LOUISIANA COMMUNITY NETWORK

Funding Community Development

Funding community development is an integral part of a sustainable strategic planning process.

Funding Community Development

INTRODUCTION AND OVERVIEW

CONNECTING THE DOTS IN COMMUNITY ECONOMIC DEVELOPMENT
Community economic development encompasses a wide range of activities and initiatives that are intended to build wealth and value at multiple levels – neighborhood, city and state. These activities very often focus on creating an environment that encourages economic expansion through job growth and capital investment. Job growth usually occurs through a combination of efforts to attract and retain employers and to nurture new entrepreneurial activity that results in businesses that create new employment opportunities while diversifying the local economy.

The mix and range of economic development initiatives pursued by communities are often articulated as part of some planning effort. In an ideal world, initiatives are prioritized with input from a cross-section of the community within the framework of a strategic planning process, a topic discussed in greater detail in another training module. Suffice it to say that the strategies selected and ranked as top priorities were chosen after careful consideration of current and anticipated conditions in the community, and that these strategies were regarded as those most likely to achieve their intended purpose (objective) within a reasonable timeframe and with measurable results.

Connecting the dots in community development planning requires two critical steps that many well-meaning efforts fail to accomplish. These are: 1) assigning responsibility (accountability) for each strategy’s specific action step; and 2) identifying the specific resources (human, financial, political, etc.) needed to accomplish a task and overall strategy. This training module focuses on identifying financial resources and matching them to the specific task or strategy that the community has chosen to pursue. At its most fundamental level, a development strategy is an opportunity selected and assigned importance because it represents something that will help the community better itself in some way. In the world of entrepreneurial finance, a true business opportunity is one that has the ability to attract capital – both debt and equity. The same can be said for economic development opportunities that are intended to benefit the community at large. To be considered viable opportunities, they must be able to attract sufficient financial capital from a mix of sources to sustain their development and ongoing use or operation within a competitive market environment.

FINANCE: THE FUEL TO FACILITATE PROGRAMS AND PROJECTS
In most cases, a community's list of prioritized strategies and action steps will include a mix of programs and projects. Programs typically focus on creating a structure to carry out a range of activities. They typically extend over longer (sometimes not defined) timeframes and encompass multiple initiatives or specific projects. Projects typically are better defined with respect to start and ending dates and also contain more easily measured benchmarks. However, both programs and projects require the necessary funding "fuel" to launch and sustain them.

The charge for community economic development leaders is to identify and match possible financial resources with the risk profile of the strategic investment opportunity that has been selected. In all likelihood, the mix of resources could very well be drawn in varying degrees from the private, public, and nonprofit sectors. In fact, it would be a very rare community development initiative that did not draw resources from at least two of them. The actual mix and amount from each source will be directly related to the risk profile of the strategic opportunity; its feasibility and value; the extent to which conventional private sources can and are willing to invest; and the size of the resulting unfunded gap when compared to total costs.

CASE STUDY: ST. MARTIN ECONOMIC DEVELOPMENT AUTHORITY – BUSINESS PARK

PROJECT BACKGROUND, STRATEGIC INTENT AND GOALS
St. Martin Parish (county for those elsewhere in the U.S.) is located in Southwest Louisiana deep in the heart of Acadiana (aka Cajun Country). It is a community steeped in the cultural roots of its founding ancestors who were driven by religious persecution from Nova Scotia. It was by sheer hard-headed determination, creativity and an entrepreneurial spirit that the early settlers survived the harsh environment they found dominated by lush swamps occupied mostly by alligators, snakes and mosquitoes. This tenacity forged an economy driven by agriculture (sugar cane and rice), forestry (cypress lumber) and seafood (the ever present crawfish). The discovery of oil and gas along the Louisiana shoreline fueled growth and economic diversification throughout the Southwest region, including St. Martin Parish. Although much of this industry's infrastructure is located in neighboring Lafayette, Iberia and St. Mary Parishes, its proximity to communities throughout St. Martin Parish has fueled job growth and economic opportunity.

It was this proximity and locational advantage that created the recognized opportunity to develop a business and industrial park in St. Martin Parish. This opportunity was identified as a top priority by community and business leaders who had come together to formulate an economic development strategic plan. And, a confluence of advantageous circumstances and strong commitment from a cross-section of the community provided the momentum to move the project forward.

St. Martin Parish is served by two major highways: I-10 is in its northern most parts linking it to Lafayette and Lake Charles to the west and Baton Rouge to the east. It also has a well developed network of state highways. U.S. Highway 90 cuts across a very small portion of the parish on its southwestern side for a length of about five miles. This highway is a major transportation corridor supporting the offshore oilfield service industry and links energy-related communities such as Houma, New Iberia and Lafayette. Current proposals call for incorporating U.S. 90 into the North/South I-49 system that starts at its intersection with I-10 in Lafayette. The five mile portion of U.S. 90 in St. Martin Parish was identified as a strategic asset that could support a business and industrial park catering to the needs of the oilfield service industry and businesses in related sectors.

The initial planning process identified approximately 220 acres of contiguous parcels that would be physically and locationally suitable for a business park. The parcels either fronted the highway's existing service road or could be made readily accessible to the highway. The parcels were used for agriculture (primarily sugar cane) or were largely dormant. One of the initial challenges was to assemble the parcels for development or otherwise gain control of them. This will be discussed more fully in the financial structuring section. However, suffice it to say that assembly of the acreage into one contiguous parcel was a significant early challenge for this project and securing cooperation and commitments from property owners required creativity and ingenuity.

The primary goal of the project was to create sites within a planned business park setting that could accommodate a mix of users that would create new job opportunities and attract private investment to St. Martin Parish. The project's location would allow it to tap demand generated by the growing oilfield service industry and thus enhance its ability to achieve it projected absorption within a five to seven year period. The project would also bring somewhat underutilized agricultural land into commercial and business uses thus producing higher property values and local tax revenues.

SMEDA BUSINESS PARK – ORGANIZATIONAL PLAN

The entity leading the business park's development was the St. Martin Economic Development Authority (SMEDA). SMEDA is an agency of parish government whose primary mission is promoting economic development, job growth and capital investment. The agency does this by engaging in business recruitment and retention efforts as well as by encouraging entrepreneurial new business growth. SMEDA also serves as a clearinghouse for information and provides assistance to securing business loans and other financial resources that support its job growth goals. SMEDA served as developer for this project relying on existing parish staff as well as consulting engineers and others for technical support. Marketing of the business park sites was handled by an experienced local real estate firm that had brokered industrial land sales throughout Lafayette and St. Martin Parishes. Sales commissions were paid directly by individual property owners from the proceeds of each sale. SMEDA did not bear responsibility for payment of commissions since at no time did the agency actually take title to the property in the business park.

Partners in this project included the land owners, the U.S. Department of Agriculture (USDA) and the Economic Development Administration (EDA). The property owners agreed to provide SMEDA with options to purchase acreage that would be developed as the park. When a prospective buyer/user for a parcel or site was secured, SMEDA assigned these option rights to prospective buyers at an option price fixed by agreement between SMEDA and the individual property owner. These binding option agreements allowed SMEDA to gain control of the acreage without taking possession or paying option money. Property owners agreed to a no cost option in return for SMEDA's efforts to secure infrastructure financing and to market the project. The option prices were established based upon existing acreage sales for comparable property in St. Martin and Lafayette Parishes and in accordance with guidelines established by EDA.

The EDA provided a $1.0 million public works grant for the construction of street, sewer and water infrastructure for the park. Because of this federal investment, property owners had to sign a "Property Value Agreement" that established a fixed baseline fair market value with allowances for normal market value appreciation that did not result directly from EDA's grant investment. This agreement, however, did not limit value appreciation that resulted from the owner's investment such as on-site land improvements or building construction.

The USDA provided a 10- year no interest loan of $450,000. This loan was used to build a water tower and distribution system throughout the park to provide sufficient pressure for sprinkled fire protection and thus advantageous insurance rates. This loan was made to St. Martin Parish through the local utility cooperative SLEMCO (South Louisiana Electric Membership Corporation).

In addition to direct financial commitments previously discusses, St. Martin Parish government committed uncounted hours of personnel to ensure the success of this project. This started with a firm commitment from the Parish President and the entire Parish Council and extended through every necessary agency and department within their jurisdiction. This included, but was not necessarily limited to, public works, maintenance, public safety and the assessor, as well as the executive director and staff of SMEDA. Any attempt to place a value on these contributions of time, effort and expertise would certainly understate reality. However, the lesson for community leaders is that executing successful projects takes such commitments. Without it, there is, to put it bluntly, no project.

SMEDA BUSINESS PARK – MARKET PROFILE

The absorption of acreage, sites and finished building space at the SMEDA site would be driven by demand fueled by growth in the oilfield services and related sectors. Users in these sectors required a mix of finished buildings for warehousing, distribution and fabrication as well as land area for open storage and equipment yards. The SMEDA location and acreage were well suited for these purposes.

St. Martin Parish is part of the Lafayette region which also includes St. Landry, Acadia and Lafayette Parishes. The region has a rich agricultural heritage that remains an important part of the economy. Since the 1940's, the region has played a significant role in the oil and gas industry with Lafayette serving as a host to many corporate and regional headquarters locations.

St. Martin's population grew steadily since 1970, despite periods of sharp economic contraction during the 1980's caused by turmoil in the worldwide energy-related sectors. Overall, total population in St. Martin Parish rose from 32,453 in 1970 to 48,583 in 2000 or by 1.7% annually. By comparison, the region grew from 276,569 to 385,647 or by 1.3% annually over the same period. Although a steadily expanding job base has driven much of St. Martin Parish's population growth, residential migration from neighboring Lafayette Parish has also made a contribution. From 1978 through 2000, wage and salary employment in St. Martin Parish grew from 6,915 to 10,714 or by 2.5% annually. This compares to region-wide employment growth averaging 3.2% annually over the same period.

Pre-development marketing of the project by SMEDA resulted in preliminary commitments from six potential users. Four were firms engaged in the oilfield services sector, while two others were firms requiring space for light manufacturing, assembly, warehousing and distribution. These preliminary commitments accounted for the use of approximately 110 acres, an estimated $50 million in net new private investment and the creation of about 300 to 325 new jobs. The results of this very limited predevelopment marketing effort provided sufficient evidence that the business park could be developed and fully utilized within the five to seven year horizon anticipated by SMEDA.

These expressions of interest were based upon offering prices (as per SMEDA option agreements) ranging from $14,000 to $23,000. Higher priced acreage was located in close proximity to U.S. Highway 90, while lower prices were for sites in the interior of the business park. These prices would be adjusted up by about $3,000 per acre ($17,000 to $26,000) to retire the loan principal on the USDA zero interest loan. However, even with these adjustments, the prices still compared very favorably with acreage values along the U.S. 90 corridor ranging from $30,000 to $50,000.

From a competitive standpoint, the availability of developable, fully serviced parcels along the U.S. 90 corridor was limited. Major land holdings were closely controlled in family ownerships, many of which maintained some type of agricultural enterprise directly or through lease agreements. The option agreements secured by SMEDA created a unique opportunity to offer strategically located business sites that would have a significant competitive price point advantage over many properties in the surrounding area. As such, the park encountered relatively little direct competition, was able to attract its fair share of overall demand for business and industrial space and meet or exceed its projected absorption.

SMEDA BUSINESS PARK – FINANCING PLAN

Table 1 summarizes the project's sources and uses of funds. The single largest source was a $1.0 million public works grant from EDA followed by a $450,000 USDA/Rural Utilities zero interest loan. Additionally, SMEDA secured $200,000 in funding from the State Capital Outlay budget. This produced $1.65 million for development and site improvements.

Construction of streets and other infrastructure consumed the largest share (85%) of the project budget at an estimated $1.65 million. The securing of binding options with property owners eliminated direct land costs to SMEDA, thus significantly reducing both budgetary outlays and the risk profile of the project. Risks to property owners were also mitigated since they encountered no out-of-pocket expense to improve their sites for sale nor did they incur any marketing expense unless their properties were placed under a binding purchase agreement. Property owners did assume some degree of market risk due to the "Property Value Agreement" they signed limiting the appreciation rates that would adjust acreage prices during the development period. However, there was enough flexibility to produce satisfactory market-level compensation for sale of their acreages.

SMEDA BUSINESS PARK – IMPLEMENTATION AND STAKEHOLDER RISKS AND BENEFITS

Marketing and development of the business park started in April of 2004. By September of 2007 all of the 180 acres secured by binding option agreements had been sold. A total of 32 businesses had either purchase property or located in the SMEDA Park. Twenty-one businesses have either completed or started construction of new facilities. Total employment was expected to exceed 350 by the end of 2007 with a combined annual payroll of $7.9 million and average salary of $45,000. Of the 32 businesses acquiring property in the park, 26 were recruited from outside of Louisiana or St. Martin Parish, or were newly established businesses in the parish. Included in the park's business mix are five large companies with corporate headquarters in Texas and California. The total estimated economic impact of the park for St. Martin Parish ranges from $22 to $24 million.

Table 1
Sources and Uses of Funds
SMEDA Business Park

Sources of Funds:	
Economic Development Administration	$1,000,000
USDSA/Rural Utilities Zero Interest Loan	$450,000
State Capital Outlay	$200,000
Total	**$1,650,000**
Use of Funds:	
Land	$0
Construction	$1,400,000
Relocation and Other Costs to Acquisition	$1,000
A/E Fees and Inspection	$137,000
Administrative/Legal	$6,000
Contingencies	$106,000
Total	**$1,650,000**

FRAMEWORK OF COMMUNITY DEVELOPMENT FINANCE

WHY COMMUNITY DEVELOPMENT FINANCE?

It is a rare community development opportunity that has all of the financial resources to fund its conceptualization, creation, and ongoing operation. Like a new or emerging entrepreneurial business, community development projects go through various life stages, from very early gestation to growth and ultimately maturity and stabilization. As projects progress from one stage or phase to the next, the stakes get higher in terms of financial commitments and risk. Also at each stage, there are likely to be different players or sources of financial support on the field. Who these players are and when they are most likely to enter the community development funding process will be discussed later. Suffice it to say that in all likelihood most community development projects, no matter what stage they are passing through, will face resource and funding gaps that will have to be filled by one or more possible resource players.

It is not uncommon for community leaders to become frustrated and sometimes overwhelmed by these resource gaps and the difficulty they inevitably face in trying to attract funding to fill them. Unfortunately, frustration can easily become an excuse to do nothing or to procrastinate while an opportunity passes by the community. In many cases, the frustration can be the result of community leaders seeing an opportunity when many others see problems or, worse yet, nothing. It is important to maintain perspective and understand that by definition virtually every community development loan or investment will have a social or broader community-wide mission. This can range from providing affordable housing for low and moderate-income persons to revitalizing distressed commercial districts or residential neighborhoods and to establishing loan pools to assist small businesses.

However, it is critical for community leaders and elected officials to understand one very fundamental truth: By its very nature community development lending and investment activity is financial, not social. In short, the project must “pencil out”; it must be a fundamentally feasible investment. If it is not, then the project may represent a good idea, but it is not an opportunity that can effectively attract capital.

WHAT IS COMMUNITY DEVELOPMENT FINANCE?

Before answering this question, it is probably important to address what community development finance is not. Most fundamentally, it is not a mechanism, tool, or strategy for making a poor, fundamentally flawed project a good one. All the community development finance enhancements or incentives available cannot fix a faulty business model; a dismal location; or a concept with low to no possible market support. In short, community development finance cannot fix a project with an unreasonably high risk profile. This is called “putting lipstick on the pig” and hoping nobody notices it is not a beauty queen.

The market generally punishes these kinds of attempts, and they do significant damage to the community that may take many years from which to recover. The damage can be financial in that the community may be saddled with nonperforming assets or financial obligations that create a serious drain on its operating resources. More importantly, manipulating conditions to ignore stark market realities creates credibility gaps for community leaders. This erodes public trust and confidence; impedes future efforts as potential financial partners steer clear; and fosters a sense of frustration and hopelessness.

In essence, forcing a poor or ill-conceived project through a community development process is a “no-win” proposition. The goal of community development finance is to take those fundamentally sound projects that almost but not quite work and make them a “win-win” proposition for the financial stakeholders and the community at large.

Since community development lending and investment activity is governed by fundamental financial considerations, every project requires a sharp pencil and careful due diligence. Without these, few projects will make it off the ground or sustain themselves over the long run. Conventional lenders/investors typically gauge their interest in a project by looking carefully at three components: 1) the dollars or cash equity already committed; 2) the collateral or value of the assets (including the revenue streams that will be used to secure the investments); 3) ability to generate and manage cash flow; and 4) the expertise and capabilities of the individuals or entity requesting their financial commitment. Community development finance enhancements are typically needed because one or more of these components is not quite up to their typical or normal expectations and requirements. These expectations or requirements are driven from the inside (i.e. policies and guidelines adopted by the organization) and the outside (i.e. regulatory oversight, particularly in the case of depository institutions such as commercial banks, federal savings banks, or credit unions).

The primary focus of community development finance is fundamentally twofold: 1) To fill the all-but-inevitable private capital market gaps and 2) To ensure capital availability to viable projects when private sources are either unable or unwilling to provide the full extent of the financial resources needed.

WHAT IS THE ROLE OF FINANCE IN THE COMMUNITY DEVELOPMENT PROCESS?

Finance, although crucial, is only one component of the local community economic development effort focused on creating jobs, capital investment, and wealth. Financial resources are necessary by not sufficient by themselves to create new economic activity in a local community. Many other factors help produce successful community development outcomes, and they are typically environmental or location attributes that influence the risk profile and basic feasibility of an individual project or initiative. Although most of these factors are addressed on one or more of the other training modules, several are worth noting because of their influence on gap-filling financing decisions.

Community development finance decisions are more easily made in areas where the **surrounding economic dynamic** is stable or showing signs of at least slow to moderate growth. This dynamic creates demand for goods and services that community development projects may be positioned to provide, even if indirectly.

Growing economies allow for new entrants that can gain market position without the necessity of taking business away from existing goods and services providers. Having to take market share from established businesses to render a project feasible raises its risk profile significantly and begs the question of its ability to be supported in a competitive market environment.

Successful community development projects, particularly those creating new or expanded business opportunities, usually require access to a **trained, well-prepared workforce**. Using financial incentives to create new facilities and positions that cannot be filled with capable and prepared workers is a misuse of community development finance tools.

Infrastructure speaks volumes about a local area's ability to support and sustain community economic development projects. In fact, community infrastructure – physical, technical, financial, and educational – is the very foundation upon which economic development strategies are built to attract new businesses, retain existing ones, or nurture home-grown entrepreneurial enterprises. At the same time, actual or perceived infrastructure deficiencies are quite often the very focus of community development initiatives requiring some form of creative financing intervention or enhancement. This is what makes local infrastructure issues such a "chicken and egg" dilemma in the world of community economic development. It lies at the heart of difficult decisions that require careful thought, reliable information, and leadership willing to consider trade-offs that might not be popular with some community members.

In many cases, there are no easy solutions and the answers are not couched in terms of "either/or" but "both/and." That is, as a community, we not only need to move forward with this significant project, but we also need to move forward with infrastructure improvements to increase the project's likelihood of success and sustainability. Increasingly community development finance challenges involve identifying and securing resources for a specific project (i.e. building construction) as well as the infrastructure needed to enhance its likelihood of market acceptance and support (i.e. street, sewer, water, technology improvements). While enhancing infrastructure can improve a project's chances of success, it can also increase its risk profile due to the longer time period over which the project will unfold. Again, these are difficult choices that require strategic thinking, prioritization, and trade-offs.

ALTERNATIVES FOR FILLING FUNDING GAPS

The presence of institutions in a local area that are willing and able to participate in financing economic development projects is a critical element of a community's infrastructure. Generally, larger communities with significant regional or national bank presence have a well diversified mix of institutions, most of which are comfortable with and have experience in using community development finance tools and strategies. However, this is not to say that smaller communities cannot tap into these resources as well. Many regional or national banks have extensive branch networks that extend over large geographic areas encompassing many small to medium size communities. These branches are an entre' to the resources these institutions have to offer.

Community development finance interventions generally take two basic forms. The first involves working with private financial institutions to adapt their conventional lending and investing activities to the challenges of financing community development projects. This is done in one of several ways. One is to help reduce what are known as market imperfections. By their very nature, financial markets are somewhat imperfect, particularly the private markets that characterize lending and investing at the local level. Pubic financial markets, on the other hand, tend to be more efficient due to the active trading of financial instruments on public exchanges (i.e. stocks, bonds, mortgage-backed securities, etc.) Although local community development projects may involve some form of bond financing that touches the public markets, the majority of local development finance interfaces with the private financial market populated by banks, thrifts, and other depository institutions. Reducing market imperfections for these institutions usually requires preparing good project-level and local market area information that can be used in performing the institution's due diligence.

Depository institutions are highly regulated at the federal and state levels (some at both). In some instances, regulation discourages investments in somewhat risk-prone community development projects (safety and soundness), while other regulations seem to do just the opposite (community reinvestment). In short, many institutions find themselves on the horns of a dilemma; they may be criticized if they do a deal and they may be criticized for not doing the deal. Community development finance interventions or enhancements do not eliminate regulatory barriers but they do help mitigate them by reducing a project's risk profile from the standpoint of the conventional lender. This intervention could take a variety of forms and be drawn from a mix of nonconventional sources. Examples would include tax credits to provide additional equity, third-party guarantors, and long-term triple "A" credit tenant leases to ensure cash flows and enhance debt coverage.

A third approach involves tapping into the secondary mortgage market to enhance capital flows to resource deficient local communities. Although this has long been a staple of housing finance, it has become more frequently used in nonresidential lending for community development projects. This can occur through larger banks that use correspondent relationships to secure loan participations from other, usually smaller, banks located in communities they serve.

When these types of interventions fall short of providing the necessary level of resources to fill community development finance gaps, the next approach is to create alternative sources that directly supply capital to make up the funding deficiencies left by conventional lenders and investors. A wide variety of alternative financial sources will be discussed later and are described in the appendix to this training manual. Suffice it to say that the menu of such sources has grown significantly over the past 20 years; that stakeholders in these alternative sources include institutional and organizational entities across the spectrum of the public, private, and nonprofit sectors; and that they represent a significant volume of financial resources that, when tapped effectively and applied strategically, can make the undoable deal a doable one.

There is, however, one cautionary comment that community development leaders should take to heart. Alternative financing sources should never be used where conventional sources are more than sufficient to accomplish community economic development goals and execute specific projects or programs. This would be categorized as a substitution of capital through a duplication of effort. The net result is no net gain in economic activity at the local level but merely a reshuffling of resources. As such, there is little to no new value added and thus little, if any, new wealth created.

WHO ARE THE MAJOR PLAYERS IN COMMUNITY DEVELOPMENT FINANCE?

Community development finance has emerged as an industry unto itself over the past 20 to 30 years with the proliferation and growth of programs created to fill funding gaps. Although most of these programs are rooted in legislative initiatives at the federal, state, and local levels of government, they are embraced and used by community development players in the private and nonprofit sectors. Participants in each sector have their own motivations in community economic development, but they very often converge around issues such as job or wealth creation, capital investment, and improvement in the quality of life. How players in each sector are rewarded for their contribution to and participation in community development initiatives varies with how the initiatives are structured and their individual purposes or missions.

PUBLIC SECTOR PLAYERS

Government roles in community economic development are generally driven by broad policy goals to promote the public good and welfare at the national, state, or local levels. These policy goals are typically pursued with legislation and budgetary appropriations that create specific programs or initiatives that address one or more needs related to the policy goals. The legislation and accompanying budgetary appropriations are then carried out in accordance with detailed regulatory guidelines. Although somewhat cumbersome, the process is generally designed to ensure equity and fairness in how community development resources are delivered.

Federal agencies that provide direct funding sources for community economic development include the U.S. Department of Housing and Urban Development (HUD), the Economic Development Administration (EDA) of the U.S. Department of Commerce, the U.S. Department of Agriculture (USDA), the U.S. Environmental Protection Agency (EPA), the Small Business Administration (SBA), and the U.S. Treasury. Agencies playing a more indirect role in providing resources for community economic development include the Federal Home Loan Bank System and secondary market intermediaries such as the Federal National Mortgage Association (FNMA or Fannie Mae), the Government National Mortgage Association (GNMA or Ginnie Mae), and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac). In some cases, funding is passed through to states or local communities as a block grant to support development initiatives.

Regardless of how the funding resources find their way to individual projects or programs, the application process to secure agency commitments is competitive, often intensely so. This usually reflects the motivation and intent of the granting agency to demonstrate that their investment decisions are effective in fulfilling the ultimate goals of the driving legislation and appropriation. In some agencies this effectiveness may be measured by how many jobs were created or saved and how many dollars of nonfederal financial resources were attracted to the project investment.

The federal government also directly influences community economic development by offering tax credits linked to certain types of private investment. Most important to community development initiatives are the New Markets Tax Credits (NMTCs), Historic Tax Credits (HTCs), and Low Income Housing Tax Credits (LIHTCs). Each of these tax credit programs is designed to attract equity to community development projects. This is accomplished by allowing the developer/owner of a project to sell tax credits to one or more third-party investors who use the credits to reduce their federal tax liability. Very often the purchasers of tax credits are large multi-national businesses or financial institutions such as large commercial banks. In some cases, these banks are also providing a layer of debt financing for a project.

State governments play an important role in community development finance, particularly in small towns and rural communities. State agencies serve as conduits for federal block grants from agencies such as HUD with its Community Development Block Grant program. Very often states also offer a wide range of other programs which piggyback on agencies, such as the U.S. Small Business Administration (SBA) and the U.S.

Department of Agriculture (USDA), in providing some form of guaranteed business loan, or with the U.S. Department of Housing and Urban Development (HUD) when offering programs to promote affordable housing. In some cases, state funds are used as credit enhancements when federal program guarantee limits leave a funding gap, or they take the form of direct loans through a Revolving Loan Fund (RLF) program. RLFs themselves may be capitalized with a combination of resources with funding contributions from federal agencies (i.e. EDA), state appropriations, and private banks. Some state programs also provide equity capital and subordinated debt structures to fill financing gaps for economic development initiatives in local communities.

States also encourage community economic development initiatives using target tax credit programs. These tax credits may also be piggybacked with federal tax credits (i.e. HTCs, NMTCs and LIHTCs), or they may stand alone to encourage development and investment in specific industries or clusters, such as film and video, performing and visual arts and the like. These sector-specific tax credits usually link to the state's economic development strategic plan and are usually limited in amount on an annual basis by legislative mandate. Securing such credits usually requires demonstrating that the state's investment in foregone tax revenues will result in direct job creation and net new capital investment. The use of some state tax credits may also be limited to businesses or projects in state-designated Enterprise Zones (EZs) or other targeted depressed communities or neighborhoods.

States also have the ability to offer favorable (below market cost) financing for community economic development projects by issuing bonds. This is particularly true for Industrial Revenue Bonds (IRBs that are issued by an authorized state agency, including local economic development entities). IRBs are federally tax exempt and thus investors or holders of the bonds pay no federal taxes on interest earned. This results in a lower debt carrying cost for local projects that qualify for IRB financing.

Local governments are generally the beneficiaries and recipients of development finance programs and funding flows that start at the federal and state levels. Like states, local governments through their community and economic development agencies may offer a mix of financing opportunities that piggyback onto federal and state programs. Local efforts may include credit enhancements to supplement other guarantees or direct lending through local RLFs that have been capitalized with federal, state, and local dollars. Local agencies may also directly or indirectly provide technical assistance to project developers or serve as a point of contact and referral. The best results are typically produced when the local agency establishes what is known as “One Stop Shops” or where services are directed through business support centers such as incubators.

Local governments also have the ability to issue bonds that can be used to finance infrastructure and other improvements needed to support an economic development project. This could include General Obligation (GO) bonds that are underwritten based on the full faith guarantee of the issuing municipality or a Revenue Bond (RB) that is tied to a dedicated funding stream for its repayment. GO municipal bonds (municipals) are rated and priced based upon the strength of the local community’s general tax base and its ability to service and retire existing and new debt obligations. Major improvements to streets, sewer, and water systems and other necessary municipal infrastructure are typically financed using GO bonds.

Revenue bonds are potentially more risky since their repayment is often directly linked to the success of a specific project or group of projects in a particular area. Revenue bonds are often used in conjunction with another state-authorized development finance tool called Tax Increment Financing (TIF). The TIF is a mechanism that allows future or incremental growth in property or sales tax revenues generated by development in a defined area to pay for the current and future costs of improvements. TIF-related revenue streams can be used to service revenue bond debt issued to acquire land, make infrastructure improvements, build utility, parking and other types of structures, and for a variety of development costs that represent enhancements intended to create jobs and attract more private investment. The ultimate goal of a TIF is to generate enough net new private investment to produce gradually rising property values and thus more tax revenues. TIF Districts usually encompass physically or economically distressed areas where private investment is not likely to occur without some public subsidy or other intervention that helps reduce the risk profile of one or more development decisions. In the long run, the effects of TIF creation are cumulative in that success breeds success, thus creating an environment where development finance interventions and enhancements can be phased out or redirected to other areas or strategic initiatives.

Local municipalities may also use property tax abatements to promote community economic development in areas designated as blighted, distressed, or as an officially established Enterprise Zone. Tax abatements can take two forms. They can be either a complete forgiveness of taxes or a deferral of tax payments until some future date, possibly as long as 10 to 20 years. The net effect of such abatements is to reduce the burden on the income stream being produced by a project and thus reducing the risk of cash flow deficiencies, particularly in a project’s most vulnerable start-up and growth stages. Once an income stream is stabilized and the property’s likelihood of success has improved, the obligation to pay property taxes will begin. When this payment will start is a matter of negotiation with the taxing authority or is based upon reaching predetermined operating benchmarks. In many cases, a full or partial abatement is granted with certain limiting conditions. One is that the developer demonstrated benefits to the community in terms of net new jobs created or jobs saved. Another is that the developer/property owner agrees to a Payment In Lieu of Taxes (PILOT) or an annual payment of fees to cover certain municipal services that a tax would normally encompass. These fees are usually much less than the tax payment and almost always less than the actual cost to the municipality to provide these services. In essence, the granting of tax abatements by a municipality is a calculated risk motivated by the prospects of significantly improving its local economic base and quality of life.

PRIVATE SECTOR
The fundamental motive of most private sector participants in community economic development initiatives is quite simple: making money. This occurs as a result of making a profit, creating value, and building wealth. Development finance interventions and enhancements are designed primarily to attract private sector players by reducing project risk profiles; raising the likelihood of success; and providing acceptable levels of return on investment. Competitive returns are what attract private capital to various investments and render them a bankable opportunity. Strategically designed development finance interventions typically involve layers of supplemental or gap funding to move projects from the realm of the undoable to the doable. As previously mentioned, however, fundamentally flawed projects fall into the realm of the realistically impossible and are unlikely to attract private capital no matter how many layers of enhancement are added to the mix.

There are three major groups of private sector players: commercial banks and thrifts; investors, both individual and institutional; and property owners themselves. Although each is driven largely by the profit motive, some understand clearly the benefits and potential value of community economic development.

Depository institutions such as **community banks and thrifts** usually have significant vested interests in seeing the areas they serve grow and prosper. Economic vitality is crucial to the profitability of their core business, which usually focuses on attracting deposits and making loans. Economically depressed communities create problems on both sides of institutional balance sheets. Declining property values impair loans on the asset side, while weak job growth and business expansion impair deposit growth on the liability side of the ledger. Many local institutions are attracted to community development initiatives because it is good business and because they are strongly urged to do so by regulatory mandates such as the Community Reinvestment Act (CRA).

When attempting to encourage participation by banks and thrifts in financing community economic development projects, it is important to understand several items regarding their basic structure and operating requirements. First, the banking and thrift industry is continuing to evolve and in some ways undergoing significant structural shifts. For the most part this has been driven by continuing patterns of de-regulation and re-regulation and by the globalization of the financial system. The cycles of regulatory change which started in the late 1970s have repeated themselves on a decade by decade basis. Each time the cycle repeats itself, distinctions that once existed between different types of institutions tend to get further blurred. This gives some institutions more flexibility in the lines of business they may offer and increases competition. This increased competition has in many ways helped community development finance in that it forced many previously disinterested or overly cautious institutions to pursue participation in community economic development projects and programs.

Increased global competition and the proliferation of banking alternatives for customers have further tightened profit margins in an industry that has always been characterized by tight margins on high transaction volumes. The shrinkage of net interest margins (the difference between rates earned on loans and paid on deposits) has reduced many financial institutions' latitude for making mistakes. Depending on asset size, relatively few bad lending decisions can reduce profits and potentially impair capital (or net worth) of the institution. So even if a local bank is strongly committed to a community development project, its enthusiasm for making a loan or other financial investment will be tempered by its own financial performance and the extent to which risk can be mitigated by the introduction of incentives or enhancements.

The third and perhaps most important factor to understand is that a financial institution must match or attempt to match the term structure of its assets and liabilities. That is, if it obtains most of its loanable funds from checking and other short-term demand deposits, then the maturity structure of most of its loan portfolio should mirror this term structure by offering funding over a one- to three-year period. For those with a high proportion of long-term time deposits, longer term loans are more readily justified. This is called asset/liability or balance sheet management and is watched closely by some regulators. Failure to manage the term structure of the balance sheet increases interest rate risk and can potentially lead to liquidity and capital deficiency issues for the institution.

Individual investors, like banks and thrifts, also usually have vested interests in the community and are thus supportive participants of initiatives that will help them achieve their goal of earning competitive market returns for their capital commitments while building long-term wealth. Individual investors typically involve themselves as equity contributors through legal entities such as partnerships or limited liability companies (LLCs). Their appetite for the amount of equity they are willing to invest will be linked to the estimated value of the project and an identifiable exit strategy. Equity investors are rarely willing to provide all of the capital needed to fill the funding gap between cost, value, and loan proceeds. The gap is filled by a mix of investor equity and credit enhancements. Very often these equity enhancements are provided through the sale of one or more types of tax credits to the same or another group of outside investors. Those additional equity investors may very well be institutional investment banking entities that see sufficient opportunity in the project or that are motivated by social and broader public good concerns.

Involvement of such institutional investors is more likely when they already have a vested interest in the community (i.e. existing significant capital investments) or when significant events such as natural or man-made disasters create a sudden, severe, and very visible impact on one or more local communities. Access to these institutions may require networking with locally based financial service providers such as banks and investment brokers, or with wealthy individuals or families who are residents, or major property or business owners in a community.

Property owners, particularly those who control large land holdings or strategic parcels and buildings in a community, may also have a vested interest in the growth and economic prosperity of the area. Growth drives demand for all types of goods and services and thus is the underlying force creating demand for housing and business locations. These all require land or existing buildings that should grow in value over time and thus create more wealth for property owners and rising tax revenues for local government. If property is located in a TIF, the rising values fuel greater incremental tax collections that can be used to finance more infrastructure improvements and target community development projects.

Property owners very often control strategically located sites or buildings that are crucial elements required to execute a community's economic development strategy. This could include buildings in a core business district targeted for redevelopment and revitalization or large vacant land holdings on the perimeter of the community that essentially land locks future expansion unless they are brought into commerce.

Although most private property owners find the prospect of developing or redeveloping their assets an attractive alternative, some communities do encounter resistance and are unable to execute some portions of their plans. Property owner resistance can often be traced to fear or uncertainty about change or be linked to legal or ownership restrictions placed on land or buildings by ancestors. This could include deed restrictions or placement of the property into some form of family trust or encumbering it with long-term agricultural or timber leases. An essential part of any community development team is good legal counsel who can help address some of these issues and negotiate terms that are acceptable to all parties.

Another potential barrier for some property owners is the fear of creating significant income tax liabilities for themselves or their heirs as a result of development. Again, good tax and legal counsel can help mitigate if not eliminate these fears by creating legal and tax strategies that provide protections for the property owner, assure wealth accumulation for themselves and their descendents, and allow land or buildings to be used in executing an effective community development strategy. In some cases, this could involve financing structures that include property owners as equity investors in the project. Whatever the structure, the intended end result is a “win-win” outcome for all stakeholders.

NONPROFIT SECTOR PLAYERS

The nonprofit sector sometimes referred to as the charitable, independent, or third sector, experienced significant growth over the past 20 years. The sector’s combined operating budgets now exceed $1.0 trillion and account for 7 percent to 8 percent of GDP (as compared to 3 percent to 4 percent during the 1960s). Nonprofit organizations employ over 10.0 million people in the U.S. alone (about 11 percent of the labor force) and on average engage about 95 million people annually as volunteers. Like the emergence of nonprofits in the early 1900s, the more recent expansive cycle can be traced to entrepreneurial successes that created substantial wealth for owners and investors during the 1980s and 1990s. Nowhere is this more evident than in the proliferation of technology-based companies that catapulted their founders into the ranks of the super wealthy. Some of these newly minted billionaires have transferred large portions of their wealth into foundations that support a wide variety of charitable and philanthropic causes throughout the U.S. and across the globe.

Although these and other large foundations garner much of the attention, the “trench work” of the nonprofit sector is carried out by relatively small organizations, those with annual operating budgets generally under $50,000. This would include the vast majority of nonprofits focused on community economic development, particularly housing and neighborhood revitalization. Very often these functions are carried out through community development corporations (CDCs), which will be discussed later.

Nonprofits are private, nongovernmental organizations that are incorporated and governed by a Board of Directors or trustees with fiduciary responsibilities to oversee and manage the interests of those who donate money or otherwise provide financial resources to support the organization’s mission. Although nonprofits are not an extension of the government, their operations are facilitated by the extension of tax exempt status and funding support through a wide range of grant programs, many of which are only available to nonprofits.

Nonprofit status does not mean that charitable or community development organizations do not make money. They can and should generate operating excesses (i.e. profits) and build their net equity (i.e. net worth) position. Unlike corporations organized to make a profit for the benefit of its owners (stockholders), nonprofits are organized for the advancement of a group of persons or the community (stakeholders). Because they are mission-driven and not profit-driven, nonprofits are granted tax exempt status under Section 501 of the Internal Revenue Service Code. Most nonprofits are exempted as 501(c) 3 organizations, although there are others that may fall under other parts of the code such as (c) 6, (c) 7, etc. Aside from not paying corporate income taxes on net operating excesses, individuals and legal entities can make donations to qualified nonprofits that are deductable for purposes of calculating taxable income.

Community Development Corporations (CDCs) act as conduits for public and private investments that are focused on community economic development and revitalization projects. They are often formed as an outgrowth of work undertaken by community groups at the local or neighborhood level whose focus is contributing to the public good through housing renewal and commercial revitalization. Their motivations are job creation and the attraction of private and government resources to upgrade the quality of life and build wealth within their target areas of influence.

Neighborhood-based CDCs are often governed by local residents and small business and property owners. They form alliances and partnerships with other CDC's as well as with local government agencies and private businesses that are willing to financially support the mission of the CDC. Both public and private sector partners usually have vested self-interests in seeing CDCs succeed at their mission. This can range from removing or rebuilding blighted and abandoned housing to reduce crime and restore neighborhood stability to increasing the population and purchasing power of residents to support more retail, banking, and other business activities.

Some of the more creative and entrepreneurial CDCs will also create profit-making subsidiaries that can route money into the nonprofit to further its mission. For example, a nonprofit CDC with a major housing and workforce focus can use job training programs supported by private donations and government grants to provide qualified skilled workers for a profit company that provides various contracting services. In addition to job training, nonprofit CDCs may also operate day care centers, community health clinics, and other social service programs while creating profit entities such as local grocery stores, restaurants, auto repair shops, and a wide variety of business start-ups that can offer job opportunities for neighborhood residents.

Bank CDCs are a special form of community development corporation authorized under two federal banking regulators: the Office of Comptroller of the Currency (U.S. Treasury) and the Board of Governance of the Federal Reserve System. These agencies have established regulations that allow nationally supervised banks to undertake a wide range of investments and activities that advance the public welfare. These regulations permit banks to make one-time investments (by grant, loan, or equity) in specific projects or entities (called Community Development Projects [CDP]) or to establish and capitalize ongoing entities to finance or directly undertake community economic development initiatives.

Bank CDC activities can be structured in a variety of ways. This could include a bank division or business unit; a for-profit or nonprofit (usually 501(c)3) subsidiary; a partnership with a community-based organization or public agency; a multi-bank organization; or an umbrella entity to pool bank funds with other funding sources.

Bank CDCs are commonly used to provide riskier loans to small businesses such as subordinated debt for business expansions that do not meet conventional credit standards. Sometimes, depending on the amount of funds needed, several bank CDCs will pool resources in a participation agreement to make the necessary resources available. Some bank CDCs also combine lending and investment activities with technical assistance and business support services such as incubator facilities or entrepreneurial development programs.

Bank CDCs may also pursue real estate development as part of their mission. This could include acquiring and rehabilitating severely distressed residential and commercial properties in targeted neighborhoods throughout their service area. In this way, bank CDCs are filling a market void where private developers and other lenders see an area as too risky for investment or where the circumstances involving severely blighted properties and neighborhoods are particularly difficult and complex. In the latter instance, many bank CDCs will form alliances with other neighborhood-based CDCs, particularly faith-based organizations that have complimentary missions.

Faith-Based Organizations (FBOs) are by their very nature and missions focused on making community improvements that permeate not just the social and economic conditions of an area but also provide uplifting spiritual support and encouragement to people who may have lost hope in themselves and others. FBOs have emerged as vital links to deliver a wide range of social services (i.e. medical, counseling, schooling, etc.) in areas where public and private delivery mechanisms have failed or have been severely deficient. Bank CDCs often partner with FBOs to provide financial support to social services that will improve the quality of life in targeted neighborhoods and thus enhance the chances of success for housing and commercial redevelopment efforts. FBO CDCs are often best equipped to secure and train prospective buyers for affordable housing financed by a bank CDC and to maintain an ongoing relationship with new homeowners to assure their success in this new role. Bank CDCs can also serve as conduits to provide financing to FBOs that acquire and renovate properties themselves and provide technical and management assistance to ensure an FBO's long-term sustainability. Successful partnerships or strategic alliances such as these produce win-win situations for all parties. The bank CDC makes good investments for which its parent bank receives favorable CRA credit; the FBO takes more steps forward as a viable player in community economic development; and community residents gain access to affordable housing, improved services, and a better quality of life.

Foundations, both privately-funded and community-supported, have historically been a source of grant funding used to support community economic development projects and programs. Receiving financial support from foundations is typically a highly competitive process that requires the potential grantee to conduct careful due diligence research on potential donor organizations, to prepare detailed, fully documented applications, and to nurture relationships with foundation contacts to maintain good communication. Although foundations control a significant asset base, they have traditionally accounted for 10 percent to 12 percent of total nonprofit support supplied annually. They are, however, an important player in community economic development for a wide range of initiatives either on a one-time basis or with multi-year commitments.

In addition to making outright grants, many large foundations also make what are known as program-related investments (PRIs). These may include direct equity or equity equivalent investments in projects such as long-term or non-amortizing subordinate debt, usually at below-market interest rates. PRIs are most likely made when they directly and significantly reflect the core mission of the foundation providing the resources. They may be targeted to a range of community economic development projects such as neighborhood shopping centers, commercial district revitalization efforts, small-business and microenterprise revolving loan funds, and business incubators. Unlike direct grants, PRIs are financial instruments designed to provide some rate of return to the foundation even if it is below market. PRIs are a strategic way for foundations to accomplish their mission and make money at the same time.

National entities such as the Mott, Ford, and Calvert Foundations are important investors in community economic development initiatives. Also, most major corporations have charitable foundations that support community development projects and programs. These include companies in just about every sector such as banking (Capital One, Wells Fargo, and Bank of America), communications and technology (Sprint, Microsoft, and AT&T) and insurance (Prudential, Hartford, and Allstate). Two excellent sources of foundation information is the Council of Philanthropy (www.philanthropy.com) and the Foundation Center (www.foundationcenter.org).

STRUCTURING COMMUNITY DEVELOPMENT FINANCE OPPORTUNITIES

Financing community economic development projects typically requires a mix of funding that is creatively tailored and drawn from a variety of sources. In most cases, this involves parties (players) that are providing either debt or equity capital to meet the funding needs of the project. The type and amount of capital supplied by private sector players will typically be governed by market forces and their need to earn a satisfactory rate of return in relation to the investment opportunity's risk profile. Their decision will be driven by a due diligence process that focuses on project evaluation, risk measurement, and asset valuation. This process helps conventional lenders and investors assess their appetite for a project or the amount they are willing to fund in relation to market value. If this appetite is at a level sufficient to cover the project's total cost, then the project can move ahead to achieve a community's economic development goals and objectives. This, however, is not the norm, but the rare exception. It is more likely that after the due diligence-driven appetite is established, there is a funding gap (often significant) between the total estimated cost of the project and the amount available from conventional sources.

Community development finance offers a "toolbox" of various incentives and enhancements that can be used to fill the funding gap and thus allow the project to move forward. A fairly comprehensive discussion of possible tools is presented in Appendix A. It should be emphasized that not every intervention or enhancement tool is necessarily applicable or appropriate for every project. Selecting the right tool is important to the ultimate success of a project. It is also equally important to reemphasize that using good tools will not revive a poorly conceived project any more than using a good hammer is likely to fix rotten wood. Projects that are fundamentally flawed usually have one common attribute: conventional lenders and investors have avoided them like the plague.
If that is the case, community leaders should be quick to take note and either address the project's fundamental flaws or abandon it (even if temporarily) and move on to more promising opportunities. This may mean giving up someone's or a group's "pet project," but that is far better than having the pet turn into an all-consuming nightmare of a monster.

DEBT AND EQUITY MIX

Most major assets owned by individuals or legal entities are acquired or built and developed using a mix of debt and equity financial resources. In both cases, debt and equity investors expect or anticipate receiving some reward for their contribution of resources, typically measured as an interest rate on debt or rate of return on equity. Conventional investors expect to earn returns that are competitive in the financial markets. These may be benchmarked against some minimal return expected for a riskless U.S. Treasury security to an average return on equity based upon the long-term performance of the Dow Jones or Standard & Poor's stock indices. No matter what the benchmarks, debt and equity investors are expecting a return for the use of their capital (or the capital they invest for others).

Equity and debt investments can take many forms and be mixed in varying proportions depending on the type of asset they are being used to fund. In its simplest form, equity can be represented by cash used by an investor to buy stock or some other evidence of ownership in an asset, such as a partnership or limited partnership, share, or interest in a limited liability company, or undivided interest in a business or real estate. In a pure equity investment, there is no fixed or guaranteed rate of return and equity investors are usually last in the priority of claims on income streams produced by the asset behind contractually bound debt-holders.

In the typical community development project, equity investments may be generated from a wide range of sources. These could include individuals in the community (or their network of friends and family) or local professional investors sometimes referred to as "angel" investors that may include wealthy business and property owners who stand to benefit from the development initiative or who are motivated purely by civic-minded philanthropy. Formal venture capital from outside professional investors will rarely find its way into local community development projects unless the investment partnership is primarily a socially conscious fund that is very patient and willing to accept below-market yields for its investment.

Equity investments in community development projects are increasingly represented by tax credits. These may include historic, low-income housing or new markets tax credits that can represent 25 percent to 30 percent (and sometimes more) of the total anticipated project cost. These credits are sold to business entities seeking to reduce federal and state income tax liabilities and may well involve banks or other depository institutions providing a portion of the debt capital and seeking additional CRA credit. The major risk for tax credit investors in most community development initiatives is a project failure involving defaulted loans and then foreclosures. In these situations, unwinding the tax credits has the potential of creating tax liabilities plus accrued penalties, the cost of which could be substantial. This is another reason to ensure projects are fundamentally sound.

Debt financing is typically linked to a specific contractual obligation requiring some form of periodic repayment of the loan amount (principal) plus interest to compensate the lender of the use of the funds. In community economic development projects, conventional sources of debt may include commercial banks, thrifts (savings and loans and savings banks), insurance companies, and possibly pension funds. Although insurance companies and pension funds usually invest in what are known as “trophy” projects or properties, those with a socially conscious “streak” can sometimes be attracted to local projects, particularly if they have a vested interest (i.e. a major presence in the community itself). However, their participation may be limited by their organizational charters or internal operating and investment policies. In these cases, their role may be more of a donor (equity contributor) than a lender.

Debt instruments in community development finance usually include promissory notes, mortgages, or bonds. No matter what the form, they all usually have the same fundamental contractual obligations placed on the borrower: periodic repayment or retirement of the debt over some specified period at a fixed or variable interest rate. Additionally, there is usually a pledge of assets (at a minimum that which is being financed) as collateral that can be (in the event of default) foreclosed upon and sold to satisfy the outstanding debt obligation. When the collateral value of the assets falls short or the likelihood of default is higher than in conventional projects, credit enhancements and guarantees are usually required. A wide range of loan guarantee programs exists and is discussed in Appendix A. However, the fundamental principle of any guarantee program is to protect the lender from loss, particularly on the top or riskiest portion of the loan.

There are several advantages to debt financing. First, it is usually less costly than equity and the return earned by the lender (and cost incurred by the borrower) is fixed or at least fixed within a fairly predictable range. Second, a fairly wide range of debt sources are generally easier to identify and attract to community development projects. Third, if ownership and control of a project asset is an issue for the community, there is no dilution of ownership when using debt.

Debt, however, also has several disadvantages that are important to community development projects. First, by contract, debt payments must be made on schedule even if sufficient income is not available. Failure to service debt results in default that can lead to foreclosure on the pledged collateral, liquidation of the asset to pay creditor claims, and calls upon guarantors to satisfy potential deficiencies. These are the downside consequences that careful due diligence is intended to avoid. Debt may also involve project performance covenants that can be restrictive and potentially lead to default.

VALUE: THE UNDERLYING CRITERIA, WHAT DRIVES IT AND MEASURING IT

After most everything else is stripped away from the decision framework guiding the community development finance process, a fundamental issue remains: What is the market value of the project or asset being financed? This is true because value basically drives the funding decision for private lenders and investors and defines the gap that must be filled by development finance incentives and enhancements. At its most fundamental level, the gap would be determined as shown in Exhibit 1. As previously discussed, the proportion and amount of project financing derived from private sources will be governed by factors such as regulatory or policy restraints, the risk profile of the potential investment, and the anticipated returns the investment is likely to generate.

Exhibit 1
Market Value and the GAP

- $ Project Total Market Value
- X % Supplied by Private Sources (Debit & Equity)
- $ Total Supplied by Private Sources (Debt & Equity)
- Less: Total Project Cost (Direct & Indirect Costs)
- $ Gap to be Filled by Development Finance Incentives & Enhancements

A project’s market value is formally estimated in an appraisal performed by an independent, qualified professional relying on well-established methodologies to measure the impact of a wide range of market forces on a specific site or building as of a given date. The appraiser relies on market derived data to assess the impact of four major determinants on value. These are Demand, Utility, Scarcity, and Transferability or DUST. If community economic development projects are to be successful, all of these value determinants must be favorable or at least moving in that direction.

Demand is probably the most fundamental and central determinant creating value. If there is no measurable and observable demand for a proposed community development project, then by definition is not an opportunity that will attract capital but simply a good, well-intentioned idea. Demand is usually driven by population, household, income, and employment growth in a community. This growth does not necessarily have to be dynamic to create demand, just sufficient to demonstrate that a proposed project can reasonably be expected to fill a market niche. For a particular project this means that the space created (housing units or office, retail or warehouse square footage) must be able to be absorbed within a reasonable period of time at prices or rents that render the investment feasible. Very often, appraisals may be done in conjunction with market and economic feasibility studies. These do not focus as much on value as they do the dynamics of the market environment to demonstrate that demand is deep enough to allow entry of a new project over a certain period of time and that the space introduced can in fact be absorbed at prices or rents that support the investment's underlying cost. The conclusions from feasibility studies provide the appraiser with support for his or her value conclusions.

Utility is a determinant of value that focuses on the usefulness of the product or asset being offered to the market. An asset's utility might be impacted by its age or design or its currency with respect to technological expectations of potential users. In community development projects, particularly those involving reuse and redevelopment of existing structures, this is a potentially significant issue. Older buildings by definition usually contain features that are functionally obsolete (i.e. old plumbing and wiring, immovable walls, awkward floor plans, etc.) or that are environmentally challenging (i.e. containing asbestos or other hazardous materials). If the cost of remediating these deficiencies is not offset by a commensurate increase in market value, then the funding gap may grow larger and in some instances be insurmountable, thus negating the project's feasibility. These kinds of deficiencies, however, may open the door to additional community development interventions such as remediation funding from HUD or EPA. Of course, they could also raise the risk profile beyond levels acceptable by some private investors and lenders.

Scarcity is fundamentally another term for supply. However, it usually has a somewhat narrower interpretation as a determinant of value. Scarcity is supply qualified by location or area specificity. In other words, an over-supply of space (i.e. housing units, retail or office square footage) in a market as a whole does not necessarily negate or minimize the need to introduce additional supply in underserved areas (blighted neighborhoods) or in certain market niches (affordable housing). An area-wide oversupply may very well put downward pressure on prices and rents in a general market area and increase the perceived riskiness of individual projects. However, it may not have a negative impact on targeted geographic areas or specific segments of demand. There often are unfilled demand gaps that create fundable community development project opportunities.

Transferability covers a potentially wide array of issues as it relates to impacting value. However, with regard to valuing community development projects it often centers on ownership rights or zoning or other land use restrictions encumbering the property or asset. Value appreciation potential is impaired if covenants or deed restrictions limit the type or extent of uses allowed on a parcel of real estate. In fact, restrictions may very well impede the utility of the property and thus render it unmarketable or at the very least raise its risk profile. Other limitations on transferability may arise due to complicated ownership structures. This is not uncommon in community development projects involving existing buildings that have been held by multiple generations of one or more families. In many cases, it only takes one uncooperative party to stop or delay transfer of ownership rights to allow a community development project to move forward. Leases, particularly long-term ground or agricultural leases, are another common impediment to transferability of property or building assets as part of a community economic development initiative. In some cases, total project cost may include a buyout of the lease. In other instances, the lessee may be encouraged to cooperate by including his leasehold interest as an equity contribution, thus making him an investor with rights to receive future benefits if the project succeeds.

MEASURING, COMPENSATING AND PRICING RISK

Every community economic development project presents its investors (both equity and debt) with opportunities and risks. The “art” of making sound project investments is striking a reasonable balance between the two so that the opportunities available are sufficient to offset and compensate the risks being incurred. Project investors do not try to avoid risk. If they did, they would reject the opportunity outright and move on to others. Those who try to avoid risk are really not players in community development. However, astute players understand that while risk avoidance is impossible, risk mitigation and control are strategically necessary to minimize losses and maximize returns. Risk mitigation can take many forms, but in community development finance it usually involves sharing and/or shifting risks. Loan guarantees are a common intervention used in development finance to both shift and share risk. Careful due diligence (i.e. appraisals, feasibility studies, legal title research, etc.) are tools used to identify and develop strategies for mitigating or controlling risk exposure.

Typically several types of risk are associated with most community development projects, particularly those involving investments in real estate assets or other income producing properties. Although most are typically associated with the extension of credit or issuance of debt instruments, some directly impact the decision of equity investors as well. Credit or business risk is a significant concern for both debt and equity project investors. This risk addresses the likelihood or possibility that the income being generated by the project will fall short of the levels necessary to cover operating costs and debt service (i.e. principle and interest payments). Measuring this type of risk is usually the focus of market and financial feasibility analysis. These studies focus on making realistic assessments of achievable and sustainable rents based upon demonstrated market experience as well as estimates of operating costs to support the property. The result is a forecast of net operating income (NOI) that represents resources available to service debt. When NOI is divided by required debt payments, the result is called a debt coverage ratio (DCR). Most conventional lenders expect minimum DCRs in the range of 1.20 to 1.30 depending on the type of property. As the DCR approaches 1.0 or less, credit or business risk or the possibility of default risk rises.

Liquidity or marketability risk is associated with the ability of the originating lender to sell or otherwise convert a loan asset to cash or near cash equivalents. Loans that do not conform to requirements of secondary market investors typically have the highest liquidity risk. Although loans originated for community development projects are not typically underwritten and packaged for sale in the secondary market, there are some opportunities to do so and thus mitigate liquidity risk. This is particularly true for some SBA-guaranteed loans as well as USDA-guaranteed business loans. If these alternatives are not available, some lenders may attempt to secure loan participations from other local institutions that maybe willing to buy or invest in a development finance opportunity. Loan participants may also be used when the amount of funding advanced exceeds a single institution's regulatory limitations as to how much it can loan to a single borrower. This is a more frequent problem for smaller community banks with limited capital positions. Loan participations help to reduce loan concentration, keep the bank in regulatory compliance and spread the risk of the investment among several institutions. Loan participations are also a strategy employed to attract lenders that are seeking CRA credit but that do not want to take the lead position in a community development project.

Maturity risk is typically defined by the repayment terms of the loan instrument. The longer the repayment period, the greater the maturity risk. This greater risk is associated with the likely erosion of the loan's value due to inflation as well as to the fact that the longer the loan is outstanding, the greater the possibility that changing conditions and uncertain circumstances will increase possibility of default. A common strategy for addressing maturity risk is to structure loan payments over an extended amortization period (say 20 to 30 years), while requiring a shorter loan payoff or maturity data (say five to 10 years). This gives the lender(s) the ability to revisit and reconsider the loan, adjust its terms and decide to extend new terms or call the loan (i.e. demand a balloon note payment).

This kind of loan structuring can also be used to mitigate interest rate risk. This is the risk associated with the possibility of a decrease in the market value of a loan due to the movements of market interest rates. As market rates move higher in relation to fixed contractual rates on loans held in portfolio, lenders are exposed to a decrease in market value of their loan assets. Lenders may also mitigate interest rate risk by structuring loans with floating or adjustable interest rates. These instruments allow for changing the interest rate earned on a loan as financial market conditions fluctuate as evidenced by any one of several indexes (i.e. Treasuries, LIBOR, N.Y. Prime, etc.) If they are able to do so, lenders may also sell loans into the secondary market to mitigate the interest rate risk. However, this is less likely the case in nonresidential community development finance opportunities.

The price of risk is reflected in the interest rate ultimately charged on a loan. Although pricing occurs within a competitive framework, lenders attempt to build a rate considering each type of risk they face in a particular loan decision. The starting point is usually the risk-free rate typically associated with the rate of return that the institution could earn on what are generally referred to as “no brainer” investments in U.S. Treasury securities with a maturity term comparable to the loan being considered. If the risk free rate is 4.0 percent and the target rate based on competitive conditions in a local market is say 8.0 percent for the type loan requested, then the compensatory risk premium is 4.0 percent. In other words, the lender is earning a 4 percent return to compensate for business or credit risk as well as interest rate, maturity, and other risks associated with the loan investment. The lender must then determine if this return satisfies internal policies and sufficiently matches the investment’s risk profile. If not, lenders have several options. They can deny the loan request; attempt to restructure the loan and secure concessions from the prospective borrower; or seek credit enhancements or other interventions from third parties. This third option is the focus of community development finance strategies and structures.

PUTTING COMMUNITY ECONOMIC DEVELOPMETNT PROJECTS TOGETHER

Successful community economic development projects do not “just happen.” They are not the result of osmosis or spontaneous combustion. They come together as an outgrowth of a well conceived set of prioritized development initiatives (projects and programs) that are fully fleshed out in a strategic business plan. This is a critical document for local economic development that articulates a comprehensive approach to achieving a project’s long range goals and short term objectives. The plan describes the roles, responsibilities and anticipated rewards for each project player including but not limited to equity partners, lenders, development finance investors, government agencies and community organizations. A strategic business plan provides all parties with the necessary information to make decisions that are important to a project at each stage of its unfolding. It describes, within the context of development timeline, how the project will be produced, how the project will be organized, how the financing is structured, how the project will be marketed and fully implemented and how a project’s inherent risks will be balanced by its anticipated benefits and returns. This last component should also include discussion of an exit strategy, particularly for a project's private sector players.

It is beyond the scope of this training module to explore in great detail the composition and preparation of a strategic business plan. The accompanying bibliography provides several references that are helpful in this respect. However, this section of the module discusses the major elements of such a plan within the context of two case examples. The first case involves the development of a 180 acre business and industrial park in predominately rural St. Martin Parish, LA. The case involves a somewhat unique locational, situational and financial structure issues that hopefully will provide community development leaders with productive food for thought. It has unique challenges and involved creative approaches to overcoming development barriers and obstacles.

DEFINE THE PROJECT'S STRATEGIC INTENT AND GOALS
This involves describing the overall project, its over-arching goals and objectives and how its success fulfills broader community strategic goals. This section should also address how participation in the project fulfills the mission and purpose of key players. This statement of strategic intent will guide the entire development process and help to keep it on course when unanticipated (and all but inevitable) complications and challenges arise. It is not a matter of if challenges will arise; it is just a matter of when and how severe they are to a project's ultimate success. This section of the business plan essentially addresses the goals and objectives the project is intended to achieve; how they will be achieved; who will be responsible and accountable for their achievement; and articulation of how and when remedial action should be taken if the project fails to unfold as intended. The last item addresses the need for community leaders to monitor and closely oversee a project's progress and to be ready with a "Plan B" if necessary.

Describe the Organizational Plan and Identify Key Personnel
Although money is important to the success of a community development project, people and their gifts, talents and experience are what make them happen. And those who are financial stakeholders in a project are very often more interested in the abilities of the people and organizations involved than they are in the project itself. The most marketable of projects is only as successful as the abilities of the people necessary to implement and execute it. The failure of many projects (as well as many new business start-ups) can be traced ultimately to people problems. What appear to be money issues at first glance are very often symptomatic of deeper, more fundamental organizational and people problems, particularly those involving poor financing resource decisions. If anyone doubts this, just read one of the many "corporate autopsies" written after the now infamous "dot-com" crash of the late 1990's. Community development finance intermediaries have become more selective over time and very often weigh their

investment decisions in a manner comparable to professional venture capitalists and institutional investors. They invest in people (who they are, what they know and who they know) first and the entrepreneurial opportunity (what will be produced and how it will be marketed) second.

This section should identify who the strategic players and partners are and why they are included on the project team. It should describe clearly the organizational structure that will be relied upon to carry out the project and why it best suits the needs of all the players. Very often, projects are developed using one of several legal entities such as a corporation, limited liability company, partnership, etc. The organizational plan should include a clear description of each player's relative ownership interest, the rules of governance and identification of key professionals responsible for day-to-day business activities necessary to carry out the project. This plan should also discuss how critical strategic decisions are made and by whom and most importantly how disagreements that are also inevitable will be resolved. This part of the plan should also describe what each team member will contribute to the project in terms of people, time, financial resources, equipment, space and expertise.

Provide an Analysis of the Project's Market Dynamics
This section will vary greatly depending on the nature and scope of the proposed project. However, it should always address the market rationale for conceiving and executing the community development opportunity already described. This section provides evidence that the project is in fact driven by identified and quantified forces of demand and that it has a place or fills a niche in the competitive environment in which it will function. In short, the market analysis shows that a project is sustainable and supportable and that its business risk tolerances are within a reasonable and measurable range. The market analysis identifies sources of market demand (i.e. customers or users); where they are located; their demographic and economic profile; and how they will be drawn to the project location. It should also present a realistic identification and quantification of existing and possible future competition; address market shares or penetration rates necessary to achieve financial objectives; and substantiate price or rent target points that drive the project's economic feasibility. The market analysis should encompass short, intermediate and long term planning horizons with particular interest on forecasting revenue streams for the first five to seven years of a project's life. This is particularly important for some forms of development finance intervention (i.e. tax credits and term loans) with a maturity structure of five to seven years.

Describe and Fully Document the Project's Financing Structure
Although this section of the business plan should be able to stand alone, it must also fully integrate each of the plan's other major elements. The financing structure must be consistent with the realities of the marketplace while reflecting

the expectations and risk tolerances of the stakeholders and the abilities of the team assembled to execute the project. Inconsistencies breed credibility gaps that can undermine the mission and goals of the community development initiative. Most importantly, cost and revenue estimates must be realistic and derived from market evidence and reliable sources. Nothing does more harm to a project and the credibility of its proponents than “low-balled” cost figures and “pipe-dream” pricing estimates. This is the short path to project failure and financial disaster. And, since the due diligence of most private sector players will tend to ferret out such apparent analytical flaws, community proponents should be forewarned lest they tarnish their chances for support and participation from these financial and technical resources.

At a minimum, the financial part of the plan should include the following:

- A detailed estimate of start-up costs covering capital as well as operational expenses associated with launching the project. For real estate related projects this should include interest-carrying costs during development and construction as well as operational expense coverages during initial absorption and lease up of the property. Capital items should detail acquisition and construction costs including equipment, furnishings, supplies and the like.
- A detailed five-year operating budget and statement of cash flows should also be included. This should cover the development period through lease-up to normalized occupancy and at least four years thereafter. This budget should show all sources and uses of funds and the cost and timing associated with each source. The budget should also identify each source’s maximum initial commitment and its willingness and ability to increase its financial stake in the project if necessary and at what cost. This would include equity investors, private lenders and government or nonprofit grant agencies. The budget should be presented in at least two to three scenarios (i.e. most likely, best and worst case) but free of the paperwork blizzard effect fueled by electronic spreadsheets. Each scenario must be grounded in realistic assumptions and careful thought.

The financing section should also demonstrate the range of returns each investor/lender is likely to achieve over the life of the project or for the duration of their individual commitments. For equity investors this may include their annual cash on cash returns as well as their internal rate of return at the end of their holding period. For lenders, their returns may vary depending of how terms are structured and whether or not equity-kicker incentives are build into the project’s financing plan.

The financing section should also address the issue of cash burn and identify how cash will be infused into the project when cash burn rates and cost overruns exceed expectations. This is a critical element of "Plan B" and possibly even a "Plan C."

The financing section should also include a discussion of exit strategies for various project participants/stakeholders. This would include, but not necessarily be limited to, take out or permanent financing commitments, sale or other disposition of the physical assets, and possibly forgiveness or cancellation of some debt used to carry the project in its initial development period. Structures involving tax credits sometimes include such provisions.
If debt is to be refinanced, the financial forecast should anticipate the funding level and possible sources needed for such a transaction.

Describe Project Implementation and Stakeholder/Participant Risks and Rewards
This section of the business plan should help to answer several basic questions for each of the project players: Why are we doing this? What are we getting out of it? When can we expect to see the fruits of our labor? Project implementation must be presented within the context of scheduling timelines. Of the many things that can harm a project, time is among one of its potentially most serious enemies; as time horizons lengthen, uncertainty rises, and the chances for something to go wrong increases. Stretched time periods can also result in rising costs, footloose space users and nervous financial partners looking for the exit ramps (or as they are called in South Louisiana "crawfish clauses"). This does not mean that implementation schedules are unreasonable rigid. In fact, they should have a fair dose of flexibility built into them. However, they should establish periodic benchmarks that hold all participants accountable to complete their assigned duties on schedule. The more complex the project, the greater the need to meet scheduling deadlines, particularly when another stakeholder's role or participation may be linked to one or more of them. In some cases, scheduling deadlines will be driven by contract terms such as loan agreements, leases and construction contracts and thus may entail penalties for non-performance.

The implementation plan should include not only what a participant's deadlines are, but also the specific person or persons to whom responsibility has been assigned to see that they are met. If there are critical or absolute "drop dead" dates in the schedule, these must be clearly articulated and understood by all parties. It is also important to understand the nature of non-performance penalties that may accrue and specifically who will be held responsible for them.

Lastly, this section of the plan should describe as succinctly as possible the range of risks and rewards for each participant/stakeholder. For private participants, the previously discussed financial returns are a start. For private lenders, regulatory compliance rewards through community reinvestment are very often included, while for private property owners there is the ability to realize greater value appreciation over time as a result of the development initiative. For local government, there is the prospect of returning underutilized property to the tax rolls, attracting more private investment and growing a more diversified job base. Where possible, the public sector's investment should be evaluated using a simple economic impact and cost/benefit analysis. For participating nonprofits, the rewards may be as simple as fulfilling their missions while bettering the general public welfare of the community and thus improving the quality of life.

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