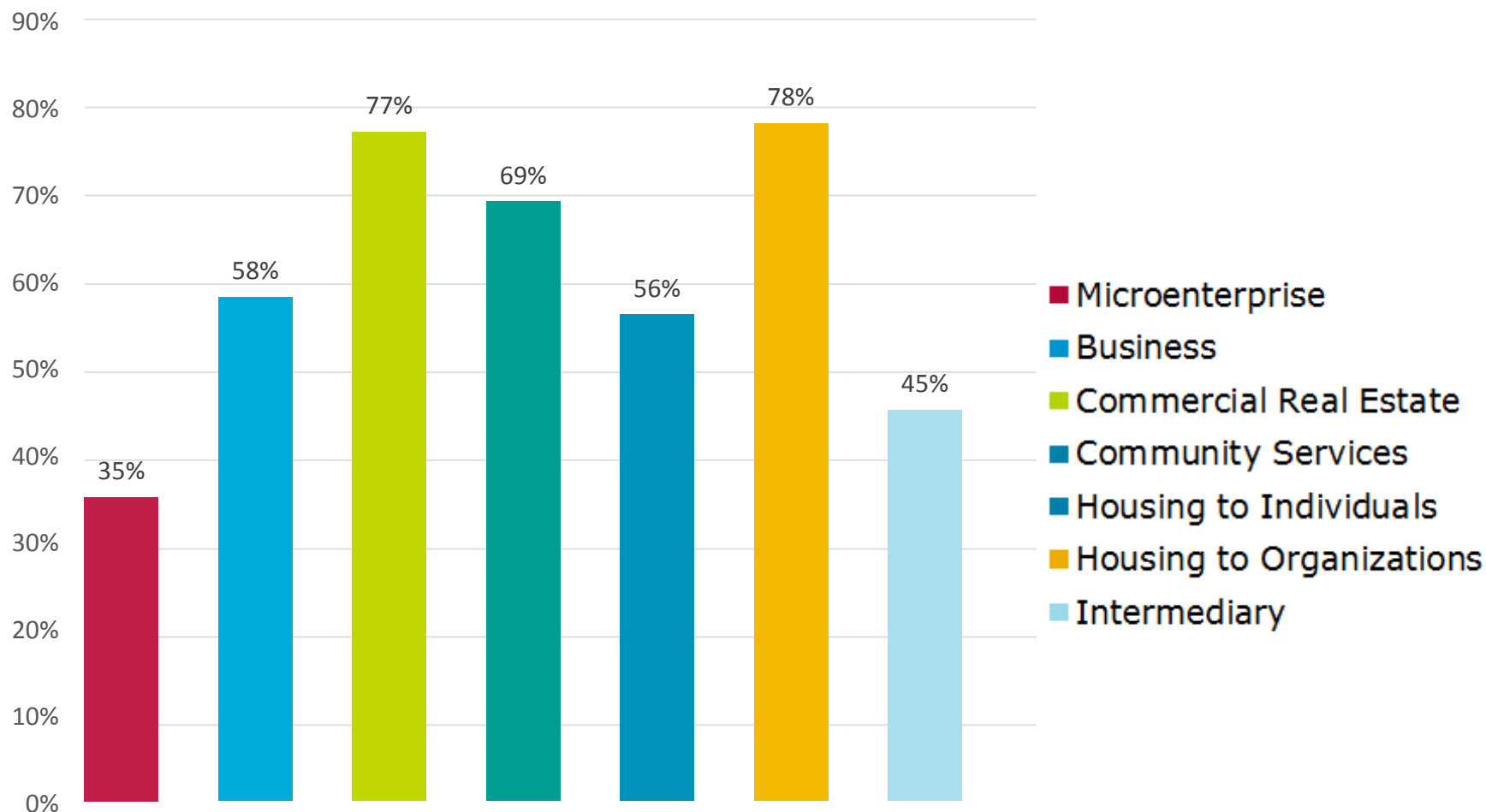
\$6,511,582 ÷ \$9,447,326 = 69%

*operating expenses + financing expenses

Self-Sufficiency By Loan Fund Asset Size



Self-Sufficiency By Sector



Liquidity

- **Understand both operating and financing liquidity**
 - Liquidity of resources for operations
 - Strategies for managing cash for operations vs. financing
 - Reliability of revenue reduces required level of operating liquidity
 - Quick and Current Ratios - Trends
 - Liquidity of resources for financing
 - Ability to meet short-term commitments
 - Asset-liability matching
 - History of meeting investor obligations
 - Off-balance sheet liquidity tools
 - Interest rate risk management (*historically, interest rate risk for most CDFIs has been low*)

Asset Liability Management

- Typically included in Investment & Cash Management policies
- Managing assets and cash inflows to satisfy various lender/investor and other obligations
- Liquidity risk
- Interest rate risk
- Form of risk management
 - Matching assets & liabilities
 - Operating and capital liquidity reserves
 - Lines of credit
 - Interest rate management

Asset Liability Management

- To the extent that a CDFI borrows short term and lends long term, it has a mismatch that it needs to address through structuring of assets and liabilities or using swaps, options and futures.

Deployment

- Measures the percentage of total financing pool that is deployed; CDFIs need to manage this ratio. Should be considered over time. Can all include loan commitments.

Loans & Notes Outstanding ÷ (Debt + EQ2 + Net assets Available for Financing + UNA)

$$\begin{aligned} & \$ 85,589,275 \div (\$71,423,752 + \$8,600,000 + \\ & \$1,000,000 + \$7,688,150 + \$11,074,468) = \\ & \quad \quad \quad \mathbf{86\%} \end{aligned}$$



Structuring Loans to CDFIs

- Factors
 - Loan Term
 - Loan Type (balloon, amortizing)
 - Secured vs. Unsecured
 - Pricing (fixed, variable)
 - Corporate Structure and Subsidiaries
 - Covenants
 - Reporting
 - Exposure
- Typical Loan Covenants
 - Net Asset Ratio
 - Allowance for Loan Loss Ratio
 - Operating Surplus
 - Liquidity

Evaluating a CDFI's Financials

Small Group Exercise

- Calculate ratios
- What questions do you have?
- What are strengths and challenges?

Site Visits

Off-Site Lunch, Bus Tour Site Visits to CDFI
Projects & Underwriting a CDFI
borrower

Hosted by New Hampshire Community Loan Fund
(NHCLF)

Jennifer Hopkins, Director of Single Family
Housing, NHCLF

