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Tapping the Capital Markets: A Primer for CDFIs

"This bond deal is the next step in the evolution of community development financing. Now, institutions like LISC have the scale and track record they need to become public bond issuers."

– Robert Rubin
Former U.S. Treasury Secretary and Chairman, LISC

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Community development financial institutions ("CDFIs") exist to lead community revitalization and economic development in the nation's most underserved communities. The increasingly complex challenges struggling urban, rural, and suburban areas face today drive a growing need for capital. In light of mounting demand, the time is ripe for CDFIs to look beyond their historic providers of capital, depository banks, and explore capital-raising alternatives in the capital markets. This is not an "either/or" choice; it is a "both/and" opportunity.

In addition to opening the spigot of capital flows beyond the realm of depository banks, the capital markets offer numerous benefits to CDFIs. For example, financing available through the capital markets can provide more flexible funding and longer durations than what is generally available through depository banks alone. As such, it facilitates a bolder economic empowerment vision and more dynamic community development outcomes.

In April 2017, the Local Initiatives Support Corporation ("LISC") became the first-ever CDFI to tap the capital markets by raising $100 million via a public offering of debt securities. The bond issuance was rated 'AA' by Standard & Poor's and was offered in 5-year, 10-year, and 20-year tranches. The bonds were purchased primarily by mainstream investors interested in highly-rated investment grade paper. LISC's position as a leading CDFI and its clear mission and long track record of creating economic opportunities in rural and urban communities were central points in the offering and were especially compelling for bond purchasers interested in impact investments.

LISC's decision to tap the capital markets was carefully considered and involved months of painstaking internal analysis and discussions with global investment banks. That experience offers three key take-aways for others interested in exploring this new asset class:

1. **Know Your Objectives:** What problem(s) are you trying to solve? In LISC's case, the organization was seeking to (i) reduce interest rate risk, (ii) increase funding duration to allow for more ambitious programs that rely on longer-term funding, (iii) reduce the administrative burden of bank covenants, (iv) diversify its funding/investor base beyond depository banks, and (v) create a pathway to the capital markets for other CDFIs. LISC's clear objectives set the parameters and direction for its bond underwriting and marketing. They also set the framework to determine whether the capital markets were the right source of financing to meet LISC's objectives and, if so, whether the organization should tap the public or private capital markets.
2. **Know the Costs and Benefits of Achieving Your Objectives:** LISC conducted deep research to evaluate the cost/benefit tradeoffs involved in a public issuance. For example, LISC's analysis identified several benefits of its bond offering with longer durations, including (i) lower interest rate risk resulting from reduced exposure to variable-rate debt, (ii) lower administrative burden and operating costs given that the bond had no covenants, and (iii) lower funding risks resulting from an increased investor universe. LISC also recognized that extending the duration of its borrowings would result in higher interest rate costs. In summary, LISC identified the costs and benefits of tapping the capital markets and weighed them on the scale of optimal capital efficiency in the context of the organization's strategic goals.
3. **Seek Advice From Trusted Experts:** Experienced capital markets professionals can deliver feedback on your analysis and objectives, generate creative ideas to expand your view of the possibilities, direct you toward the best investor markets to tap, provide a roadmap of the process and timeline, and advise you on the resources you'll need to close the deal. In the best case, among the experts from whom you seek advice will be a global investment bank where your community development relationship manager has an understanding of the capital markets and strong working relationships with that investment bank's capital markets execution professionals.

A CDFI that seeks to raise capital through a public capital markets bond issuance like LISC's can derive many benefits, but the path is not for everyone. Smaller CDFIs may not be well-positioned to tap the capital markets on a standalone basis. On the other hand, smaller CDFIs could band together for a joint execution through an industry group intermediary. A CDFI without an investment grade rating may face higher yields in the public capital markets. But, a non-investment grade CDFI could collaborate with a foundation to structure a guarantee or PRI-enabled credit enhancement.

There are pathways to capital markets outside of public bond issuances that also lead to benefits not available through depository banks; private placements, private equity fund vehicles, and investor notes programs are just three examples.

The process of pursuing a public bond issuance is time consuming and resource intensive, but for many organizations, the rewards may outweigh the costs. The right combination of internal teamwork and external advice and execution will facilitate the most efficient, effective outcome. Furthermore, as demand for impact investing grows, the opportunities for CDFIs to tap the capital markets will expand. That will be good for CDFIs, the communities they serve, and the people and institutions seeking to invest with positive social and environmental impact

For more information, please contact CRA@morganstanley.com.

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