DUE DILIGENCE PRIMER FOR COMMUNITY INVESTING

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Section 1. Introduction

Since the Social Investment Forum Foundation and Co-op America launched the 1% in Communities Campaign in 2001, the dollar amount of investments targeted to communities underserved by traditional financial services grew by 84% to $14 billion in 2003, as reported in the "2003 Report on Socially Responsible Investing Trends in the US" (www.socialinvest.org) The community investment industry has also increased in sophistication with an increasing number of community investment options available and a broad range of investors now involved.

This Primer will help you understand what kinds of community investment institutions you can invest in, what kinds of investments you can make, how these investments may differ from the rest of your portfolio, how to evaluate potential community development investments, and what kind of impact you can have.

Section 2. Community Investing Defined

Community investing is capital from investors that is directed to communities that are underserved by traditional financial services. It provides access to credit, equity, capital, and basic banking products that these communities would otherwise not have. In the U.S. and around the world, community investing makes it possible for local organizations to provide financial services to low-income individuals, and to supply capital for small businesses and vital community services, such as child care, affordable housing, and healthcare.

These local financial service organizations prioritize people who have been denied access to capital and provide them with opportunities to borrow, save, and invest in their own communities. In addition to supplying badly needed capital in underserved neighborhoods, community investment groups provide important services, such as education, mentoring, and technical support. They also build relationships between families, non-profits, small businesses, and conventional financial institutions and markets.

Section 3. Types of Community Investment Institutions

Investors, either individuals or institutions, who want their dollars invested in underserved communities, have several different options. There are different types of community development institutions in the US and in developing countries that accept investments from individuals and/or institutions to help them carry out their work. Community development entities that offer financial products in the US are known as "CDFIs", or community development financial institutions. There are also different types of investments. Investors can find a community investing option that supports a specific geographic area or social impact sector (affordable housing, small and micro businesses, etc). Or, investors can invest in a CDFI Intermediary that can spread the investment across multiple locations or impact sectors.

For example, Community Development Credit Unions often focus their efforts on providing financial services in specific low-income communities (such as **Vermont Development Credit Union**: (www.vdcu.org) which serves underserved areas of Vermont). Investors can buy federally insured Certificates of Deposit (CDs) from VDCU, open a money market account, a savings account, or even a checking account. Institutional investors can also make a secondary capital deposit to the credit union, a type of deposit that strengthens the credit unions balance sheet (but is not insured and consequently riskier for the investor).

The following different types of organizations offer community investing options to investors:

Community Development Banks (CDBs): Community Development Banks are regulated, commercial banks and occupy the category of CDFIs with the greatest amount of assets ($7.2 billion). CDBs are located throughout the country and provide capital to rebuild many lower-income communities. For account holders, they offer services available at conventional banks, including savings and checking accounts as well as cash management options like money market funds that may have a social impact perspective. Like their conventional counterparts, they are federally insured. The **CDFI Fund of the US Treasury Department** lists more than 50 Certified Community Development Banks on its website(http://cdfifund.gov/docs/certification/cdfi/CDFI-type.pdf).

Community Development Credit Unions (CDCUs): As of 2003, with combined assets of $2.7 billion, there are more than 200 membership-owned and –controlled nonprofit CDCUs serving people and communities with limited access to traditional financial institutions. Account holders receive all the services available at conventional credit unions, and their accounts are federally insured. The CDFI Fund lists more than 130 Certified Community Development Credit Unions (http://cdfifund.gov/docs/certification/cdfi/CDFI-type.pdf) and the National Federation of Community Development Credit Unions (www.natfed.org) provides links to the web sites of many of its members.

Community Development Loan Funds (CDLFs): Community Development Loan Funds are the second-largest type of CDFI, with $3.6 billion in assets. These funds operate in specific geographic areas, acting as intermediaries by pooling investments and loans provided by individuals and institutions at below-market rates to further community development. CDLFs use this capital to make loans to small businesses, developers of affordable housing, and community services such as childcare and urban arts centers. There are more than 480 CDLFs certified by the CDFI Fund (http://cdfifund.gov/docs/certification/cdfi/CDFI-type.pdf). You can find more information about many of these CDFIs from the Community Investing Center website (www.communityinvestingcenter.org).

An important subset of CDLFs is international microfinance institutions. International funds, with $72 million in assets, focus their lending and equity investments overseas, often providing or guaranteeing smaller loans to communities and individuals in need.

Some of the leading microfinance organizations are members of the **Microfinance Network** and are listed at: (www.bellanet.org). The World Bank estimates that there are more than 10,000 microfinance institutions around the world. The **Microfinance Information Exchange** (www.themix.org) also has profiles of international microfinance entities and other resources that may be helpful to investors.

Community Development Venture Capital (CDVC) Funds: Community Development Venture Capital Funds use the tools of venture capital to create jobs, entrepreneurial capacity, and wealth, thus improving the livelihoods of low-income individuals and the economies of distressed communities. With $485 million of capital under management, CDVC funds make equity and equity-like investments in highly competitive small businesses that hold the promise of rapid growth. The investments typically range from $100,000 to $1 million per company, smaller than most traditional venture capital investments. The companies in which CDVC funds invest generally employ between 10 and 100 people. **The Community Development Venture Capital Association (CDVCA)** lists many CDVC funds both in the US and overseas at www.cdvca.org.

CDFI Intermediaries: In addition to the many types of CDFIs above to which investors can channel their investments, there are several intermediaries that can do the channeling to local CDFIs for you. CDFI Intermediaries offer important advantages for investors by serving as a 'fund of funds', providing investors with the financial advantages of portfolio diversification, professional management, investment monitoring and credit enhancements. These intermediaries pool investments from different types of investors and then conduct due diligence prior to making investments in the types of entities described above. They monitor the investments, report to the investors, and manage loan loss reserves to reduce investor risk.

With a single investment into a CDFI Intermediary investors can channel their resources to several CDFIs, reaching well-known and newer innovative organizations. Some CDFI Intermediaries offer investors the option of targeting their investments to specific geographic regions or social impact sectors. CDFI Intermediaries were conceived of to make it safer and easier for investors to place their capital with CDFIs.

The **Calvert Foundation** (www.calvertfoundation.org) accepts investments from individuals and institutions ($1,000 minimum) and uses that capital to make loans and investments to both domestic and international community development institutions of all types.

The **Community Development Venture Capital Association** (www.cdvca.org) accepts investments from institutions ($250,000 minimum) for investing in community development venture capital funds.

National Community Capital Association (NCCA) (www.communitycapital.org) accepts investments from institutional investors and individual trusts ($50,000 minimum), and makes loans and investments to domestic CDFIs of all types. NCCA also provides asset management services to investors, which can include marketing, underwriting, and servicing investments in different types of CDFIs.

National Community Investment Fund (www.ncif.org/) accepts investments from institutional investors ($500,000 minimum) to invest in Community Development Banks. Investment terms are customized, and there are also New Markets Tax Credit investment opportunities, which can provide an enhancement to risk adjusted return for qualifying investors.

National Federation of Community Development Credit Unions (www.natfed.org) accepts investments from institutional investors and individual trusts ($100,000 minimum) to invest in individual credit unions.

Partners for the Common Good (www.pcg21.org), associated with Christian Brothers Investment Services, offers similar services with a special focus on community development corporations and social enterprise.

MMA Community Development Investments (www.mma-online.org/cdi/contents.html), associated with **Mennonite Mutual Aid**, offers traditional community investment options and a near-market pool.

The Shefa Fund (www.shefafund.org) concentrates on select cities and involves Jewish community education along with its community development investments.

Some of the CDFI Intermediaries mentioned above also work with investors to help them invest directly in CDFIs, rather than through the intermediary itself. The **Calvert Foundation** and **National Community Capital Association** conduct due diligence and monitor investments in CDFIs on a fee for services basis. The investor's capital goes straight to the CDFI (such as **Boston Community Capital**) and the note is between the investor and the CDFI. But, the investor contracts out the underwriting and servicing of the loan to an entity with expertise in CDFI underwriting and monitoring. In addition, Calvert Foundation provides consultation on designing new community loan programs and administration and design of community investor products and programs. National Community Capital's new rating system, CARS™ will also make it easier for investors to invest directly in CDFIs.

On the international front, there are several intermediaries that pool investments to channel capital for placement into microfinance lenders, serving the poorest of the poor across the globe. Intermediaries provide important supervision, foreign exchange risk management and technical assistance in addition to capital for their borrowers.

Of these international intermediaries, **Oikocredit** (www.oikocredit.org)**,** with more than $200 million in assets, is the largest and oldest of its kind, with more than 35 years of experience and support from hundreds of individuals and faith-based institutions. Launched with the support of the World Council of Churches, Oikocredit operates in more than 50 countries around the world.

Several other intermediaries are geographic in focus, including **Shared Interest** (www.sharedinterest.org), which mobilizes credit for local organizations in South Africa. **ACCION International** (www.accion.org) is another intermediary that has traditionally concentrated in Latin America but also works in Africa, Asia, and the US.

See **Appendix 3: Community Development Corporations and Affordable Housing Developers** and **Appendix 4: Social Enterprises** for an overview of these community investment opportunities that fall outside the scope of this Primer.

Section 4. Community Investment Products or Types

Just as there are many different types of institutions providing community investment opportunities, there are many different types of investments.

Investment Type	**Types of Investor**	**Organization**	**Characteristics**
Checking & Savings Accounts	Individual Institution	Bank Credit Union	Community Development banks offer conventional bank-by-mail and checking services available nationally.
Money Market Accounts	Individual Institution	Bank Credit Union	Larger Community Development Banks like ShoreBank and Credit Unions like Self-Help offer full service money market accounts.
Certificates of Deposit	Individual Institution	Bank Credit Union	Federal insurance available may range up to $10,000,000 among select community development banks and to $100,000 for credit unions; May offer market rates of interest; Terms vary.
Senior Loan*	Individual Institution	Loan Fund Intermediary	Not insured; Often below-market rate of interest; Terms vary.
International Guaranty*	Individual Institution	International institution	Investor provides a dollar denominated guaranty to a US-based international organization or bank, which in turns makes a direct loan in local currency to the recipient nonprofit. This allows the investor to avoid currency risk in international investments.
Subordinated Loan*	Institution	Loan Fund Intermediary	Subordinate to senior loans; Often below-market rate of interest; Terms vary; Helps build institution's balance sheet.

Equity Equivalent (EQ2) Investment* (An EQ2 Primer is available from NCCA: www.communitycapital.org	Institution	Loan Fund Intermediary	Deeply subordinated to other obligations; Often below-market rates of interest; Terms vary, but must be fairly long term or have a rolling term; Can provide bank investors with enhanced Community Reinvestment Act credit; Helps build institution's balance sheet.
Secondary Capital*	Institution	Credit Union	Subordinate to senior loans; Often below-market rates of interest; Terms vary, but generally fairly long term; Helps Credit Union build balance sheet.
Equity Investment*	Individual Institution	Bank Venture Capital	No maturity date or established return; Return of principal and any profit contingent on performance of investee.

* These investments are generally limited to individuals and institutions that qualify as "accredited investors." The SEC definition of accredited investors can be found at http://www.sec.gov/answers/accred.htm. Accredited investors are generally considered to be investors who have sufficient knowledge and experience with investing that he/she is able to evaluate the merits of an investment and have a defined minimum income or net worth.

Section 5. Community Investing: Opportunities and Challenges

The types of community investments described above offer investors an opportunity to earn both a financial and a social return on their investments. Investors interested in a specific local community might be able to find a local loan fund, bank, or credit union that can put their capital to work immediately in that community through loans to small businesses. An investor interested in helping entrepreneurs build a fairer economy in Peru can find a microfinance organization that will use their capital to make loans to shoemakers and carpenters. An investor committed to affordable housing for all can find a local or national community development institution that can use their capital to develop affordable housing in disadvantaged communities. Or an investor can work through a CDFI Intermediary to accomplish any one or all of these social objectives.

Community impact is one of the principal differences between community investments and other investments that investors make. Community investments can be targeted to build affordable housing in certain communities, provide financing for expansion to childcare centers, or provide growing businesses with the capital they need to expand and employ more workers. There are other differences as well, including the challenges listed below. (For a more detailed discussion of the differences between conventional financial markets and CDFI financial markets see: "Financial Markets and the CDFI Industry-An Oversimplification" a Technical Assistance Memo available from National Community Capital: (www.communitycapital.org/).

Liquidity: Most community investments have a fixed term and investors should not count on getting their money back before the end of that term. Certificates of Deposits (CDs) have a fixed term and penalties for early withdrawal. Other types of loans to community development institutions also have a fixed term, usually ranging from one year to ten years or more. Unlike standard commercial investment products like bonds, loans to community development institutions do not have a secondary market and investors will not be able to "sell" their community development institution loans to another investor. The community development institution may repay early upon request, but early repayment is usually at the community development institution's sole discretion. There are several options for investors seeking greater liquidity in community investment products. Many community development banks offer checking and savings accounts and money market funds. Some, like ShoreBank and Self-Help Credit Union are prepared to work with investors from across the country. Calvert Foundation offers its Community Investment Management Account, which links its Community Investment Note with the Calvert Social Investment Fund-Money Market Portfolio. On the other hand, many community investment instruments are less liquid.

Regulation and Ratings: The conventional capital markets are heavily regulated by agencies such as the Securities and Exchange Commission. Companies and bond or equity issues are rated by well-known Wall Street firms such as Standard and Poor's or Moody's. Within the community development industry, banks and credit unions are regulated, but loan funds, venture capital funds and other types of community development institutions and intermediaries are not.

There is significant data available on specific community development institutions as well as on the industry as a whole (see www.communityinvestingcenter.org), but the kind of information necessary to conduct due diligence on a potential community investment is more difficult to locate and analyze for a community development institution than for conventional investments. Calvert Foundation makes available due diligence reports, prepared by independent third-party analysts, on approximately 100 community investing organizations (a mix of CDFIs and community development corporations, known as CDCs) and these are available to investors on a fee for service basis.

The only rating system to rate domestic CDFIs is beginning in early 2005. The CDFI Assessment and Rating System, CARS™, was developed by National Community Capital Association and rates CDFIs based on Impact Performance and Financial Strength and Performance. More information on CARS™ and the CDFIs that have been or are being rated is available on NCCA's website (www.communitycapital.org/financing/cars.html).

There are several rating agencies that evaluate international microenterprise institutions, including Microrate (www.microrate.org) and Planet Finance (www.planetfinance.org). CGAP (www.cgap.org) has a comparative description of the various rating agencies. Also, the MFI Rating Fund lists qualified raters as well as reputable membership networks that can be of great assistance to investors at www.ratingfund.org/mfi_institutions/qualified_raters.html.

Convenience: Investments into community development institutions have typically not been available through the conventional securities distribution channels. More conventional access to community investment products has been introduced in recent years. Certificates of Deposits issued by ShoreBank can be accessed through Schwab and the Calvert Community Investment Note is also soon to be available through Schwab and other wirehouse brokerages such as A.G. Edwards. In most cases, however, investors usually have to go directly to the community development institution (some money managers are familiar with community development institution investments and can provide guidance), and follow through their specific investment process. Community development institutions generally provide regular reports to investors on their investment. However, if the investor works with a money manager or investment management firm that provides a consolidated statement of all of their investments, it is unlikely that they will be able to include the community development institution investment on such a statement. There are initiatives underway currently to address this issue.

Scale: CDFI investment opportunities range from as little as $100 for a checking or savings account to millions of dollars. The Calvert Community Investment Note is available at $1,000 or above as are many of the CD options available from community development banks. Many community development loan funds and organizations and some of the CDFI Intermediaries, however, offer investments with $10,000 or $100,000 minimum investment levels. For investors seeking to place larger sums, the Certificate of Deposit Account Registry System (CDARS) (www.cdars.com) has made it possible for investors to get full FDIC coverage on certificates of deposits up to $10 million issued by community development banks. More than 20 certified CDFI Community Development Banks participate in this program.

Section 6. Overview of Risk of Community Investments

Because of the lack of ratings and regulation, it is difficult to assess the level of risk of different types of community development institution investments and different community development institutions. Clearly, insured investments (such as certificates of deposits) in regulated CDFIs (community development banks and credit unions) are the least risky investments. However, other types of investments in other types of community development institutions have proven safe and attractive for many investors.

Investor losses in community investing have been minimal, at most. Of the 442 CDFIs surveyed through the CDFI data project, none of them have reported that they have ever lost any investor principal. Many of the CDFIs themselves have lost money, either through operations or loan losses. However, in general, they have been able to manage the risk they take in such a way that they have been able to fulfill their obligations to investors. Hundreds if not thousands of investors, including institutions and individuals, have placed their investments in hundreds of CDFIs without suffering any late interest or principal repayments. However, unless investing in a federally insured community development bank or credit union, loss of principal remains a possibility.

While losses in the community investment field have been minimal, National Community Capital and Calvert Foundation are aware of at least three community development institutions that have gone out of existence over the past ten years due to financial problems. In one case, operating losses forced the CDFI to close and they sold their portfolio to another CDFI who assumed the liabilities. In some cases their portfolio and equity base were sufficient to repay investor capital. In other cases their portfolio was sold to another CDFI who repaid investors at maturity. These cases understandably caused concern among investors and highlighted that investing in CDFIs is not risk-free. Some investors agreed to be flexible and extend the maturities of their obligations in order to increase the likelihood of full repayment. In addition, investors have foregone interest while the borrower has worked through their issues. This flexibility on part of the investors was key in allowing the borrower to regain their footing and ultimately repay investors. To our knowledge, however, in most instances investors did either get their investments back, or are likely to get it back when their investment matures.

These situations provide valuable information to lenders in identifying key risk areas and refining best practices in order to avoid such situations in the future.

Relative Risk of Community Investments

The diagram below is an attempt to show the likely risk continuum for many types of community development institution investments. This diagram is NOT based on actual data of investor losses, which is very hard to come by, but on an analysis of the types of risk of different types of investments. In addition, it is important to note that there is a <u>wide</u> range of credit quality within each of these categories.

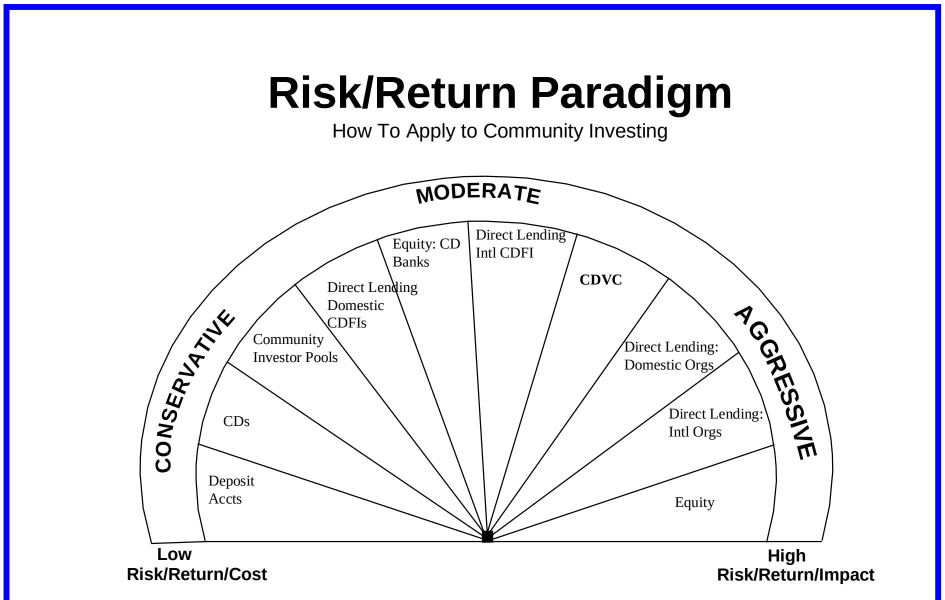

Chart Courtesy of Frank Coleman, Christian Brothers Investment Services

Certificates of Deposit in Community Development Banks and Credit Unions, as the diagram indicates, the least risky community investments are those that are insured – deposits or certificates of deposit with community development banks or credit unions. Federal insurance is typically limited up to $100,000, though some banks can insure up to $10 million through the CDARS program (www.cdars.com).

Community Investor Pools are more risky because they are not insured; however, they pool and diversify investor risk by investing in many community development institutions. Furthermore, intermediary managers are generally experienced community development institution investors who manage their risk conservatively through aggressive monitoring, loan loss reserves, and a solid equity base to protect their investors.

Direct Investments in Domestic CDFIs do not provide the investor with diversity of many CDFIs, as with an intermediary. Instead, the investor is invested in one CDFI that makes loans to businesses, housing developers, or nonprofits. As this Primer discusses below, investors can conduct due diligence on potential CDFI investees to ensure that they manage their lending risk appropriately by maintaining a strong equity base, managing loan loss reserves, and underwriting and servicing their loans effectively. We should note here that although direct loan fund loans are not insured, the typical loan fund currently has a very strong equity position (34% net assets/total assets according to NCCA's 2004 Side By Side Report, available at www.communitycapital.org).

Equity investments in Community Development Banks provide such banks with the capital base they need to grow and leverage deposits to serve their community. These equity investments are not insured and, as equity investments, do not have an established maturity date so investor capital is often committed indefinitely and there are limited opportunities to exit the investment.

Lending to International CDFIs have similar risk to investments in domestic CDFI intermediaries, but with the potential addition of country and currency risk. International intermediaries typically manage a portfolio of direct investments in local microfinance institutions so the investor is not assuming the risk of a direct investment. Investors may also benefit from the support provided by the intermediary to the local international borrowers, including operating funds, technical support and close supervision, security enhancements, like net assets, loan loss reserves and subordinated debt.

Community Development Venture Capital investments are used by community development venture capital funds to make equity or equity-like investments in businesses. These funds generally assume that while some of their investments will pay off big, others may fail. Investors into such funds receive their capital and a return based on the overall performance of the fund as the fund exits from its investments. That performance could mean the investor receives only a portion of their original investment back, or receives their original investment plus a small to substantial profit. Investment return, however, depends on the availability of exit opportunities from the original portfolio, and could be five to ten years after the initial investment is placed.

Direct Loans to CDCs, Affordable Housing Lenders and Social Enterprises are used to support specific revenue-generating activities. These types of investments are discussed in more detail in Appendixes 3 and 4.

Direct investments in international CDFIs (Microfinance Institutions) have similar risk to direct investments in domestic CDFIs, with the significant addition of country and currency risk. Investor yields may be reduced by local country taxes and there may even be restrictions on the repatriation of invested dollars. A direct investment in one international lender is significantly riskier than an investment into an international intermediary – the foreign exchange considerations can be considerable and difficult for a single individual investor to manage appropriately. Generally, though, like other CDFIs international microfinance institutions manage investor risk through aggressive monitoring, loan loss reserves, and an adequate equity base.

Equity Investments in Social Enterprises are discussed in Appendix 4.

Assessing Risk of Community Investments

So, how is an investor to know? How can you be an informed investor who is comfortable with the level of risk you are taking with your community investments? The remainder of this document focuses on how to assess the risk of different community development institutions.

Different investors have different objectives, and each investor needs to determine their objectives first, and then the appropriate level of due diligence to meet those objectives. Community investments have two different types of objectives, financial and mission or impact (sometimes referred to as "social"). Investors need to balance their financial and impact objectives and determine the needed level of due diligence for each.

- An individual investor in Florida may determine that the most important criteria for her $10,000 investment is to invest in a CDFI that will help finance more affordable housing in Florida. She determines that return is not very important for this investment and that all she needs to know to feel comfortable about the level of risk she is taking is that the CDFI has a reasonably strong balance sheet and has been operating successfully for more than 5 years. After reviewing their annual report, she determines that the **Florida Community Loan Fund** (www.fclf.org) meets her investment criteria and decides to lend them $10,000 for 3 years at 2%.

- The treasurer of a religious pension fund will have an entirely different due diligence process. He may have a mandate to invest 5% of the portfolio in community investments that improve business opportunities for urban populations in the US and in developing countries. His community investment portfolio is supposed to provide a blended return of 3% and minimal, if any, losses. He identifies domestic CDFIs and international microfinance organizations as two groups that meet his impact criteria, and recognizes that to meet his target yield and risk parameters he could invest up to 20% in international microfinance funds (that tend to pay higher interest but may be riskier) and 80% in domestic CDFIs. He then conducts a thorough due diligence on each potential investment, including an analysis of management, lending practices, portfolio performance, an analysis of 5 years of financial statements, and more before presenting each potential investment to his investment committee for approval.

- The treasurer of a national foundation may have a mandate to invest 10% of the foundation's corpus in high-impact community investments in the US, with a required return of 2% and minimal, if any, losses. She does not have the staff time to conduct due diligence on numerous CDFIs, so she contacts a national CDFI intermediary. They negotiate an arrangement whereby she will invest $2,000,000 in the pool and receive 2% interest on it. The intermediary will use that capital to lend to domestic CDFIs, and will report on their activities and financial results on a quarterly basis. She conducts a thorough due diligence on that one intermediary and presents a credit memo to her investment committee who approves the investment.

Each loan type and structure has a different cost structure associated with it from an underwriting standpoint. For example, there is little cost associated with underwriting fully insured certificates of deposit from community development banks or credit unions because information is readily available and the insurance means that little additional due diligence is needed. On the other hand a loan to a complicated CDC with moderate credit quality could be much more costly to underwrite because there are no ratings or publicly available information on the CDC and one would have to rely on a custom analysis. The cost of the analysis is also driven by the investor's tolerance for risk and the depth of information needed to make the investment decision.

Some investors may recognize that they do not have either the analytical skill and experience or the time to do the level of due diligence that they would like on potential investments. There are individuals and organizations that can provide due diligence on a fee basis. The **Calvert Foundation** (www.calvertfoundation.org) will develop due diligence reports for investors on international microfinance institutions, domestic CDFIs, and CDCs, affordable housing developers and social enterprises. **National Community Capital** (www.communitycapital.org/) will also develop credit memos and provide monitoring/servicing functions on a fee basis. National Community Capital is beginning to rate CDFIs through the CDFI Assessment and Rating System (CARS™) during the fall of 2004, and these analyses and ratings will be available to investors. There are several rating and assessment systems already in operation for international microfinance institutions and investors as noted on page 11. Lastly, there are also individual consultants who can be hired to provide these services.

Section 7. Underwriting Community Investments

The following sections provide guidance for performing due diligence on different types of community investments. This section provides guidance on due diligence for community investments in general. Section 7 provides some additional considerations for loans to international CDFIs, equity investments in venture capital funds, insured deposits in community development banks or credit unions, and equity investments in community development banks.

As described in the previous section, each investor needs to determine the appropriate level of due diligence that meet their objectives.

The purpose of the loan or investment can vary based on the need of the institution and the investor's preference. For the discussion of underwriting loans, this primer concentrates on general recourse lending as the underwriting of the entire institution, versus a specific project. General recourse lending is the most common and accessible form of community development lending by social investors. There are many other resources that address the technical aspects of other types of lending, like working capital financing and project based financing for affordable housing programs.

7.A Structure of Financing Transactions

An evaluation of the financing structure is necessary to help determine the investor's risk relative to other investors. Investors should understand:

- The type (loan, investment, credit enhancement) and terms (secured, unsecured, maturity, etc.) of the financing, and recourse of the specific investment. Issues related to recourse may include:
    - Whether the investor has recourse to the whole organization or to one subsidiary?
    - Whether a parent guarantee is advisable or available?
- Are there other lenders with specific collateral in addition to general recourse?
- Will this investment be "on par" with all other investors or in some kind of senior or subordinate position?

7.B General Underwriting Guidelines

As discussed above, through the due diligence process investors want to learn enough about the potential investment to be reasonably confident that it can meet both their financial (risk and return) and social impact objectives. A thorough due diligence generally involves three types of information gathering and analysis:

- Reviewing available documents and reports
- Understanding and analyzing audits and financial statements
- Talking to community development institution staff and board members

Documents and Reports

Community development institutions have numerous documents and reports that provide invaluable information about the community development institutions activities, strategies, impact and performance. The most helpful documents include those listed below, and the most critical documents are **bolded**:

- Annual reports
- **Business or strategic plans (with projections)**
- Descriptions of programs, products offered, marketing materials
- **Social impact reports or studies**
- Organizational chart
- Resumes or bios of key staff members
- Board roster with affiliations or bios of board members
- Minutes of board meetings over past year
- Policies and procedures for internal financial management
- **Audits**
- **Interim financial statements**
- Capitalization plan
- List of significant investors and terms of investments
- **Underwriting policies and guidelines; portfolio management policies/guidelines**
- Investment policies for idle funds
- **Risk rating report on portfolio**
- **Aged delinquency report on portfolio**
- **Loan loss reserve strategies and practices (how is reserve established)**
- Minutes from Investment Committee for past year
- Risk management strategies and practices
- Liquidity management strategies and practices (including asset-liability matching)
- Budget versus actual reports
- **Activity reports on loan volume, other activities**
- Other available policies and reports

The community development institution may not have all of these documents, may be able to develop some of them, or may be able to explain certain practices that are not formalized into policies or documents.

Analyzing Financial Statements

Financial statement analysis includes the analysis of certain numbers and ratios over time to detect trends and possible red flags. As with any financial analysis, there are numerous possible ratios and variations that can be analyzed, depending on the investor's primary objectives and concerns. Appendix 2 lists some of the key ratios commonly used to analyze community development institutions.

Although there is an ever-increasing amount of data available on community development institutions, specific ratio benchmarks do not exist for the unregulated institutions. In addition, due to the many different types of financing conducted by CDFIs, relying on straight comparisons without context and analysis can lead to mistaken conclusions. For example, a community development institution that makes loans to microentrepreneurs may have an unrestricted net asset ratio of 20% and a loan loss reserve of 15% of loans outstanding, while a community development institution making housing loans may have only 10% unrestricted net assets and a loss reserve of 5%. On the surface, the microenterprise lender may appear to be less risky because they have higher reserves and a larger net asset base. However, the microenterprise lender may experience much higher annual loan losses than the housing lender, and need the larger net asset base and higher reserves to manage the higher level of risk of their lending.

Comparisons of data of specific community development institutions to their peer groups can be a very helpful part of the analysis (if not conclusive in itself). An investor looking at a $15 million asset-size rural housing lender can learn a lot from comparing basic data on that housing lender to similar types of CDFIs. Detecting differences between a CDFI and its peers can help an investor ask the right questions and gain a better understanding of the specific CDFI and its operations.

CDFIs Side by Side is an annual publication of the National Community Capital Association (www.communitycapital.org) that provides data on more than 100 CDFIs organized by peer groups. In addition, investors can request customized peer analyses from National Community Capital if the generic analyses in the document do not meet their needs.

Through financial analysis as described above, analysis of the documents listed above, and conversations with key CDFI staff and board members, an investor can develop a thorough understanding of the following key areas of the community development institution's activities:

Mission and Strategy

An evaluation of the community development institution's vision and plan, as well as demonstrated results in and progress towards achieving its vision. Investors should look for:

- Consistency and clarity about mission among staff and board and in the organization's public and internal materials.
- Programs and products consistent with the organization's mission.
- Alignment between mission, strategy, and financial projections.
- Organizational structure appropriate for and efficient in promoting community development institution's strategy.
- Clear definition of what organizational success looks like and tracking of the appropriate social and financial indicators to measure that success.

- Impact in terms of outputs (what does the community development institution deliver, such as number and size of loans, participants in training, etc.); outcomes (what results the community development institutions activities bring (number of jobs retained or created, affordable housing units financed, increase in child care slots, etc.) and community impact (changes in the community such as increasing incomes overall, increased investment, etc.)

Market and Programs

An evaluation of the community development institution's responsiveness to its market as demonstrated by its success at providing needed financing and capacity building (training and technical assistance) to its market. Investors should look for:

- Consistent financing productivity and sufficient deal flow.
- Staff knowledge of market, potential customers and their financing and technical assistance needs, competitors, potential partners, etc.
- Market definition consistent with mission, institutional capacity, and products.
- Proven capacity to bring products to market.
- Entrepreneurial approach to working with borrowers.
- Clear rationale for community development institution's capacity-building (training and technical assistance) activities and financing products.
- Partnerships and relationships that further mission and increase visibility and impact within market.
- Visibility in its market to customers, investors, other partners and the public.

Staff and Management

An evaluation of the organization's management and staff to ensure that the organization has the appropriate leadership, experience, competencies, and organizational structure to foster strong performance and growth. Investors should look for:

- Executive director has a vision for the organization and has communicated the vision to staff.
- Management depth is appropriate to the scope and complexity of the organization's activities.
- Staff size and competencies appropriate to scope of activities.
- Low staff turnover (or an understanding of why there is moderate or high turnover)
- Staff is organized according to a rational plan that supports growth.
- Organization has given consideration to succession planning.

Board and Governance

An evaluation of the organization's Board of Directors and governance structure to ensure that they provide appropriate leadership to further the organization's mission and ensure accountability to the public. Investors should look for:

- Board and committee (esp. investment committee) composition appropriate to institutional needs.
- Good working relationship between board and executive director, with areas of accountability clearly delineated and understood.
- Board's role is appropriate to community development institution's strategic priorities and stage of development of the organization (which committees are active, what type of oversight does Board provide?).
- Governance structure which allows for accountability to core constituencies (look at who elects Board and investment committee, and Board composition)
- Board capacity to carry organization through a leadership transition.
- Whether the community development institution is a subsidiary, parent, or otherwise affiliated with any other entities, and whether those relationships bring additional risks or can reduce risk (in the case of a guarantee) in any way.

Capitalization

An evaluation of the organization's ability to recruit the appropriate capital for the organization's financing programs. Investors should look for:

- Investor's capital as a % of the organization's financing capital.
- Growth in capital under management.
- High reinvestment rate.
- Equity as a % of total capital appropriate for financing risk (preferably at least 10%).
- Character of capital appropriate to market served.
- Diverse funding sources and operational independence from investors and funders.
- Plan/strategy for recruiting new capital.
- No investor defaults.

Finance and Operations

An evaluation of the organization's finances and operations to ensure the organization has the appropriate resources to sustain its operations and repay National Community Capital. Investors should look for:

- Financial statements that are clear, consistent (between audit and interim), GAAP-compliant, and timely.
- Evidence that community development institution has set realistic financial goals and is making progress towards achieving those goals.
- Demonstrated capacity for financial sustainment (self-sufficiency ratio appropriate to organization's circumstances). If goal is to raise the level of self-sufficiency, how do they propose to do so and are the plans to do so, and the level they would like to reach, realistic?

- Diverse sources of operating revenue.
- Strength of relationship with funders, assessment of these funders to stand by organization during difficulty times
- Adequate cash flow planning
- Increasing unrestricted net assets over time (or an understanding of why not)
- Adequate operating liquidity (i.e. operating reserves on hand for 3-6 months).
- Adequate systems for receipt and disbursal of cash, investment servicing, and other internal controls.
- Methodology for matching assets and liabilities that ensures the community development institution can meet its financial commitments to its lenders and community development institutions.
- Facilities, computers, information management systems, etc. are adequate to scope of activities.

<u>Financing Methodologies and Performance</u>

An evaluation of the organization's financing activities, including its financing process, its risk management policies, and the portfolio's performance. Investors should look for:

Underwriting

- Rigorous, objective, and consistent financing decision-making process (including community development institution's financing of its subsidiaries and affiliates).
- Consistent and clear underwriting criteria.
- Adequate financing documentation.

Risk Management Policies and Procedures

Portfolio management policies are sufficient for the community development institution's size and scope and the organization is adhering to its policies, such as:

- Limits on size of individual loans and investments
- Limits on balloon loans
- Loss reserve policies (portfolio risk tied to loss reserves)
- Adequate systems for monitoring portfolio
- Technical assistance programs/services are appropriate for the mission, strategy, and market of the community development institution.
- Equity financing process and structure: Is equity financing carried out by a separate subsidiary? Are there different policies for equity financing? Has the community development institution adjusted its risk management policies and practices to consider the risks of equity financing?
- Overall risk management strategies of the community development institution: Has the community development institution considered and taken steps to minimize risks related to liquidity, interest rate fluctuations, prepayment by borrowers, organizational risks (i.e. contingency plans for infrastructure crises or departure of management staff), and other potential risks?

- Security/collateral adequate for risk of loans and investments
  - Collateral position taken and analysis of the quality of that collateral, ease of liquidation and readily available market for disposition.
  - If a significant portion of collateral is real estate – what's the highest LTV allowed by policy, what's the average LTV of the portfolio (if they look at such a factor)?
  - Does allowable LTV change depending on where the organization's security position (second or third vs. first). If so, what is the allowable LTV on first position lender?
  - Dollar amount of restructured loans in the portfolio and percentage performing under restructured arrangements.
  - Industry and geographic mix in the portfolio and the ability/strategies to manage a diverse portfolio.

Financing Performance

- Acceptable level of write-offs and delinquency, consistent with mission and programs.
- Growth in portfolio.
- Overall portfolio characteristics (concentrations in industry, geography, type of financing, etc.).
- Productive use of capital (organization can make effective use of additional financing). Consider any off-balance sheet sources of capital that the community development institution may be using as well.

7.C Additional Guidelines for Specific Types of Loans and Investments

Loans to International CDFIs

Internationally community investments typically support microenterprise, but there are also opportunities to support cooperatives, affordable housing and social enterprises. There is a significant amount of information available to investors on microenterprise, but few resources for other types of investments.

International investments can be made directly to an institution that makes loans (a direct loan) or to an intermediary that would use your capital to make a variety of direct loans. The benefit of lending to an intermediary is less risk. The intermediary absorbs the foreign exchange risk and provides supervision to borrowers that may be located in remote regions across the globe. Furthermore, the intermediary offers the standard advantages of portfolio diversification resulting from the pooling of investments and the experience of the intermediary in managing international operations. In addition, investors may benefit from the equity or loan loss reserves that the intermediary carries on its balance sheet. The benefit of lending to a specific CDFI in a specific country is that the social impact is more direct and the investor can have more direct contact with the entity. In the international context that benefit has to be weighed against the considerable costs and risks of investing abroad.

For all international investments, the following areas should be explored in order to understand the unique risks of the investment and how they may affect repayment of the investment:

- Foreign exchange considerations
- geo-political environment;
- the country's current economic condition; and,
- any regulatory restrictions on fees, interest charges, and repatriation of investment.

There are several Rating agencies that evaluate international microenterprise institutions, including Microrate (www.microrate.org) and Planet Finance (www.planetfinance.org). CGAP (www.cgap.org) has a comparative description of the various rating agencies.

Furthermore the number of microenterprise funds, seeking debt and/or equity has grown in recent years. The Council on Microenterprise Equity Funds (CMEF) provides information about equity fund opportunities, while numerous funds seek to raise debt from investors. Shared Interest (www.sharedinterest.org) and Oikocredit (www.oikocredit.org) are experienced international lenders, other funds are associated with technical support organizations such as ACCION (www.accion.org), FINCA (www.villagebanking.org), Freedom from Hunger (www.freedomfromhunger.org), and Opportunity International (www.opportunity.org). Newer fund options seeking equity and/or debt include: Blue Orchard (www.blueorchard.ch), Grey Ghost, Microvest (www.microvestfund.com), and ShoreCap (www.shorecap.net).

Equity investments in Venture Capital Funds

Venture capital funds typically accept only equity or equity-like investments as the investments they make are also structured as equity or equity-like. However, venture capital funds may offer a loan product to borrowers and in that case may seek debt investments from investors. The investment options should be clarified from the venture capital fund.

When an investor invests in a community development venture capital fund they are essentially investing in management's ability to make investments in companies that will grow, prosper, and eventually allow them to take their capital out with a return. The fund itself is a consolidation of capital from other investors and each investor will gain or lose based on the performance of the specific investments in businesses. This is very different from making a loan to a loan fund where the loan fund may have a net asset base and performance history that can be analyzed to provide comfort to the investor. In the case of venture capital funds, investors are investing in the fund's management and their ability to make enough profitable investments that the fund as a whole will generate a positive return for investors.

For the reasons mentioned above, performing due diligence on a venture capital fund is very different from performing due diligence on a loan fund. Typically, the fund will raise its capital prior to making its initial investment. In most cases, the fund itself will be very new and may not even have made any investments in businesses. If they have made investments, chances are they will be too new to show whether they will be producing a positive return or not. Instead of analyzing the Fund, which may not have anything to analyze, potential investors need to focus their due diligence on the management: their venture capital experience, their strategies, the performance of prior funds they have managed, etc. For additional information about investing in community development venture capital funds, investors should contact the Community Development Venture Capital Association (www.cdvca.org)

Insured Deposits in Community Development Banks or Credit Unions

Certificates of Deposit up to $100,000 from Community Development Banks and Credit Unions typically are fully insured through the Federal Deposit Insurance Corporation. Some banks can offer full federal insurance on amounts over $100,000. Therefore, since the risk of repayment is eliminated, due diligence is typically brief. In terms of analyzing these investments, the community impact of the institution is examined to ensure that the investor's goals are being met. In addition, for community development credit unions, it is important to check if that credit union is able to take "non-member" deposits, as the membership in credit unions is typically limited by geography, except for a percentage that is available to investors outside the membership area.

While there is full federal insurance at $100,000 and below, investors should make a quick analysis of the institution to examine the bank or credit union's portfolio quality, profitability and capitalization, which is readily available on these web sites: Federal Depository Insurance Corporation (www.fdic.gov) and National Credit Union Administration (NCUA – www.ncua.gov).

Equity investments in Community Development Banks or Credit Unions

Community development banks raise equity from time to time in common or preferred stock issues. Equity investment is critically important to developments banks, as they can leverage equity up to 20 times with deposits and other borrowing. It is this ability to leverage equity with deposits that gives development banks (and also credit unions) their capacity to generate very significant volumes of new development loans each year.

As with any common stock investment, the investor receives an ownership interest in the company. However, while the vast majority of development banks are profitable and some are very profitable, this may not translate to an income generating strategy for investors. Given their mission, development banks generally reinvest a significant portion of their earnings into expanding development activity rather than paying large shareholder dividends. In addition, while the value of the stock may appreciate over time, most development banks are not publicly traded and therefore it can be difficult for investors to sell their positions. As a worst case scenario true of any common stock investment, if the institution is not profitable, investors can lose some or all of their investment. For these reasons, some community development banks offer stock only to accredited investors, whose substantial net worth positions them to take the risk of limited earnings and liquidity in support of mission. Other development banks offer stock to the broad range of interested investors. In reviewing an equity investment opportunity, investors should perform the full range of due diligence outlined above. In addition, they should ask whether the stock is traded on any exchange, confirm that they will be able to sell the stock, if desired (particularly if it is not traded on an exchange), and confirm that they will have dividend income in line with their expectations or needs.

Development banks may offer preferred stock with a fixed coupon that provides current earnings. Some preferred stock issues also have a fixed maturity date. Investors should inquire whether development banks offer preferred stock, as it generally mitigates some of the risk associated with common stock investment. The trade-off is that a preferred stock investment will not appreciate in value.

Credit unions are nonprofit cooperatives. Although they are member-owned, their nonprofit structure determines that they are not able to raise equity capital. The National Credit Union Administration (www.ncua.gov), the credit union regulator, has created a class of deeply subordinated debt called secondary capital, which Low Income Credit Unions can raise. Low Income Credit Unions are institutions the NCUA has designated for which the majority of the membership is low income. As deeply subordinated debt, secondary capital has some of the risk characteristics of common stock and is typically held only by accredited investors.

Section 8. Impact Assessment

Accurately assessing the impact of community investments is very difficult. Most CDFIs collect "output" data which quantifies their activities, such as number and dollar amount of loans disbursed, percentage of financing to minorities or women, percentage of financing to borrowers that are low income, number of new affordable housing units to be created in financed projects, number of participants or graduates of training programs, etc. Much of this data can be found on the Community Investing Center website (www.communityinvestingcenter.org) or in the CDFI Data Project's Report (http://www.communitycapital.org/cdp_brochure.pdf).

Some CDFIs also collect "impact" or "outcome" data that actually gets at some of the results of their activities: number of jobs actually created; number of housing units occupied by low-income families, etc. And, some CDFIs go a step farther and conduct periodic impact evaluations, either internally or by hiring additional expertise. Investors considering a direct investment in a specific CDFI can request whatever impact information or studies that they might have available.

Given that many valuable and indirect outcomes of a community development institution's work can not be quantified, investors are encouraged to complement their review of performance statistics with anecdotal stories. These stories frequently offer a good insight into how their work ultimately affects their clients' lives.

Lastly, the CARS™ rating system being implemented by NCCA analyzes and rates CDFIs in the areas of both Impact Performance and Financial Strength and Performance. The Impact Performance analysis is an assessment of how well the CDFI does what it says it is trying to do. It is based on an assessment of the CDFI's effective use of its financial resources to achieve its stated mission, and the CDFI's own evidence, or data, of how its activities contribute to its mission.

Appendix 1: Understanding Nonprofit Financial Statements

One of the first steps in underwriting any entity is to analyze its financial statements to gain an understanding of its financial strength and performance over time. Nonprofit financial statements differ from for-profit financial statements in important ways and, as most loan funds are non-profits, it is important to understand these differences.

The "CDFI Financial Statement Primer," developed by National Community Capital, is a concise guide to CDFI financials statements and can be found at www.communitycapital.org. The brief explanation below is drawn from that Primer.

The primary financial statement difference between nonprofits and for-profits is that nonprofits do not have equity (as they have no owners). Instead, the difference between assets and liabilities is called "net assets" and net assets have three possible classifications.

- **Unrestricted Net Assets** are net assets unencumbered by donor-imposed restrictions. community development institutions often use these funds to support the community development institution's operations, typically, to fund operating expenses. These net assets truly belong to the community development institution and the community development institution can determine how to use them.
    - **Designated Net Assets** are Unrestricted Net Assets that the community development institution's Board of Directors has earmarked for a certain purpose (i.e. for lending or for a specific operating program). Funds that have been designated can be undesignated by the Board at any time.
- **Temporarily Restricted Net Assets** are net assets restricted for a specific time period or for a specific period <u>by the donor</u>. Examples include multi-year operating grants, grants restricted for certain programs, or grants restricted for lending/investing. When the community development institution fulfills the restriction on these grants (by incurring expenses during the intended period or carrying out the intended programmatic activity), these funds are "released" from temporarily restricted net assets and become unrestricted. While temporarily restricted net assets are net assets (as opposed to a liability) the community development institution is obligated to use them in the way specified by the donor. They are not available for the community development institution to use for any purpose at any time.
- **Permanently Restricted Net Assets** are net assets restricted <u>into perpetuity by the donor.</u> Usually, permanently restricted net assets arise from capital grants and are restricted for lending or investing. That means that the community development institution can never use these funds for operating expenses.

The different net asset classifications can complicate the understanding of a community development institution's financial statements considerably. The very simplified examples below indicate how a lack of understanding of the different net asset classifications can lead to a significant misinterpretation of community development institution financial statements.

Sample Statement of Activities	**12/31/XX**
Unrestricted Revenues	
Loan and Investment Interest	$85,000
Program and Loan Fees	$10,000
Grants and Contributions	$50,000
Net Assets Released from Restrictions	$40,000
Total Unrestricted Revenues	$185,000
Temporarily Restricted Grants and Contributions	$250,000
Total Expenses	$210,000
Change in Total Net Assets	**$225,000**

A quick look at this statement indicates that the community development institution generated a sizable surplus of $225,000 during the year. However, upon further analysis, it becomes apparent that the community development institution actually ran an operating **deficit** of $25,000! Total revenues ($185,000+$250,000) minus expenses ($210,000) produce an overall surplus of $225,000. But, only $40,000 of temporarily restricted funds was “released” during the year for operations. The $250,000 in temporarily restricted grants might be restricted to the loan fund and not available at all for operations. There may not be any way for the investor to understand the nature of the donor restrictions without asking the community development institution. However, no matter the intention of the $250,000 in temporarily restricted grants, the community development institution incurred $210,000 in expenses and had total revenues of only $185,000 that was used to cover those expenses, leaving it with an **operating deficit** of $25,000.

Investors need to look at the **change in Unrestricted Net Assets** to determine whether a community development institution had an annual operating surplus or deficit, rather than the **change in Total Net Assets.** Understanding the nature and restrictions around temporarily restricted revenue and net assets is an important piece of interpreting community development institution financial statements.

Similar confusion can result from a cursory review of the Statement of Financial Position (or Balance Sheet), as shown in the simplified example below:

Statement of Financial Position	**12/31/XX**
Assets	
Cash and Cash Equivalents	$400,000
Interest Receivable	$10,000
Loans Receivable (net reserves)	$1,000,000
Other Assets	$5,000
Fixed Assets (net)	$5,000
Total Assets	**$1,420,000**
Liabilities	
Accounts Payable and Accrued Expenses	$16,000
Notes Payable	$930,000
Total Liabilities	**$946,000**
Net Assets	
Unrestricted	$24,000
Temporarily Restricted	$450,000
Total Net Assets	**$474,000**
Total Liabilities and Net Assets	**$1,420,000**

At first glance, this community development institution has a solid net asset to total asset ratio of 33% ($474,000/$1,420,000), and has plenty of cash ($400,000). However, further analysis might raise some red flags. Of the community development institution's total net assets, only 5% ($24,000/$474,000) are unrestricted, and the Statement does not provide any information as to the nature of the restrictions for the temporarily restricted net assets (TRNA). If the TRNA are restricted by donors for use as lending capital, the community development institution could be facing a serious operating cash shortage, as the maximum operating cash they could have is $24,000.

If, on the other hand, the TRNA is restricted for specific operating programs (such as training), then the community development institution is in violation of donor intentions, and could have serious problems with donors. (The total of notes payable and unrestricted net assets total $954,000 and the community development institution has $1,000,000 in outstanding loans so they must have lent out some of their TRNA that were not for that purpose.) To make matters even more complicated, the most likely scenario is that <u>a portion</u> of the TRNA may be for operations and a portion for the lending activities, and the investor will have to have a conversation with the community development institution's accountant or Chief Financial Officer to understand the nature of the restriction. Without that conversation, it may be virtually impossible to gain a clear understanding of the community development institution's financial position.

These very simple examples are not representative of community development institution financial statements. Instead, they are provided to show that an accurate analysis of community development institution financial statements requires an understanding of the peculiar net asset classifications required by nonprofit accounting regulations.

Appendix 2: Key Financial Ratios

These averages are intended to give readers some idea of the range of values for some of the ratios. They are based on two peer groups from National Community Capital's Side by Side report, using 2003 data. The first peer group is Business Loan Funds with total capital less than $3 million, a group that includes 24 CDFIs. The second peer group is Housing Loan Funds with total capital between $6 million and $15 million, which includes data from 16 CDFIs.

Ratio	Formula	Sector	Select Averages*	
Statement of Financial Position				
			Group 1	Group 2
Net Asset Ratio	Net Assets / Total Assets	All nonprofits	51%	36%
Unrestricted Net Asset Ratio	Unrestricted Net Assets / Total Assets	All nonprofits		
Liability Ratio	Liabilities / Total Assets	All	59%	67%
Current Liability Coverage	Cash and Cash Equivalents / Current Liabilities	All		
Current ratio	Current Assets / Current Liabilities	All		
Months of Operating Cash	[Operating Cash and Equivalents / (Annual Op Expenses / 12)]	All		
Leverage	Debt/ Net Assets	All, esp. affordable housing lenders		
Statement of Activities				
Net Margin	(Unrestricted Revenue – Expenses) / Unrestricted Revenue			
Net Interest Margin	Weighted Average Interest Earned – Weighted Average Cost of Debt			
Self-Sufficiency	Earned Revenue / Total Expenses	All nonprofits	40%	63%
Debt Service Coverage	(operating cash flow + interest expense) / (interest expense + current portion of LTD)			

Portfolio Ratios: For Lenders				
Deployment	Outstanding and Committed Loans and Investments / (debt and net assets for financing)		81%	87%
Delinquency	Loans past due > 90 days / total loans outstanding		5.2%	3.1%
Reserve ratio	Loan Loss Reserve / Outstanding Portfolio		18.7%	7.0%
	Loan Loss Reserves / Loans Past Due > 60 days			
	Loan Loss Reserves / Charge-offs			
Charge-Offs	Amount written off / Outstanding Portfolio		3.9%	1.0%

Appendix 3: Community Development Corporations (CDCs) and Affordable Housing Developers

Affordable Housing Developers and Community Development Corporations (CDCs): Community Development Corporations are typically structured as nonprofit corporations and serve a variety of different missions, including affordable housing development, social services, and community organizing to revitalize a low and/or moderate income community. According to a national census of CDCs conducted by National Congress for Community Economic Development (NCCED) in 1998, there are an estimated 3,600 such groups across the United States. Since the emergence of the first CDCs in the late 1960s, they have produced 247,000 private sector jobs and 550,000 units of affordable housing. Typically, CDCs receive social investments to support affordable housing and commercial development as well as to support social enterprises. You can find out more about CDCs from the NCCED website at www.ncced.org.

There are also many nonprofits that specialize only in affordable housing and are not considered CDCs. Affordable housing is generally defined as housing for which a household pays no more than 30 percent of its annual income. Typical residents of such housing are at or below median household incomes for the communities in which they live. Social investors can make loans to generally support the development of affordable housing, versus a specific project. Affordable housing developers also raise considerable amounts of debt to finance their projects, and this could potentially be an investment opportunity for social investors, but a discussion of such project-based financing is beyond the scope of this primer.

The Fannie Mae Foundation website (www.knowledgeplex.org) also has considerable information about affordable housing issues and institutions. There are numerous other affordable housing resources on the web, including: Housing Partnership Network (www.housingpartnership.net), Neighbor Works (www.nw.org), Local Initiatives Support Corporation (www.lisc.org) and Enterprise Foundation (www.enterprisefoundation.org).

This Primer concentrates on general recourse loans to CDCs and affordable housing developers, which can be more risky than project-based financing because there is typically no collateral or secondary source of repayment and because general recourse loans assume the risk of the entire institution, versus a single project.

Loans to support social enterprises are basically loans to a small business and have the same level of risk as this type of direct loan. Loans to all three types of entities can be riskier than lending to an intermediary or loan fund because risk is concentrated in fewer, larger projects and because loan funds typically have more available to protect investors in the form of collateral on underlying loans, loan loss reserves, subordinated debt and equity.

Additional Underwriting Guidelines for Loans to CDCs and Affordable Housing/Commercial Developers:

CDC Lending
When lending to a CDC as a general recourse lender, it is important to understand all of the major projects and programs. As described in the first section of the memo, CDCs can engage in a variety of activities, including loan funds, social services as well as commercial and affordable housing development.

Affordable Housing Lending
It is important to have a complete understanding of the financial risks associated with completed real estate projects that may be owned and managed by the entity as well as projects in the pipeline. The scale of many affordable housing projects is such that missteps could affect the health of the entire financial institution.

The following are key issues to investigate when underwriting affordable housing lending:

- Asset quality: The quality of real estate assets is generally based on whether properties cash flow or not and have adequate reserves.
- Description of Housing/Commercial Development product
- Assessment of the quality of monthly property reports, occupancy rates, level of reserves, and profitability; dependence of operating revenues on Section 8; exposure on tax credit deals from both a financial and moral hazard perspective; responsibility for troubled projects, if any; pipeline of projects and past experience with such projects; sufficiency of operating cash flows for the properties; major property improvements required
- if there is a significant LIHTC portfolio and/or number of properties with long term affordability covenants, how much equity is tied up in those projects and what is the impact on the balance sheet if that equity is removed from net assets?
- Quality of property management company – in terms of accuracy and ready availability of reports, experience with the types of properties under management
- if commercial space, is it fully leased; type of business leased to; terms remaining on lease; is lease income necessary for project sustainability and viability; is lease triple net – if not, what's our borrower's responsibility ?
- How many failed projects experienced causes of the various failures? Any trend identifiable?
- Trends in operating cash flow
- Strong fiscal management and accounting practices that are responsive to the complexities of project funding and contract management are critical evaluation points.
- Accounting for contingent liabilities (I.e. guaranty of indebtedness, endorsement of notes or accounts receivable with recourse, borrowing through partnerships as a general partner who is not specifically exculpated, operating leases and performance letters of credit) should be examined.
- Moderate diversity in assets is desirable (portfolio of owned properties, projects in progress, other assets), assets are positively cash flowing (where applicable), confidence in valuation of assets in audited statements.

Appendix 4: Social Enterprises

Social Enterprises: Social Enterprises are any earned-income business or strategy undertaken by a nonprofit to generate revenue in support of its charitable mission, which is a new paradigm based on sustainability and social entrepreneurship. "Earned income" consists of payments received in direct exchange for a product, service or privilege. Social enterprises generate the capital they need to carry out their mission and are frequently operated as programs of social service nonprofits or can be separately incorporated as a nonprofit or a for-profit entity.

The Social Enterprise Alliance (http://www.se-alliance.org/) serves as a trade association for social enterprises located in the US. Community Wealth Ventures and Social Enterprise Alliance have assembled a directory of nonprofit organizations with business ventures and strategic alliances as a reference tool for the field, found on their web sites. Community Wealth Ventures is a for-profit consulting firm that assists social enterprises, corporations and investors (http://www.communitywealth.com/). The Roberts Enterprise Development Fund is an excellent resource for learning more about social enterprises and metrics for measuring the success of social enterprises (www.redf.org).

There are several other web sites that provide additional information on social entrepreneurs and social entrepreneurship both domestically an internationally, including Ashoka (www.ashoka.org) Schwab Foundation (www.schwabfound.org) and Echoing Green Foundation (www.echoinggreeen.org).

Equity investments into social enterprises are very similar to the risk of investing directly in any other business, except that the investor may expect to receive some amount of "social return" in addition to the potential for financial return. Equity investments into social enterprises are typically more risky than investments into community development venture capital because the risk is concentrated in one business, versus a pool.

Additional Underwriting Guidelines for Equity Investments in Social Enterprises

Investors can choose to make an equity investment in a social enterprise versus a debt investment. Typically, investors target a higher return on equity versus debt because of the additional risk assumed with equity investments. However, this is not often the case with social enterprises as investors may be receiving a social return versus a financial return as compensation for the increased risk. Equity is essential to the social enterprise because of the flexibility in the use of capital and the longevity of the availability of the equity. There may also be internal or external requirements for keeping a proportion of equity to amounts of debt on the balance sheet and so social enterprises may need to raise equity prior to raising additional debt.

Each equity offering is unique and the investor must clearly understand the structure and terms of the offering. Typically, equity investments are much longer term than debt, and may be illiquid, that is there is no clear exit form the investment. With a debt investment, the investor will receive principal payments to pay down the debt, but with equity there is no or limited scheduled repayments. Sometimes and investor can exit an equity investment if another investor buys out their position, but one should assume that there is a limited market for such equity sales.

Investors in equity benefit financially from equity investments: from appreciation of the equity over time and from dividend payments based upon earnings or from a sale of the company.

The valuation of the equity is classically based on future revenues. So the investor must have a clear understanding of the business plan, financial projections and assumptions to evaluate the expectation for increased appreciation and dividend payments.

The general underwriting guidelines apply here as well as the additional guidelines specific to social enterprises listed in the above section.

Additional Underwriting Guidelines for Debt Investments in Social Enterprises

The underwriting of the social enterprise, like the affordable housing developer, starts with understanding the organizational structure of the institution. You need to determine whether this is a program of a larger organization or a separately incorporated entity. Assuming that the investor is making a general recourse loan, the entire legal entity must be underwritten. In the case that the social enterprise is separately incorporated, this is straightforward; but if the social enterprise is operated as a program of a larger institution, the general recourse lender must understand the entire institution, including unrelated programs. As a general recourse lender, there is no collateral tied to the loan, and so the organization’s net assets, or equity, are really all that is available to repay investors. Therefore its important to have a good understanding of those net assets and the risks that are associated with them underlying assets.

Some of the specific issues to consider for loans to social enterprises, in addition to the general underwriting guidelines outlined above are:

- Description of all programs/services and populations served
- Funding sources –are any entitlement program pursuant to federal statue? If so, identify and give brief description.
- Provide brief history of federal state funding levels for the relevant program
- If heavily dependent on grant/contract revenue, discuss history of being able to realize these funds, number of years remaining under the grant/contract, performance under the grant/contract per Grant/Program manager?
- Other means of generating revenues

In essence, underwriting a social enterprise is basically underwriting a business and so the investor should have a good understanding of:

- The products or services offered, their market
- The business plan and its plans for growth
- Profitability of various products