

POLICY DIRECTIONS:

INVESTING IN NONPROFIT HOUSING SOCIAL ENTERPRISES

Written for STRENGTH MATTERS™ by Mary White Vasys
Version I: May 2010

This paper is a product of STRENGTH MATTERS™, a collaborative initiative among national and local organizations in the affordable housing field, co-sponsored by NeighborWorks® America, Housing Partnership Network and Stewards of Affordable Housing for the Future.

INTRODUCTION

STRENGTH MATTERS™ is sponsored by NeighborWorks® America, the Housing Partnership Network, and Stewards of Affordable Housing for the Future. The vision of Strength Matters is to expand the supply of affordable homes by supporting the expansion of high-performing nonprofit affordable housing developers and owners whose mission is to provide stable and affordable homes - market-driven housing social enterprises that operate with a “double-bottom line” approach that balances mission with sound business practices.¹ These entrepreneurial organizations serve both as developers and also as long-term owners of our affordable housing resources. They are central to having the nonprofit sector expand its impact as long-term stewards for quality affordable homes. Strong organizations with more capital will preserve and produce more housing that is affordable, stable and contributes to the diversity of housing choices in communities across our nation.

Growth of high-performing nonprofit mission-focused owners requires access to additional equity, quasi equity, and debt at the enterprise (or “parent”) level of the organization. Historically, most funding for nonprofit housing social enterprises occurs at the property level in the form of debt. Yet, it is at the enterprise level where the expenses are incurred to develop and run these properties and the social and financial returns are produced. While experience demonstrates that most successful businesses are built on equity, nonprofits are severely limited in their ability to raise enterprise level capital for their organizations.

Participants of the Strength Matters Lender Working Group working in consultation with chief financial officers (“CFOs”) involved in Strength Matters contributed to this paper (see Exhibit 1 for acknowledgements). It is the intent of these Strength Matters’ participants that the ideas discussed herein will launch a more substantive dialogue about how investors can provide and high performing housing nonprofits can effectively use enterprise-level capital to sustain and grow their organizations and produce social and financial returns for investors, residents and the community.

¹ For purposes of this paper “housing social enterprises” are high-performing nonprofit organizations that are primarily focused on the initial development, preservation and long-term ownership of affordable housing serving low-income communities or low-income households. They are large and small, national, regional, statewide and local. These organizations are mission-focused and have business models that are driven by rigorous risk management, a focus on sustainable revenues, managing for a return on investment and aggressive cost minimization. Certain for-profit companies have similar business models. However, the Strength Matters initiative focuses on nonprofit organizations due primarily to the differences in accounting rules and various preferences/restrictions in government programs that impact nonprofits differently than similar socially conscious for-profit companies.

Enterprise-Level Investment Defined

What type of enterprise-level investment does a nonprofit housing social enterprise need for its business? Historically the nonprofit sector primarily relied on grants from the public sector and philanthropies for equity in part because of tax code limitations on a nonprofit's use of other equity products (e.g. issuing stock). Unrestricted grants for equity capital are still a preferred source of equity for nonprofits. Equity-like products that do not have specific repayment requirements and long terms (e.g. equity equivalent loans sometimes referred to as EQ2s) and debt facilities that are unsecured, medium to long-term in duration (e.g. 3 – 10 years), and charge lower interest rates (e.g. 0 – 3 percent) also are desirable.

Housing social enterprises use this flexible capital for the following purposes:

- **Working Capital.** Short-term capital used to fund the organization's day-to-day operations. Defined in financial terms as the difference between current assets and current liabilities, it is a measure of an organization's liquidity. It is used to fund an organization's recurring noncapital expenditures such as payroll, accounts payable and accrued operating expenses. This type of capital is typically generated internally from excess unrestricted cash balances, or the conversion of accounts receivable into cash. Working capital can also be generated internally from surplus operating revenues (a positive change in net assets). Externally, this capital is typically generated from short-term borrowings such as a line of credit (often secured by the organization's current assets) or from unrestricted operating grants. It is the most flexible capital available to an organization and helps the organization maintain a consistent level of liquidity to even out fluctuations in its cash flow from operations. This is a critical type of capital for nonprofit developers and owners, which often have cash tied up in new development projects for two to three years prior to receiving any development fee revenue from the project.
- **Investment Capital.** Sometimes referred to as "growth" capital, this type of capital is used by the organization for investment purposes to expand its existing business, grow its assets, start a new program or invest in systems and staff. It may be used to start a new line of business (such as a property management company), provide upfront acquisition and predevelopment capital for potential real estate projects, start a computer learning center for residents at a property, purchase new hardware or software or add critically needed staff. The assumption with this type of capital is that it will be "tied up" for one to three years for a specific purpose until either the new activity generates sufficient surplus revenues to repay the capital (in the case of an investment in a property management company) or an alternative source of capital is identified (project financing returns capital used for predevelopment). Investment capital can be generated internally from surplus operating revenues, which increase unrestricted net assets. Unrestricted net assets are a flexible source of investment capital compared to external sources for this type of capital such as program-related investments or temporarily restricted grants from foundations or loans from financial intermediaries or banks that have specific programmatic requirements.
- **Permanent Capital.** This is long-term capital, such as endowments or reserves, that is not meant to be liquidated until the organization goes out of business, although it might be drawn upon occasionally for special needs and opportunities, and the

income they generate is often used as working capital.² This capital provides a “base” or “cushion” for the organization to absorb potential losses and maintain the organization’s solvency over time. It also can be invested in fixed assets (such as a new building) or it can be held in cash and investments. Permanent capital is typically raised externally from permanently restricted grants or from capital campaign contributions (such as money raised to build a new facility). However, the permanently restricted nature of this capital may limit its flexibility. Unrestricted net assets can also be used for permanent capital, when designated for that purpose by the organization’s board, and in this case provide a more flexible source of permanent capital.

The availability of flexible long-term patient capital is critical for nonprofit affordable housing owners to make new investments, improve operating efficiencies, and hire professional personnel, thereby increasing their impact through their mission-oriented approach to affordable housing ownership. At the same time, capital providers need tools to evaluate the risk of investing in housing social enterprises and methods to measure their economic and social returns on investment.

The sections below (and attached appendixes) discuss different phases in the process of applying for and obtaining an enterprise-level investment from a prospective investor, how the prospective investor may underwrite the request for capital and, once the organization has received the loan or investment, how the investor and organization track the organization’s financial performance and program activities. A final section of the paper discusses circumstances when there may be changes in the organization’s business model or financial situation.

APPLYING FOR ENTERPRISE-LEVEL CAPITAL

Appendix A is a list of materials that nonprofit housing social enterprises may be asked to provide investors when applying for an enterprise-level loan or investment. In compiling this list, the lenders and CFOs considered what materials the organization already produces for its management team, board and/or investors and funders. The list is a mix of both financial and nonfinancial information. It includes information on the organization’s mission, its major lines of business and programs, its real estate holdings, new developments in its pipeline, and information on the organization’s management team, board and governance structure.

This list assumes that the type of capital being provided to the housing social enterprise will be unsecured and that the use of funds will be for either working capital or investment capital (as described above). Therefore, the list does not include items related to a specific project that might otherwise be requested by an investor contemplating a loan or investment in a specific project. Items on the list are a combination of historical data, point-in-time information and forecasts of future results, including a cash flow forecast. The lenders and CFOs highlighted the relevance of the cash flow forecast – as a management tool for the organizations and as a predictor of the organization’s ability to achieve its projected repayment schedule for the new loan

² William P. Ryan. *Nonprofit Capital: A Review of Problems and Strategies*. Prepared for The Rockefeller Foundation and Fannie Mae Foundation, 2001, p. 11.

This list of information, while comprehensive, can be used to help the prospective investor gain a deeper understanding of the organization's mission, business strategies and financial condition. This is the first step in a process of building a lasting relationship between the organization and the investor.

UNDERSTANDING THE FINANCIAL STRENGTH AND PERFORMANCE OF NONPROFIT HOUSING SOCIAL ENTERPRISES

An underwriting process used by a potential investor is in many ways similar to what the organization's management team and board do on a routine basis to track the financial strength and operating performance of the organization. An assessment of the organization can be accomplished by considering a variety of qualitative and quantitative factors that address the following aspects of the organization's operations:

- **Operating Sustainability** through an analysis of its capital structure, earnings history, cash flow forecast and liquidity position;
- **Asset Quality** through an analysis of its real estate holdings and other major asset categories, in part to determine the financial contribution of the real estate portfolio to support corporate operations; and
- **Management and Governance** through an assessment of its business and/or strategic plan, organizational structure, management team, staffing model, board composition and governance structure to understand the leadership style and decision-making process for both operational and strategic decisions.

The lenders in consultation with the CFOs developed a series of underwriting criteria and key performance indicators to guide the underwriting process, which are discussed in more detail in Appendix B. The criteria and performance indicators are both quantitative and qualitative in nature and in many cases, are what the organizations use internally to evaluate their own performance against annual goals and overall health of the organization.

Another key factor of underwriting an enterprise-level investment in the organization will be an evaluation of the organization's **Social Impact** through a review of its mission and vision statements and understanding how the organization measures its success towards achieving its mission. The topic of how nonprofit housing social enterprises measure social impact and how investors can realize a social return when making enterprise-level investments will be addressed in a future paper.

TRACKING PERFORMANCE OVER TIME

The relationship between an investor and the nonprofit housing social enterprise continues over a long period of time and provides the organization and the investor with periodic opportunities to communicate and provide updates on strategic initiatives and new business opportunities.

Reporting on the Organization's Performance

Loan documents typically require organizations to report to the investor on a quarterly and annual basis. A list of reports commonly provided to a funder or investor appears in Appendix C. In arriving at this list, the lenders and CFOs considered reports that the organizations already generate internally for their management and/or boards. The reports can provide information on the organization's activities, financial results, real estate holdings, real estate projects under development and other major lines of business, if applicable. Most investors perform a more comprehensive review once a year following receipt of the organization's audited financial statements for the previous year.

Ongoing Covenants

Given the nature of this type of capital (unsecured and long-term), it is expected that the lender and the organization will agree upon certain financial covenants that will track the organization's leverage and operating performance over time. See Appendix C for a list of commonly used loan covenants for unsecured enterprise-level borrowings. Again, the covenants presented in Appendix C are ones identified by the lenders and CFOs as being those commonly used by the organizations as key performance indicators.

SPECIAL CIRCUMSTANCES

There will be some cases where circumstances change and the organization is unable to repay a loan at the scheduled maturity date. At that point there are several options for the lender and organization to consider including a loan extension, a partial repayment or a complete restructuring of the loan. In some cases, additional funding may be appropriate.

The organization typically provides the lender with updated financial information similar to those items listed in Appendix C. The lender may request additional information to evaluate the new circumstances. Lenders and CFOs agree that a key element to working through these situations is open two-way communication. Full and early disclosure by the organization of the potential that it may be unable to repay a loan at the maturity date is useful for opening the door to productive discussions with the lender.

Early Warning Signs

Appendix D provides a list that the lenders and CFOs identified as early warning signs of a change in an organization's financial condition or operations that may warrant more attention by the organization and may be a sign that more frequent communication with the lender could be beneficial.

EXHIBIT 1: ACKNOWLEDGEMENTS

STRENGTH MATTERS™ would like to acknowledge the following individuals and organizations that contributed to the content of this paper.

Winell Belfonte, Reznick Group, P.C.+
Frank Buss II, Novogradac & Company LLP+
Lori Chatman, Enterprise Community Loan Fund*
Allison Clark, John D. and Catherine T. MacArthur Foundation*+
David Conway, Novogradac & Company LLP+
Kathleen Devine, NeighborWorks® America
Vincent Dodds, Mercy Housing Inc.+
Frances Ferguson, NeighborWorks® America*
James Ferris, NeighborWorks® Capital Corporation*
Benjamin Greenberg, Community Housing Capital
Lisa Hall, Calvert Foundation*
Caroline Horton, Aeon+
Joseph Kasberg, National Church Residences+
Mark Knight, NeighborWorks® Capital Corporation*
Michael Kurtz, Common Ground+
Deborah Leland, Low Income Investment Fund*
Christopher Madden, NeighborWorks® America+
Greg Maher, Local Initiatives Support Corporation*
Tim Martin, Enterprise Community Loan Fund*
Matt Perrenod, Housing Partnership Network*
James Radja, Calvert Foundation*
Jeffrey Reed, Community Housing Partners Corporation+
Debra Schwartz, John D. and Catherine T. MacArthur Foundation
S. Scott Seamands, Lindquist, von Husen & Joyce LLP+
Kimberly Smith, Novogradac & Company LLP+
Harry Thompson, Community Preservation and Development Corporation+
Mary Tingerthal, Housing Partnership Network*
Virginia Tranchik, Local Initiatives Support Corporation*
D Valentine, BRIDGE Housing, Inc.+
Laura Vennard, Preservation of Affordable Housing, Inc.+
Mary White Vasys, Vasys Consulting Ltd.*+

* Strength Matters Lender Working Group as of December 2009

+ Strength Matters CFO Working Group as of December 2009

APPENDIX A: APPLICATION MATERIALS

Listed below are examples of materials that nonprofit housing social enterprises may be asked to provide to prospective funders or investors when applying for an enterprise-level loan or investment.

Borrower Entity* – Financial Information

- Audited financial statements – last three years
- Most recent interim quarterly financial statements
- Cash flow forecast – 24 months forward
 - Include detail on major revenue sources
- Schedule of accounts and notes receivable
- Schedule of contingent liabilities
- Current fiscal year corporate operating budget
- Previous fiscal year corporate operating budget with actual results

Borrower Entity* – Organizational Information

- Organization chart
- Legal entities chart
- Organization bylaws
- Current strategic (and/or business) plan
- Description of major business lines
- Minutes of board meetings for past year
- Most recent board packet
- Board(s) list(s), including tenure and affiliations
- List of board committees and committee members
- List of key staff indicating current responsibilities and previous experience
- List of management staff departures over last three years, including start and departure dates and positions
- Succession plans for key staff and board leadership
- Policies and procedures for internal financial management
- Investment guidelines/policies for idle funds
- Management Information System (“MIS”) description and plan
- Disaster recovery plan

Borrower Entity* – Other Information

- Mission statement
- Most recent annual report
- Description of social programs
- Political support and stakeholder involvement
- Track record in competition for subsidy
- Philanthropic – track record on grants and fundraising

* Similar information may also be provided for entity that will guarantee loan, if applicable.

Real Estate Holdings – Operating Properties

- Schedule of properties owned/operated by the borrower entity
 - # of units
 - unit mix (e.g. studio, 1BR, 2 BR, etc.)
 - address of property
 - type of market (e.g. urban/suburban/rural)
 - target population (e.g. family, senior, special needs, etc.)
 - target income ranges (e.g. < 80 percent AMI, etc.)
 - date acquired or placed in service (for new construction)
 - type of construction – new/renovation/acquisition
 - financing structure / major subsidy program(s)
 - community facilities on-site, if any
- Summary portfolio reports summarizing current year and previous fiscal year operating results for each property

Real Estate Holdings – Development in Process

- Pipeline report – rental properties
 - # of units
 - unit mix (e.g. studio, 1BR, 2 BR, etc.)
 - address of property
 - type of market (e.g. urban/suburban/rural)
 - target population (e.g. family, senior, special needs, etc.)
 - target income ranges (e.g. < 80 percent AMI, etc.)
 - type of construction – new/renovation/acquisition
 - financing structure or major subsidy program(s)
 - community facilities on-site, if any
 - project status and timeline
 - schedule of anticipated developer fees and timing of receipt
- Pipeline report – for-sale housing
 - Indicate current inventory on market/sales pending/year-to-date closings
- Schedule of anticipated development fees for next two years
 - Differentiate between cash and accrual

APPENDIX B: UNDERWRITING CRITERIA / KEY PERFORMANCE INDICATORS

Any organization, when evaluating its own financial health and operating performance, and any capital provider, when considering an enterprise-level investment, will use a series of quantitative and qualitative factors to assess the following aspects of the company's operations:

- **Operating Sustainability** through an analysis of its capital structure, earnings history, cash flow forecast and liquidity position;
- **Asset Quality** through an analysis of its real estate holdings and other major asset categories, in part to determine the financial contribution of the real estate portfolio to support corporate operations; and
- **Management and Governance** through an assessment of its business and/or strategic plan, organizational structure, management team, staffing model, board composition and governance structure to understand the leadership style and decision-making process for both operational and strategic decisions.

The sections that follow provide further input from the lenders and CFOs on the factors they use to assess these different aspects of a nonprofit housing social enterprise's financial health and operating performance.

Any assessment of a nonprofit housing social enterprise's operations will typically review past performance by reviewing historical financial information and assess future revenue potential through an analysis of the cash flow forecast. The adequacy of the organization's cash flow forecasting was identified by the lenders as a key indicator of the organization's financial management expertise.

Often the nonprofit housing social enterprise that is applying for the capital investment will have several major business lines and/or programs and be a combination of several legal entities and/or subsidiaries. Therefore, it is helpful to have access to supporting schedules to the consolidated audited financials that break out the major lines of business and their related legal entities.

Underwriting Operating Sustainability

There are three key components to understanding the operating sustainability of an organization: its capital structure, its profitability, and its liquidity position. Any analysis of these components will involve a review of historical trends and an assessment of future conditions – shifts in capital structure, future earnings potential and sources of liquidity. The following four charts list key financial ratios and other indicators identified by the Strength Matters lenders and CFOs to assess each of these three components. The lenders then assigned a priority ranking to each indicator of “I” for indicators that are given first priority for analysis and “II” for indicators that are used for more comprehensive analysis.

A. CAPITAL RATIOS: Measure the long-term solvency of the organization			
Priority	Name	Formula	Comments
I	Net Asset Ratio	Total net assets*/total assets <i>*Do not include net assets of noncontrolling interests.</i>	High percentage indicates strength to withstand losses and repay loan. Negative trend indicates organization relying more on debt to finance its operations.
I	Unrestricted Net Asset Ratio	Unrestricted net assets*/total assets <i>*Do not include unrestricted net assets of noncontrolling interests. Include board designated unrestricted net assets.</i>	Measures ability to repay loan from unencumbered assets. Important to understand the composition of unrestricted net assets – significant illiquid unrestricted net assets should be noted as a weakness. High level of concessionary capital, limited contingent liabilities and strong asset/liability matching practices indicate organization’s prowess.
I	Leverage	Total liabilities/net assets* <i>*Do not include net assets of noncontrolling interests.</i>	Indicates how much protection there is for creditors. The higher this ratio the less protection there is for creditors. Increasing trend indicates debt growing at faster pace than equity generated by operations.
I	Leverage – Adjusted ³	Total liabilities – “soft” debt*/net assets** <i>**“Soft” debt defined as debt with deferred or long-term nonpayment provisions, zero- or low-interest payment, and/or other deeply subordinated debt.</i> <i>**Do not include net assets of noncontrolling interests.</i>	More stringent calculation. Recognizes the equity-like terms of equity-equivalent (EQ) loans, program-related investments and other soft debt.

B. LIQUIDITY RATIOS: Measure the short-term solvency of the organization				
Priority	Name	Formula	Comments	
I	Current Ratio	<p>Current assets*/current liabilities**</p> <p><i>*Scrutinize developer fee receivables, government grant receivables and intercompany receivables to verify that such amounts can be collected with 12 months.</i></p> <p><i>**Exclude from denominator portions of loans payable being used to fund construction or predevelopment costs that are offset by a noncash current asset (i.e. development in progress).</i></p>	<p>Indicates ability to meet short-term (due within 12 months) obligations as they come due. Useful indicator of short-term operating cash flow trend. Declining trend may indicate operations not generating enough cash flow to pay operating expenses.</p>	
I	Quick Ratio (also known as Acid Test Ratio)	<p>Unrestricted cash and equivalents*/current liabilities**</p> <p><i>*Include only readily available, unencumbered cash (i.e. exclude reserves, security deposits, etc.) in numerator.</i></p> <p><i>**Exclude from denominator portions of loans payable being used to fund construction or predevelopment costs that are offset by a noncash current asset (i.e. development in progress).</i></p>	<p>More stringent measure of ability to meet short-term obligations. Measures extent to which current obligations can be covered by current assets that can be readily converted to cash. Negative trend may indicate liquidity problems.</p>	
I	Months Operating Cash	<p>Operating cash and cash equivalents/[total operating expenses – depreciation, amortization, and other noncash operating expenses]/12</p>	<p>Measures adequacy of operating cash to cover operating expenses</p>	
I	Adjusted Months Operating Cash	<p>Operating cash and cash equivalents + operating cash reserves + unused lines of credit available to cover operating expenses/[total operating expenses – depreciation, amortization and other noncash operating expenses] / 12</p>	<p>Measures adequacy of available resources to cover operating expenses</p>	
II	Short-Term Solvency	<p>Realizable current assets*/short-term unsecured debt</p> <p><i>*Exclude receivables and construction in progress that are unlikely to be converted to cash in 12 months.</i></p>	<p>Measures adequacy of short-term realizable net assets to repay unsecured short-term debt.</p>	

C. PROFITABILITY RATIOS: Measure performance of the organization.			
Priority	Name	Formula	Comments
I	Profitability Ratio	Unrestricted net operating income/total unrestricted revenues	A positive result indicates the organization is able to internally generate retained earnings to build its capital base.
I	Self-Sufficiency Ratio	Earned income/operating expenses* <i>*Exclude operating grants, contributions, and investment income from the numerator. Exclude capital grants and pass-through grants from revenues and expenses.</i>	Measures proportion of operating expenses covered by income earned from business activities. Used to evaluate the sustainability of programs and lines of business.
I	Debt Service Coverage Ratio	Operating cash flow + interest expense paid /CPLTD + interest expense paid * <i>*Include all current obligations in denominator including obligations to repay advances to fund operating deficits of properties and partnerships.</i>	Measures ability of operating cash flow to cover current maturities with a cash reserve remaining as a cushion for income/expense fluctuations.
II	Cash Flow Adequacy	Operating cash flow + depreciation and amortization + interest expense paid /5-year average debt maturities	Measures the ability to cover average debt maturities due over five years.
II	Return on Assets* <i>*or Average Return on Assets</i>	Net profit after taxes/average total assets* <i>*Can also be calculated as average of prior two years net profit after taxes/average of prior two years total assets.</i>	Measures management's effectiveness in deploying the organization's assets

D. OTHER FINANCIAL CONSIDERATIONS			
Priority	Name	Formula	Comments
I	Operating Trends	Annual percentage change in balance sheet and income statement categories	Evaluates trends in revenues and expenses. An increase in expenses as a percentage of revenues indicates that the organization’s profit margin may be deteriorating. Declining trends on the balance sheet may indicate a weakening of the organization’s solvency and ability to handle short- or long-term obligations.
I	Cash Flow Forecasts	A two-year cash flow forecast, by month is recommended	The forecasting model should include both operating cash flow and capital needs for the organization’s primary lines of business.
I	Debt Characteristics	Provide a detailed list of all debt obligations in a note in the audited financial statements. Include interest rate, maturity and any required principal payments.	Evaluate amount of full recourse debt, unsecured loans, approved but unused loans and/or lines of credit.
I	Contingent Liabilities	Include methodology for calculating the amount of contingent liabilities	Evaluate guarantees of third-party debt, lines and/or letters of credit, surety bonds, corporate leases or contracts, corporate guarantees of partnership liabilities and contractual obligations. Evaluate potential liability of any outstanding lawsuits.
II	Reliability of Contributed Revenues	Is there a consistent stream of funding from grants and contributions? * <i>*Distinguish between contracts for services rendered and charitable contributions</i>	

Underwriting Asset Quality

When evaluating the quality of a nonprofit housing social enterprise's assets, there are several different categories that are considered, which are discussed in more detail below. Generally, an analysis will focus on the organization's portfolio of real estate assets, because this is typically the largest asset category for a nonprofit housing social enterprise.

- **Asset Composition.** Evaluating major asset categories (e.g. cash and equivalents, receivables, fixed assets, investments, etc.) and how the composition of those assets changes over time.
- **Portfolio Composition.** Reviewing the characteristics of the organization's operating rental property assets (typically the largest proportion of a housing owner's balance sheet). This will include a profile of portfolio characteristics such as the following:
 - # of units
 - unit mix (e.g. studio, 1BR, 2 BR, etc.)
 - address of property
 - type of market (e.g. urban/suburban/rural)
 - target population (e.g. family, senior, special needs, etc.)
 - target income ranges (e.g. < 80 percent AMI, etc.)
 - community facilities on-site, if any
 - date acquired or placed in service (for new construction)
 - type of construction – new/renovation/acquisition
 - financing structure / major subsidy program(s)
- **Portfolio Performance.** Analyzing the financial performance of the organization's operating real estate assets by comparing actual results to property budget, paying particular attention to reserve levels, need for capital improvements, and property cash flow.
- **Portfolio Quality.** There are a number of qualitative indicators to assess the quality of individual properties in an organization's portfolio:
 - REAC scores
 - Most recent physical needs assessment date
 - Curb appeal/site inspections
 - Inspection reports from compliance agencies
 - Major capital expenditures
 - Gap between subsidized rents and market rents
- **Single-Family Portfolio.** In cases where an organization also develops single-family housing, the underwriter will review existing inventory levels and turnover, status of closings and contracts for sale, and absorption rates.
- **Receivable Analysis.** Differentiate between accounts receivable and intercompany receivables, and determine if the organization has a policy for reserving against uncollectible accounts.
- **Composition of Other Major Asset Categories.** This may include a review of the organization's investment portfolio, verification of unrestricted vs. restricted cash balances, and/or an evaluation of other real estate assets (e.g. commercial developments) if applicable.
- **Other Considerations.** The lenders and CFOs identified several other questions to raise during the underwriting process related to asset quality:
 - What is the approval process for new projects?

- How is pipeline risk (predevelopment risk and/or refinancing risk) evaluated?
- How are resident services delivered?
- How is the need for resident services evaluated?
- How are resident services funded?
- What is the organization’s watch list policy?
- Does the organization have a rating methodology or process for its real estate assets?

Underwriting Management and Governance

While mainly qualitative in nature, the underwriting of the management’s ability to run the business and the board’s strategic oversight of the mission and goals of the organization is critical to making a final assessment prior to a potential investment by an investor. The following two charts present several aspects of review.

MANAGEMENT AND STAFFING			
	Category	Considerations	
	Strategic Planning and Oversight	<ul style="list-style-type: none"> • Does the organization have a current strategic plan? • What was the process for preparing the strategic plan? Who was involved (management, board, other stakeholders)? • Do annual work plans track performance to strategic plan goals? • Has the organization achieved its goals from previous strategic plans? • Does management have a good understanding of the organization’s mission and strategies? • Does management have a good understanding of external environment and competitors? • Has the organization exited any unprofitable lines of business? • Are the organization’s products and programs consistent with its mission and goals? • Are the organization’s growth plans aligned with current and future market conditions? 	
	Organizational Structure	<ul style="list-style-type: none"> • Is the legal and organizational structure appropriate? • Which products, services, or programs are delivered in-house (e.g. – property management, resident services) and which are delivered by third parties? • Are business lines appropriate to achieve strategic objectives? • Does organization track profitability of each business line? • Does the organization have a formal human resources function? 	
	Quality of Management	<ul style="list-style-type: none"> • Who are the members of the management team? Expertise? Tenure? • What is the company’s turnover rate? • Is there a succession plan for senior leadership? • What is the recruitment process? • Is there an established training program for employees? • Does the organization utilize consultants or technical advisors? In what capacity? 	

MANAGEMENT AND STAFFING (con't)			
	Category	Considerations	
	Financial Management and Reporting	<ul style="list-style-type: none"> • What is the tenure and expertise of the CFO? • Is there a partnership between the CEO and CFO? Which one answers financial questions? Are CEO and CFO transparent with responses? • What is the timing and frequency of reporting to both management and to the board? • How quickly does the organization close its monthly books? • Is the preparation of the annual audit delayed? • What is the process to establish annual operating budget? Who is involved? • Does the organization have written policies and procedures for internal controls and for finance and accounting? • Are there written investment policies? • Are there written human resources policies? 	
	Systems/ Infrastructure	<ul style="list-style-type: none"> • Are network, servers and other hardware adequate to support current operations and future growth? • What major software packages are used by the organization for accounting, property management, asset management, other programs, and impact data collection? • What back-up systems for data are in place? • Does the organization have a disaster recovery plan? • Is physical space adequate for current operations and for future expansion? • What is the enterprise resource planning process for the organization? 	

BOARD AND GOVERNANCE		
Category	Considerations	
Board Structure	<ul style="list-style-type: none"> • What is the size and structure of the board? • Are there term limits? • What is the committee structure of the board? <ul style="list-style-type: none"> ○ Is there an executive committee? ○ Is there an audit committee? • Are the board committees appropriate for the organization? Has the board addressed Sarbanes Oxley issues?	
Board Composition	<ul style="list-style-type: none"> • What is the tenure and professional expertise of board members? • Is the mix of board members appropriate for the organization’s business model? • What is the level of turnover on the board? <ul style="list-style-type: none"> ○ A mix of tenures is best ○ Low turnover is often not a positive sign • How consistent is board attendance at board meetings and at committee meetings? • How are new board members recruited? 	
Board Governance	<ul style="list-style-type: none"> • How engaged are board members in the governance of the organization? • Are the board’s responsibilities understood and embraced by board members? • Does the board do self-assessments? • Are board members involved in strategic planning? • Do board members take an active role in determining the strategic direction of the organization? • How active is the board in monitoring the organization’s financial position? • What type of information is included in board packets? • Are board member’s satisfied with financial reports provided by the organization? • How comprehensive is the board’s financial review of the organization? <ul style="list-style-type: none"> ○ Does the board review financial forecasts? ○ Are there key financial measures tracked by the board (use of a dashboard report)? ○ Is the board aware of guarantees and/or other contingent liabilities? • What is the board’s involvement in the 990 approval process? • Are there written governance policies? • Does the board receive status reports on pipeline deals and predevelopment risk? • Are there written procedures on approval requirements for new transactions? New contracts? • How has the board addressed problems and issues that have arisen in the past? • Does the board routinely evaluate the CEO? 	

Other Considerations

Other factors that can impact an investor’s decision to provide enterprise-level capital are highlighted below.

OTHER CONSIDERATIONS			
	Category	Considerations	
	Policy Work	<ul style="list-style-type: none"> • Does the organization have a policy agenda and dedicated policy staff? • Is the organization a member of any national networks, state or local networks? • Is the leadership of the organization involved in policy making and advocacy work at the federal, state or local levels? 	
	Industry and Market Knowledge	<ul style="list-style-type: none"> • How deep is the organization’s knowledge of economic conditions and the housing market in its market areas? • Can the organization articulate demand and supply characteristics of affordable housing in its different market areas? • Is the organization knowledgeable about its major competitors? 	

APPENDIX C: REPORTING REQUIREMENTS/ONGOING LOAN COVENANTS

Listed below are examples of the types of monitoring reports that organizations may be asked to and/or want to submit to an enterprise-level lender during the term of the loan.

Annual Reports

- **Audited financial statements of the borrower.** If the financial results of the borrowing entity are included in consolidated financial statements, it is helpful to have consolidating financial statement included as a supplemental schedule to the consolidated financial statements.
- **Management letter.** If the organization has received a management letter from its auditors, that should be included with the audited financial statements along with any response prepared by management.
- **Organizational Update.** This is an opportunity for the organization to discuss any key organizational changes, including changes in number of staff, changes in key staff or board members, changes in organizational and/or governance structures, any anticipated changes in funding sources in the next twelve months, and how these might affect the organization. Include resumes of new management staff and current list of board members with biographical information.
- **Strategic plan updates.** Provides information on progress against annual strategic plan goals and objectives for the previous fiscal year and describes new goals and objectives for the upcoming fiscal year. If applicable, provide a copy of the new strategic plan.
- **Corporate operating budget.** Provides the corporate operating budget for the new fiscal year. Typically includes a comparison to the actual budget results for the previous fiscal year.

Quarterly Reports

- **Unaudited interim financial statements of the borrower.** For the borrowing entity only (assuming that consolidated statements are not prepared quarterly).
- **Portfolio reports.** Provides year-to-date operating results for real estate properties owned and/or controlled by the organization. Will typically include information on occupancy and delinquency rates, and reserve accounts for the properties.
- **Pipeline reports.** Includes status of site control, zoning approvals, financing commitments, target completion dates, and amount of at-risk investment to date.
- **Cash flow forecast.** A two-year rolling forecast of cash flow is the recommended minimum time period for this report, which should be updated from previous period.
- **Use of funds report.** Updates on how borrower is using proceeds of loan and, if maturity date is less than twelve months in the future, borrower's source of repayment for the loan.

Ongoing Loan Covenants

Following are several examples of loan covenants (aka key performance indicators) that may be used in loan documents to track the organization's performance and ability to repay the enterprise-level loan. The actual dollar amounts or percentages applicable for each of these examples below (or other covenants suggested by the lender) will be determined on a case-by-case basis between the lender and borrower.

- **Net income covenant.** The rolling average of the borrower's change in unrestricted net assets for the two fiscal years most recently ended shall be greater than \$_____.
- **Liquidity covenant.** At the end of each quarter, the sum of borrower's unrestricted cash and cash equivalents plus restricted cash and cash equivalents that are available to repay debt of the borrower shall equal or exceed _____% of current liabilities.
- **Net asset covenant.** At the end of each quarter, the borrower's unrestricted net assets must equal or exceed _____% of borrower's total assets.
- **Debt covenant.** Borrower's unsecured debt (excluding equity-equivalent loans) can be no greater than _____% of unrestricted net assets.

APPENDIX D: EARLY WARNING SIGNS⁴

Listed below are examples of early warning signs that may be indicative of a borrower's inability to make scheduled repayments.

Financial Early Warning Signs

- Failure to issue audited or interim financial statements in a timely fashion
- Inability to produce a cash flow forecast
- Qualified audit
- Declining financial trends
 - Deterioration in unrestricted cash position
 - Declining current ratio
 - Significant increase in short- or long-term debt
 - Significant increase in related-party receivables
 - Significant increase in accounts payable
 - Low unrestricted net asset ratio
 - Declining earnings trends
- What is the change in intercompany receivables and payables?
- Is organization in compliance with its loan covenants?
 - Does it routinely monitor these covenants?
- Change of accountants
- Loss of funders
- Ability to access resources
- What is the organization's line of credit usage?
 - What was intended purpose (operating or project funding)?
 - Is it being used for the intended purpose?
 - Is it secured? If so, what is the collateral?
- Are vacancy rates increasing at the properties?
- Are projects completed on time and/or on budget?

Management/Governance Early Warning Signs

- Changes in management or key personnel
- Illness or death of key personnel
- Is there a detailed written succession plan for the following?
 - CEO
 - Senior level staff
 - Board
- Level of collaboration amongst staff
- Level of cooperation from key leaders (CEO, CFO, Housing Director)
- Inability to meet commitments on schedule
- Lack of responsiveness
- Reluctance to provide references
- Untimely board resignations
- Lack of appropriate expertise on board for organization size and business activities
- Open litigation matters

⁴ Taken in part from *The Workout Manual*, by Richard A. Clarke, published by RMA, the Risk Management Association.

- Compliance issues that need to be addressed
- Labor problems
- Taxes been unpaid

Operations Early Warning Signs

- Change in business, economy or industry
- Change in nature of organization's business
- Loss of significant revenue source
- Poor maintenance of real estate holdings
- Are there capacity issues related to some type of expansion?
 - A new line of business?
 - A new geographic region?
 - A new product or program?
- What is the depth of project underwriting expertise?
- What is the timeliness of financial reporting?
- Are adequate financial controls in place?
- Is enterprise risk management a priority?
 - Can CFO produce a template with issues identified?