Attracting Equity to Mission Driven Development Finance Institutions

Written by Paul DiLeo

September 2003

Contents

Introduction

Part 1: What have we learned?

- ***A. Critical Features of development finance***

- ***B. Shorebank Experience and Lessons Learned***
  - ***Strategic mix of business***
  - ***Attracting and structuring equity***
  - ***Review: issues solved / not solved***

Part 2: Generalizing what we have learned

- ***A. Mobilizing and structuring capital on the individual institution level***

- ***B. Achieving liquidity at the investor level***

Introduction

This note examines four critical issues in the maturation of development finance institutions: Subsidy, Control, Growth, and Liquidity for investors. The note draws on two sources: the 30 year experience of Shorebank Corporation, the oldest and largest community development bank in the U.S., and the results of a study of Liquidity for Investors in Community Development Finance Institutions, executed by Shorebank for the Ford Foundation in 1999-2001.

The purpose of the note is to extract from Shorebank's extensive attempts – both successful and unsuccessful -- to deal with these issues some concrete guidance for other development finance institutions which are facing the need to grow, stay true to mission, and be responsive to the needs of financial stakeholders.

This note is in two parts. The first will briefly summarize the four critical issues and then review: (1) the strategic mix of business Shorebank has executed in pursuing its development mission and growth, and the consequent incidence and source of subsidy; and (2) how Shorebank has raised and structured capital under these conditions and while preserving its identity as a development finance institution. Part 2 will apply the lessons of Shorebank's experience and the findings of the Liquidity Study to two situations: that facing managers of a growing institution and that facing investors.

Part 1: What have we learned

A. Critical Features of Development Finance

1.1.1 The question of what the financial performance of institutions providing micro and small business finance should be somewhat divides the industry. A vocal segment of the industry argues that impact will ultimately depend upon such specialized institutions or mainstream financial institutions taking the lessons learned by subsidized experimentation and trial and error and focusing only on those that are commercially viable, *with commercial viability defined as including a competitive return to shareholders*. Others argue that such initiatives will become only peripherally relevant to the core development mission of reaching excluded populations and that specialized institutions must be induced or constrained to continuously refocus on the target population through control by mission committed investors and managers and access to permanent, albeit limited subsidy.

1.1.2 It is Shorebank's view that the development finance industry covers a full range of institutions, some operating with no subsidy, other than those available to any institution active in the financial sector, and some with substantial, ongoing subsidy. Because of the limited subsidies available, it is unavoidable that most financial services by volume be delivered without any significant subsidy.

1.1.3 There does not appear to be any inherent contradiction between providing selected services in a commercial, profitable manner and achieving significant development impact. In Shorebank's holding company structure it is expected that certain subsidiaries will operate profitably on the basis of core products with significant development impact. The question then becomes whether those profits are channeled to shareholders[1] or to further building the development capacity and outreach of the institution as a whole.

1.2.1 It is useful to categorize the objectives of such a subsidy. Three primary ones are: Start-up, R & D/Innovation, and Economic Externalities.

- Start-up refers to subsidy to bring a new or reforming institution up to the level of scale and experience necessary for commercial viability. While it might be argued that as commercial viability is demonstrated the need for start-up subsidies for new institutions will disappear, it does not appear likely that capital markets will function in this manner for the foreseeable future.

- R & D / Innovation refers to the ongoing process of exploring new instruments and vehicles for using financial services as development tools. R & D subsidies will always be necessary, with the only question being how much can be internally financed by an institution or by industry groups and networks and how much can be subsidized by third parties.

- Economic externalities refers to cases where an institution is producing some social and economic benefit the value of which it cannot fully capture though its pricing to the client. Examples might include stabilizing agricultural populations, diversifying production, supporting self employment opportunities for the unemployed, or connecting isolated populations to the economic and social mainstream. In such cases, ongoing subsidy is appropriate for as long as the broader economic and social benefits are being generated.

1.2.2 Several or all of these four cases – fully commercial, R & D subsidy, start-up subsidy, and economic subsidy – will usually combine in any one institution[2], either over time or on a more or less permanent basis.[3]

1.3.1 The subsidy requirement of a microfinance institution or small business bank may diminish over time to very low levels. In most cases, this would be expected as the proportion of commercially viable or more viable activities increases and as start-up and R & D expenditures decline either absolutely or at least proportionately. The level of subsidy will not necessarily, however, decline secularly. Rather it may fluctuate over

---

[1] In either case it is expected that a substantial proportion – roughly half -- of net income would be used to build the retained earnings of the institution.
[2] In this context, "institution" refers to either a single, heterogeneous institution or a group, where different activities are executed by separate entities within the group.
[3] It would be helpful if donors and management were to categorize concessional support to microfinance institutions and small business banks within this sub-activity framework, and relate it to some general guidelines for performance, outputs and duration for each sub-activity.

time as new initiatives are started up, or new products developed and introduced, or new populations targeted.

1.3.2 This recurring need for subsidy is a tangible manifestation of an institution's primary commitment to a development mission, and is the original sin from which the challenges of control, growth and liquidity derive.

1.3.3 The challenge of institutional identity and control arises from this periodic need to devote resources to financially unremunerative mission goals, rather than to strictly commercial goals. A microfinance institution or small business bank, in this view, must be controlled by shareholders committed to its role as a development vehicle, which may at any time require internal subsidy to pursue.[4] Depending on the strategic mix of activities of the institution and the availability of external subsidy, at a given moment these shareholders could sanction no internal subsidy or a high level of internal subsidy. What is essential for the institution to retain its core identity, however, is that these shareholders have sufficient control to divert resources from financial to development goals when necessary to preserve or further mission.

1.4.1 The need for subsidy and the control that mission driven shareholders must wield to ensure that it is available when needed creates challenges in attracting new shareholder equity, either to fund growth or to provide liquidity to existing shareholders.

1.4.2 Investor appetite for equity offering a less than competitive expected rate of return exists, although it is limited. What appetite exists, however, has not been effectively mobilized for the global microfinance and small business finance industry.

1.4.3 Similarly, while incentives for investors in the global sector exist, they are limited and fragmented.

B. Shorebank's Experience

2. Business strategy, Growth and Subsidy

2.1 In the nearly 30 years since its creation as a development bank, the Shorebank group has refined a number of specific products and approaches in its operating companies, including financial instruments, delivery vehicles and strategies, while also serving as a dynamic laboratory for the creation and, often, testing of innovations for the field. It is the opinion of management that it would have been difficult or impossible for Shorebank to so successfully play these dual roles had it been subject from the start or from relatively early in its life to the demands of fully commercial equity.

---

[4] A weaker form of this could be financial inducements or penalties or structural constraints which would impel an institution's development mission, but in this case an institution could opt out of the system or the system itself could change.

2.2 Over the years, Shorebank has narrowed its focus from broad, comprehensive community development to a specialization in financial and information services to small firms and low-income residents. It has developed niches in bank loans to multi-family home rehabbers and churches, and in bank and non-bank loans to small firms. These niches have demonstrated success both from the standpoint of profitability and development impact.

2.3 Shorebank's evolution has passed through several distinct phases. Creation through purchase of a $40 million-asset commercial bank was based on a small group of mission driven individuals and philanthropic groups. In its second decade (83-92), the group tested and built various development strategies. The third decade (93-02) has seen major expansions geographically and in terms of institutional scale, even as the group's strategies have been sharpened and focus narrowed. During this period the Chicago bank was first doubled in size through acquisition, and subsequently has grown rapidly in earnings and development outputs. Operating companies were established in two new cities and two rural locations. Major losses were incurred in two real estate development units. In its current phase (03 -), Shorebank is consolidating its operations and focusing on improving financial performance on the basis of tested, high impact products and strategies.

2.4 The performance of the Chicago bank has been critical to Shorebank, both in generating development outputs in its own right and by upstreaming earnings to cover losses and finance expansion. From 1992-2002, the bank's assets increased from $216 million to $1.25 billion. ROE has averaged 13.5% over the last 5 years.

2.5 The subsidy required to sustain Shorebank's operations can be roughly estimated in a variety of ways.

- From 1992-2001, retained earnings totaled 20% of net income of the profitable companies in the Shorebank and dividends only 10%. Fully 70% of profits were consumed by other group companies and initiatives. In contrast, a commercially oriented entity might expect to devote roughly half its net income to retained earnings and half to dividends.
- Alternatively, in recent years, a 10% ROE for shareholders would have required net income of about $7-8 million, whereas actual net income was about $2-3 million. ROE in 2002 was 7.8%.[5]

2.6 The implications of this performance for control, growth and liquidity are mixed. As will be discussed in the next section, Shorebank has succeeded in using a variety of strategies to greatly expand its equity base while preserving control of the institution in the hands of mission-committed investors. However, Shorebank is not consistently making enough money to both grow and pay good dividends. This has hampered Shorebank's ability to attract new investors, particularly to provide liquidity to earlier investors.

[5] ROE on common equity was 7.9%.

2.7 In summary, Shorebank's experience has been that a significant period of trial and error was required to build predictably profitable mission focused products. In Shorebank's case, the lead bank reached that point in the mid 1990s. In addition, start-up periods of geographic expansion had to be subsidized as well. For the holding company overall, significant subsidy has continued to be necessary as it sorts out its mix of initiatives and strategy.

2.8 In retrospect, it seems clear that targeting commercial returns on equity would have required management to truncate the process of developing and stabilizing mission focused products and to curtail the latitude at the holding company level to undertake expansion or new product development.

3. How Shorebank has attracted and structured capital

3.1 The basic structure of Shorebank is that of a holding company with a number of wholly-owned, for-profit subsidiaries. All subsidiaries are wholly owned by the holding company and all equity is raised at the holding company level and downstreamed to subsidiaries.

3.2 **Core shareholders**: Shorebank was created in 1973 through the purchase of an existing, ailing commercial bank. Initial equity totaling $901,000 was raised from a small group of individuals and philanthropic organizations in the form of voting common stock with a par value of $1,000. Further voting common totaling $1,632,000 was sold in 1976-81.[6] By and large, there have been no exits from this original shareholder group.

3.3.1 **Perpetual Preferred**: In 1977-78, after stabilizing the bank and beginning to grow the scale and scope of operations, Shorebank began to face a capital constraint. Because interest rates at the time were relatively high, there was little appetite in general for common stock. This was especially true in the case of Shorebank, which had not demonstrated any capacity or prospects of paying dividends on common stock. Under these circumstances, Shorebank undertook a series of issues of perpetual preferred stock that continued through 1992. In total, there were six issues which raised about $7 million. Interest rates on the issues ranged from 7% on Series A (in an environment where prevailing rates were at least double that) to 3 ½% on Series C and D.

3.3.2 Series A though D raised about $4 million for working capital to support the expansion of existing operations. Most of these series were convertible to three year notes on a schedule which provided for conversion after about 15 years.[7] However, from a regulatory standpoint, these issues were deemed to be perpetual because each

---

[6] In 1974 and 1977, convertible debentures totaling $420,000 were sold to two philanthropic foundations which preferred to invest wholly or partly in the form of non-voting common stock. At the time, Illinois law did not permit the issuance of non-voting common stock.

[7] Series B2 was convertible to voting common stock at a ratio of two shares of preferred for five shares of common.

conversion required prior approval of the Federal Reserve. Up to 25% of total Tier 1 capital can consist of instruments such as Perpetual Preferred equity.

3.3.3 Series E, issued in 1992 with a rate of 5%, raised about $3 million to fund the launching of operations in the Northern Michigan. Series E is convertible to common equity at a ratio of five shares of preferred for one share of common.

3.3.4 Purchasers of the Perpetual Preferred issues were philanthropic foundations, socially committed organizations or institutions committed to a specific place-based initiative to be funded with the proceeds. Series A and B1 were voting shares. Subsequent series were non-voting, although in some cases convertible into voting common. The purchasers have received all dividends and repayments as scheduled, and several series have been fully redeemed.

3.4.1 **Non-Voting Common**: In 1993, Shorebank began a series of issues of new common stock to finance rapid expansion and start-ups both in Chicago and elsewhere. For the most part, these issues were non-voting common stock, purchased by financial institutions which on the one hand, wanted complete clarity for regulators and accountants that they had no controlling interest in Shorebank and on the other, could benefit from the "credit" earned by such investments with respect to the Community Reinvestment Act (CRA). The 1990s were a period of intense consolidation and merger activity in the U.S. banking industry, and a good CRA record was seen as reducing the possibility of time-consuming objections to bank merger and expansion plans by community organizations.

Major Common Stock Issues

	Total Common Issue	*Shares Issued*	*Voting Shares*	*Non-Voting Shares*	*Purpose*
1973-1992	$ 2,296,004	2,555			Founding, building core operations
1993	$ 9,548,237	2,904			Chicago bank expansion
1994	$13,008,000	1,938			Cleveland group start up
1995	$17,219,186	3,194			Chicago bank acquisition
1996	$ 3,301,150	641			Chicago bank acquisition
1997	$16,139,360	3,060			Detroit and Pacific start-ups
1998	$ 799,200	*185*			Detroit and Pacific start-ups
2001 Paid in Capital	$63,456,007	15,445	4,238	11,207	

3.4.2 The new common stock issues were at multiples ranging from 1.25 – 1.4, largely protecting existing common equity holders from dilution.

3.4.3 In several cases, such as the 1994 Cleveland issue and the 1997 Detroit and Pacific issues, voting and non-voting common were sold in ratios of roughly one voting share for three-four non-voting shares. And Shorebank was initially prepared to offer a mix of voting and non-voting stock in the 1993, 1995 and 1996 issues, although as noted above, in the event, the financial institutions which took up these issues preferred non-voting shares. As in the case of some of the preferred issues, voting rights (or the option to

convert to voting shares) were contemplated to make the shares more attractive to potential investors, particularly given that dividends could be expected to be modest.

3.4.4 At the same time, however, management was committed to avoiding a serious erosion in the voting control of the initial investors. As of today, 4,238 voting shares are outstanding, of which 2,555 represent holdings of the "founding" shareholder group, taken up before 1993. Most of the voting shares taken up after 1992 are held by mission committed investors. Outstanding non-voting shares total 11,207.

3.5.1 **Trust preferred securities**: Since 1997, Shorebank has not issued any common or preferred stock, primarily because with no specific local expansions or start ups to fund, it became more difficult to attract the local institutions which had been interested in investing in concrete, discrete initiatives in their communities and service areas. Instead, Shorebank has supplemented its capital through two issues of Trust Preferred Securities (TPS), the first in 2000 for $10 million and the second for $8 million in 2002.[8]

3.5.2 The TPS issues were structured as follows:

1. A Delaware business trust sells preferred securities that entitle the holder to a pro rata beneficial interest in the assets owned by the Trust.
2. The Trust uses the proceeds of the offering to buy subordinated debentures of the sponsoring company, in this case Shorebank. The maturity and coupon rate on the debentures equals the dividend rate and maturity of the securities issued by the Trust. The maturity has tended to be a minimum of 29-30 years with the principal being paid in the final year.
3. There are no voting rights attached to the security and no ownership dilution to existing shareholders.
4. The sponsoring company has the right to defer payment of its interest payment for a period of time (as much as several years) at its discretion.

3.5.3 In the U.S., TPS issues have primarily been offered through private placements with institutional investors with an appetite for long-term, fixed income securities. The security is gradually becoming more popular with individual investors, particularly for retirement plans. Retail issues are frequently listed on the NASDAQ. The value of the securities fluctuates with the interest rate environment, and to some extent, the credit worthiness of the issuer. The recent cost to an issuer has ranged between 3% and 5% of the gross offering. Issuers of TPS can band together and create a pooled TPS and thus share the fixed costs associated with any single TPS issue.

3.5.4 The $10 million raised by Shorebank through TPS in 2000 was its share of proceeds from an offering totaling $250 million with Salomon Smith Barney as the

[8] It should be noted that under GAAP, TPS appear as long term debt rather than capital. TPS do qualify as capital for certain regulatory purposes, with certain restrictions.

placement agent. Each institution in the consortium was limited to 5% of the total transaction. Shorebank perhaps would have sold as much as $20 million in TPS equity if the offering had been larger. That particular issue is non-amortizing, has a 30-year term and is pre-payable with penalties after ten years. The prepayment penalty in year 11 is 5 1/2%, declining ratably over the following nine years. The dividend rate on the TPS is 10.875% (tax-deductible to Shorebank since the issuing business trust made a loan of $10 million to Shorebank). All institutions received the same rate, regardless of risk. The placement fee was 3%. The issue is listed for public trading.

3.5.5 The second TPS issue in 2002 raised $8mm at 6 month Libor plus 370bp, or 6.02% at the time of issue. It was part of an offering of about $400 million.

3.5.6 The "dividend" rate on Shorebank's TPS issues is obviously high, even if it is tax-deductible. In Shorebank's analysis, however, the issue of TPS equity would generate positive cash flow after two years due to the ability of Shorebank's subsidiary banks to leverage the preferred equity 15 or 16 times. The deposits and certificates of deposit leveraging the equity, of course, will be at substantially lower rates than the TPS issue. Thus, the overall cost of Shorebank's funds does not increase significantly, since the high costs of the TPS issue is diluted by a factor of 15 or 16 with much lower cost funding sources. For example, Shorebank's average cost of funds is roughly 4.3%. If $10,000,000 at 10.875% leverages another $150,000,000 with an average cost of funds of 4.3%, then Shorebank's average cost for that $160,000,000 pool of funds is 4.7%.

Summary of Shorebank Capital Structure[9]

	Paid In Common	Retained Earnings	Preferred	Other[10]	Unrealized Gains/Losses	Total Shareholders Equity
1973	$901,000	$-131,263	$0	$0	n.a.	$769,737
1978	2,453,000	-530,695	0	420,000	n.a.	1,922,305
1983	2,533,000	-1,714,113	2,416,250	420,000	n.a.	3,235,137
1988	2,550,000	2,568,439	5,658,914	260,000	n.a.	10,499,392
1993	11,844,241	8,156,707	6,767,625	-210,150	$255,778	26,814,201
1998	63,256,207	7,312,974	5,185,175	0	1,570,480	77,324,836
2002	63,456,000	19,093,000	3,620,000	0	5,232,000	91,401,000

3.6.1 **Public Offerings**[11]: To date, Shorebank has chosen not to raise equity through public offerings, although it has carefully analyzed the possibility on several occasions.

3.6.2 A publicly held class of shares would have many benefits for an institution such as Shorebank:

- Potentially easier access to larger amounts of equity capital;
- Greater access to individual (as opposed to institutional) investors;
- Enhancement of issuer's image, visibility and future financing alternatives;
- Provision of liquidity to shareholders;
- Ability to use publicly held shares as currency in merger and acquisition transactions;
- Possible elimination or reduction of company repurchase requirements for stock issued pursuant to any Employee Stock Ownership Plan[12]; and
- Increased range of compensation alternatives to attract and retain key personnel.

3.6.3 The costs associated with being a public company are also significant:

- Greater initial (up to 10% of the gross offering in the US) and on-going expenses;
- Increased public disclosure requirements;
- Limitation of ability to limit distribution of information among actual or potential investors, meaning any material information shared with one potential investor (e.g., a foundation) must be shared with all investors;
- Increased public scrutiny;
- Exposure to market fluctuations;

[9] As noted above, the $18 million raised in 2000 and 2002 through TPS issues is not included in the equity accounts in these financial statements, although it can qualify as regulatory capital, in addition to the shareholders equity reported here, for some purposes..
[10] Convertible Debentures and Common Treasury Stock.
[11] Much of the following discussion of public offerings is taken from the Liquidity Study, p 16.
[12] A company has certain federally mandated repurchase obligations so long as it is privately held. The repurchase obligations are eliminated if there is a public market for the stock.

- For microfinance institutions and small business banks, possible compromise of community development mission; and
- Possible reduction in ability of such institutions to attract subsidy for development mission.

3.6.4 In order to have an underwritten public offering that would attract mainstream market makers to a stock, an institution would have to meet certain criteria, including:

- Size (while estimates vary, issuers should have sufficient assets – perhaps several hundred million in the U.S. – and corresponding outstanding equity to permit some liquidity in the market for its shares);
- Performance (the institution should at least have performed in line with industry standards over the recent past);
- Management quality;
- Growth prospects;
- Appropriate use of proceeds; and
- Timing (a company wants to go public when demand for sector stock is strong).

3.6.5 Because of these criteria, Shorebank has determined that going public has not been an attractive option to date. While Shorebank is the largest and oldest U.S. development finance institution, it still is borderline in terms of the necessary size, performance and growth criteria. Generalizing from this, while size and performance hurdles will vary internationally, it is likely that these will be daunting in most markets.

3.6.6 Furthermore, in the case of even the larger institutions such as Shorebank, the float, or publicly held shares, would almost inevitably be small and unable to attract active market makers. Market makers are firms (usually brokerages) that specialize in buying available stock and holding it in inventory until a seller is located. Without market maker support, a publicly held stock can languish and trade at significant discounts to its "economic" value, thus compromising the liquidity benefits which are a major impetus for public offerings in the first place.

3.6.7 Most significant in Shorebank's case has been the concern that a public offering would inevitably require compromise in the core development mission. Now that Shorebank appears to be entering a period of more stable profitability and stable strategy, however, it will continue to explore the possibility of whether an appetite may emerge in the public markets for low return, non- or low-voting common equity.

3.7 **Capital conserving growth strategies**: One other strategy that bears mention is various methods of reducing the capital required to execute a particular development strategy. To date, Shorebank has not employed any of these methods, such as securitization or specially designed partnerships or products, in a focused way to reduce capital requirements. However, such possibilities are under review and could be employed in the future.

3.8 **Dividends**: During 1983-92, dividends totaled about 22% of net income, while during 1993-2002 dividends totaled about 35% of net income. However, as the table below illustrates, the bulk of these dividends have been associated with the preferred issues. No dividends on common stock were paid until 1993. In recent years, dividends on common have been paid at a rate of $10 per share or about 1% of par value or about 0.2% of book value. This has been maintained even as net income has strengthened in recent years, with more consideration given to building retained earnings and possibly using a portion of net income for buybacks to provide liquidity to investors than for increased dividends.

$ 000s					
	Net Income[13]	Preferred Dividends	Common Dividends	Change in Retained Earnings	ROE[14]
1973-1980	-973	0	0	-831	
1981	-623	62	0	-685	-51.90%
1982	-324	116	0	-440	-55.23%
1983	204	136	0	242	9.75%
1984	426	170	0	534	23.59
1985	939	169	0	852	43.29
1986	1042	188	0	854	32.71
1987	1013	330	0	683	20.34
1988	1671	312	0	1359	31.03
1989	1542	300	0	1242	22.16
1990	1474	284	0	1189	17.63
1991	866	271	0	595	7.79
1992	1600	342	0	1258	14.91
1993	1688	383	0	1305	9.00
1994	-580	339	101	-1019	-3.74
1995	379	326	0	53	0.14
1996	598	306	155	138	0.58
1997	112	289	122	-299	-0.29
1998	705	270	153	283	0.61
1999	1737	251	154	1332	2.31
2000	1811	231	154	1426	2.46
2001	3010	211	154	2644	3.74

3.9.1 **Liquidity**: There has been very limited liquidity on common stock since Shorebank's creation. There have been a few isolated cases of arranged purchases on behalf of several of the original shareholders.

4 What issues has SBK solved / not solved?

[13] Before dividends on Preferred Stock.
[14] Return on average common equity.

4.1.1 **Control and Business Strategy**: Shorebank has succeeded in crafting and executing a business strategy which reflects its primary development mission, and has been able to avoid significant dilution or compromise of this commitment in order to attract capital.

4.1.2 Shorebank has taken care throughout its history to ensure that voting control remains in the hands of mission committed investors. To a large extent, this has implied limiting the issue of new voting shares so that the founding and early investors retain the bulk of voting shares. Additional voting shares have been issued, but in most cases these have been taken up by investors with an equal mission commitment.

4.2 **Growth**: Shorebank has been able to finance significant growth in equity and assets, particularly since 1992, taking advantage of a succession of instruments which met appetites for equity without conceding to overwhelming commercial requirements or undermining mission control.

4.3.1 **Earnings**: Shorebank has demonstrated the sustainability and viability of development banking in the U.S. as a going concern. Book value of an original investment in Shorebank in 1973 has increased more than 500% to $5,684 by end-2002. While these returns are modest from a purely financial standpoint, they do demonstrate that investors interested in capital preservation and modest returns can look to the development finance sector.

4.3.2 ROEs over the years have fluctuated. After incurring losses as it established its operations in its first decade, Shorebank saw ROE strengthen through the early 1990's to attractive levels as its Chicago operations came into their own. By the mid-1990s Shorebank was embarked on a period of simultaneous rapid growth in equity, multiple start-ups and heavy losses in some operations, all of which combined to drive ROEs to low levels. By 2001-02, Shorebank appeared to have digested its growth spurt and ROE appears headed back to double digits.

4.4 **Dividends**: Shorebank has not offered commercially attractive dividends, and in a context of essentially non-existent liquidity consequently has by and large been unable to tap mainstream equity markets to meet its capital needs because no "socially responsible" equity market exists as of yet. That being said, Shorebank has demonstrated, through the TPS issues, an ability to access mainstream markets for a portion of its capital requirements.

4.5.1 **Liquidity**: Shorebank has not been able to create liquidity for common stock shareholders. The primary reason would appear to be the perceived lack of commercially attractive dividend potential, which has severely limited the pool of potential investors. In particular, here has been a dearth of "second generation" investors, who are content to support a tried and proven strategy rather than gain the credit for innovation and creativity that accrues to founding sponsors and investors.

4.5.2 The Liquidity Study suggests that a secondary reason for illiquidity is the small size of Shorebank's capital which would limit liquidity regardless of dividend potential. More generally, the small size and novelty of the U.S. development banking industry overall also works against improved liquidity as it is prohibitively expensive for any single institution to undertake the outreach and education necessary to expand the pool of potential investors. As indicated in the Liquidity Study, these secondary reasons for lack of liquidity for equity may well be amenable to remediation efforts on an industry-wide, rather than an individual institution, basis.

4.6 **Subsidy**: Shorebank has mobilized substantial external public and philanthropic subsidy and deployed it effectively, initially to develop affordable rental housing that stimulated substantial private investment and to offer higher risk debt and business development services to small firms. Shorebank's ability to mobilize and deploy this external subsidy has been enhanced by its ability to precede or complement external subsidy with its own resources, based on the composition of its shareholders and capital.

4.7.1 **New Initiatives:** For some time, Shorebank has explored various means of providing some limited liquidity to early investors, who in some cases are individuals who invested as early as 1973. A limited buyback program with the price set through a Dutch auction was originally contemplated, in the expectation that early investors, who had purchased stock at close to par with strong mission motivations, would be content with a relatively low price. However, the likelihood that such sales would trigger an unfavorable mark-to market event for more recent investors argues against the Dutch auction system.

4.7.2 Furthermore, it is Shorebank's presumption that the prospect of liquidity will need to be provided to investors more generally if its future capital requirements are to be met. While Shorebank has been successful to date in meeting its capital requirements through a combination of instruments other than common stock and sales of common stock to investors who were content to defer the issue of liquidity, management believes that maintaining an appropriate proportion of common in its future equity issues will require greater liquidity.

4.7.3 One possible basis for future sales of common stock, therefore, is to establish an annual buy-back program at a modest multiple of book value. This would avoid a mark-to-market write down for recent investors and would be consistent with sales of new stock at a modest multiple. Such a program would be predicated on consistent double digit ROEs sufficient to both fund the buyback of a meaningful volume of shares while continuing to build retained earnings.[15]

4.7.4 However, it is by no means universally agreed among Shorebank investors and managers that providing liquidity to investors is an appropriate use of resources. Those who disagree note that the buyback program, even with consistently good performance,

---

[15] The effective scale of the buyack program could be extended by encouraging investors who would be content with a lower liquidation price to donate shares to Shorebank non-profit affiliates in return for a corresponding deduction from taxable income.

will not provide an effective exit for existing investors, and that the resources would be better used to expand operations or subsidize new initiatives. An alternative strategy would reiterate Shorebank's primary development mission, and raise new capital on the basis of that commitment and for specific place-based initiatives as it has done in the past. The priority of developing liquidity and return for existing and future investors would be downgraded and/or deferred.

4.7.5 Parallel to any moves to increase the attractiveness of its common stock, Shorebank is also exploring the possibility of creating a class of super-voting shares, which would ensure that mission committed investors would always have effective voting control of the institution regardless of future issues of voting stock. The intent is to allow early investors to exit with no fear of compromising the mission commitment of the institution.

4.7.6 For example, current owners of voting stock might exchange one existing share of common stock for one supervoting share, with 100 votes. They would then be free to sell their other common stock without dramatically changing the control of the institution. The reaction to this proposal by current and prospective investors has been mixed. Many are attracted to the idea of confirming stability in the mission and strategy of the institution, while others point out that major investors do value voting rights and sale of new shares with low or no voting rights is more difficult.

4.8.1 **Summary**: Over its thirty year life, Shorebank has successfully employed a variety of instruments to build a base of committed investors and attract sufficient capital to fuel strong growth and an innovative and aggressive development strategy.

4.8.2 As will be discussed in the next section, we believe that a number of the principles and techniques that Shorebank has used can be fruitfully applied by the development finance community at large. The key to date has been a recognition that there is no single, straightforward way of reconciling the development mission with mainstream capital markets. The demand for *competitive* return is not consistent with an ongoing, innovative commitment to a priority development mission.

4.8.3 That being said, there is scope to pay competitive returns on a portion of capital, and there are opportunities to attract substantial investment on a non-commercial basis, either by targeting private philanthropic impulses or building on government programs and regulatory requirements.

4.8.4 Shorebank strongly supports industry-wide efforts to build a socially responsible equity investment market. In the meantime development finance institutions may be able to raise substantial capital by crafting creative approaches which can appeal to different segments of the potential equity market.

Part II: Generalizing what we have learned

5.1 Shorebank's experience and the results of the Liquidity Study suggest a number constructive, practical techniques for mobilizing and structuring capital on the individual institution level to support institutional growth. In Shorebank's case, these approaches have proved successful in maintaining the core identity of the institution, mobilizing significant new equity to fund growth, and have permitted a continued level of internal subsidy which, together with external subsidy, have been sufficient to execute the overall business strategy.

5.2 The following two sections generalize these lessons from two perspectives. Part A discusses how the techniques that Shorebank has employed might be of use to management of microfinance institutions and small business banks. Part B looks at the same techniques from the standpoint of the investors, and specifically details how Shorebank intends to apply these lessons in ShoreCap International, an investment fund for microfinance institutions and small business banks commencing operations in the summer of 2003

A. Mobilizing and structuring capital on the individual institution level

6.1.1 **Voting common:** Through its life, Shorebank has placed a premium on ensuring that it could preserve its overriding development mission, and take whatever strategic business decisions – innovation, expansion, pilot initiatives – were required to maximize learnings and ultimately impact, both directly and through building of the industry.

6.1.2 For any private development finance institution, it is important to begin the process of structuring its equity by deciding how critical the issue of voting control is. Clearly, shareholder voting is not the only issue in terms of institutional control and identity. There are for-profit institutions, such as Ford Motor Corp, where profit seeking investors are content with proportionately low voting power. And there are microfinance institutions where profitability and development impact appear to be closely aligned, and consequently conflicts associated with control and strategy may be minimized. For Shorebank, investors and management felt that an important pillar of institutional identity was closely held voting control.

6.1.3 For Shorebank, this strategy has been facilitated by the fact that while most common shares are now held by institutions that are not fundamentally mission oriented, these investors have preferred not to hold voting shares. Thus, while Shorebank was prepared on various occasions to offer a limited amount of voting shares to new investors, this was not, in the event, necessary. It is not clear that other development finance institutions, in other countries will necessarily face the same, fortuitous alignment of interests.

6.1.4 Generalizing this approach suggests a portion of total equity that we would call "keystone" equity, which is in effect the guarantor of the mission of the institution. It does this in two ways. First, through control of voting, keystone shareholders ensure that

management and strategy of the institution remain consistent and committed to its mission. Second, they stand ready to divert net income from dividends on common stock or stock buybacks to ensure that internal subsidy is available to execute the strategy.

6.2.1 **Non-voting or Low-voting common:** If a decision is taken to limit voting rights for non-mission driven investors, a number of possible sources of non- or low-voting equity can be explored. However, a basic regulatory constraint must be borne in mind, which is that in most jurisdictions regulatory capital standards require that the bulk of core capital must be comprised of common equity and retained earnings. Other instruments, such as non-cumulative perpetual preferred stock, other types of preferred stock, subordinated debt, convertible securities and some reserves can qualify as equity for regulatory purposes, but the total amount of such instruments which typically can be included for purposes of calculating capital adequacy is usually limited, often to 25% of the total for key capital adequacy ratios. This constraint means that while non-common equity instruments can be an important element of an institution's capital structure, for all practical purposes its continued growth will ultimately require proportional increases in common equity.

6.2.2 Thus, an important element of any institution's medium-term capital strategy should be a plan for raising non-voting or low-voting common equity. In the case of profit maximizing institutions, be they microfinance institutions, small business banks or more traditional businesses, this is a relatively straightforward proposition: prospective shareholders must be convinced that even without voting influence, their goal of maximizing value are aligned with those of voting shareholders and managers. In the case of mission-driven institutions the principle is the same, if less straightforward. The case of Shorebank provides two examples of shareholder groups who found their interests sufficiently aligned with those of Shorebank's voting shareholders and management that they were content to forego voting rights while still assuming all the risks of common equity.

6.2.3 The first such group was philanthropic foundations which shared Shorebank's priority commitment to development impact. The second group was financial institutions which derived value in their dealings with regulators and the public from their investment in Shorebank. In these cases, Shorebank's commitment to a priority development mission, and secondarily to preservation of capital, was what gave their investment value, albeit non-financial, so that their interests were well aligned with those of voting shareholders and management.

6.2.4 Looking ahead, Shorebank is considering trying to more actively and aggressively build a pool of investors whose interests are similarly aligned with Shorebank's priority development mission as an alternative to trying to appeal to more commercially oriented investors by increasing returns and liquidity on common equity.

6.2.5 Similar opportunities may or may not present themselves in every country where private development finance institutions need to raise equity. However, while the U.S. CRA may be unique, many countries have comparable schemes, often much more

demanding, with respect to priority sector assets or net income earmarks. Institutions should examine their country's schemes closely and aggressively to see how their capital requirements might help mainstream institutions meet the requirements of these schemes.[16]

6.3.1 **Preferred Stock:** While ultimately an institution may have no alternative but to seek increased common equity, in the early stages of institutional growth capital needs can often be met through the issue of instruments that can only constitute a limited proportion of core capital. An obvious choice is preferred stock. The chief advantage is that it is relatively familiar both to investors and to regulatory authorities. The chief disadvantage is the expense. On balance, strongly growing institutions which have good opportunities to quickly leverage the equity can nevertheless make profitable use of preferred stock.

6.3.2 In Shorebank's experience, preferred stock purchasers have been socially oriented investors who nevertheless have a need for some return. Consequently, Shorebank did not need to pay commercially competitive rates on its preferred issues. It was, rather, a way of tailoring an instrument to the needs of the existing pool of social investors.

6.4.1 **Fully commercial instruments:** The example of TPS shows that established institutions with the opportunity to quickly leverage high cost capital with low cost funds can pay competitive rates on a portion of their capital. Furthermore, expense can be somewhat mitigated by structural elements in some jurisdictions, such as the tax deductibility of interest. The primary issue is identifying what instruments are workable in various jurisdictions, and how can the authorities and markets be acclimated to use of these instruments by private development finance institutions?

---

[16] In some cases, the scheme may by more consistent with a capital conserving strategy, e.g. selling eligible assets or acting as agent, rather than a capital raising strategy. This would be the case if, for example, institutions were required to devote a certain proportion of their assets to certain sectors or population groups.

6.5.1 **Capital conserving strategies:** Securitization of assets provides an exit for investors through repayments generated by the underlying assets. This is the private sector solution for institutions that are equity constrained (i.e., liquidity is not an issue for equity if you do not have to raise equity in the first place). It also has the ability to offer investment vehicles for market rate and subsidized investors in the same transaction, by offering different tranches with different terms and seniority backed by a single pool of assets.

6.5.2 The drawbacks are that asset sales appear to diminish the growth rate as measured by assets, requiring a more sophisticated assessment of impact. More importantly, the originating institution would need to retain the servicing rights on loans if the connection with the borrower is to be maintained. This in turn may suggest that the purchaser have some recourse to the originating/servicing institution. Such risk sharing reduces the capital conservation of the transaction.

6.5.3 Alternatively, some microfinance institutions may never book loans on their own balance sheet, but serve as agents to other financial institutions in lending out their funds. This agency approach is much more common to date than asset sales, but does carry the same disadvantages.

Techniques for entering local capital markets:

- Preference shares;
- Qualifying securities.

Techniques for providing liquidity:

- Share buyback programs

Techniques for conserving capital:

- Agency relationships;
- Asset sales.

Techniques for preserving institutional character:

- Non voting common and preferred stock;
- Quasi equity;
- Super-voting shares.

6.7 **Liquidity:** As part of the process of devising a model capital structure, a microfinance institution or small business bank will need to consider the liquidity requirements of its target investors. These requirements can differ dramatically. Some philanthropic investors may require that they recoup the nominal amount invested, but

will count against this balance any payments, such as dividends. In this case, a preferred stock, held over a sufficient period, will in effect provide exit. Alternatively, some investors may be satisfied with preservation of their investment in real terms or with a moderate return, which might be provided through a prenegotiated buyback auction in a context of rising book value. Careful consideration of the needs of each type of investor may in some cases provide liquidity sufficient to meet some investors' needs without the need to attract new, replacement investors.

6.8.1 **Summary:** While one or another of the specific instruments and techniques enumerated above may be of interest to a particular institution, there is a broader lesson to be derived from Shorebank's 30 year experience: for all practical purposes, private development finance institutions may not need to "solve" the equity problem. Rather, they need to opportunistically exploit appetites in their market to meet their immediate needs. While not elegant, Shorebank's experience has demonstrated that such a "mix and match" approach can be consistent with strong growth *and* continued commitment to the priority development mission, achievements that neater, more elegant solutions may not be able to deliver.

6.8.2 Finally, it worth reemphasizing that ultimately it will be critical that a "social capital" market emerge which will permit private development finance institutions to take a purer mission committed approach, making clear to investors that return and liquidity should not be determining factors in their decision to participate.

B. Achieving Liquidity at the Investor Level

7.1 ShoreCap International:

7.2.1 **ShoreCap Approach:** ShoreCap's approach to exit and investor liquidity draws on the record to date of investors in regulated financial institutions financing small and micro businesses, Shorebank's own experience in raising capital for its own operations and investing in similar regulated institutions, and lessons drawn from a handful of successful exits from development finance institutions in recent years. The principle goals of ShoreCap's approach are to:

- provide liquidity to its investors;
- recycle its resources;
- help portfolio companies to reduce reliance on specialized investors such as itself and gain access to mainstream capital markets;
- encourage growing participation by local investors;
- ensure that portfolio companies build the solid capital base they need for regulatory and growth purposes; and
- ensure that focus on the small business or micro sector is maintained.

7.2.2 As of today, the ability of investment companies or funds such as ShoreCap to reliably attract new investors either at the level of the individual investment or at the level of the company or fund itself is unproven. Existing investors have found exit at the

institutional level to be far more difficult than expected. With a few isolated exceptions, newer initiatives have not succeeded in significantly extending their investor base beyond the official and philanthropic sectors that capitalized ProFund in the mid-1990s. Overall, it is clear that the relatively straightforward exits that had been anticipated when the existing micro and small business investment funds and companies were designed have not been forthcoming: strategic investors have demonstrated limited appetite for microfinance institutions; options to put shares back to the companies usually cannot be exercised without causing severe damage; and the difficulties and costs of accessing public markets have proved greater than anticipated.

7.2.3 Nevertheless, there are signs that as microfinance and small business banks – and the funds that invest them – mature, more potential investors are gaining confidence in future performance. ShoreCap intends to accelerate this process by applying the lessons drawn from Shorebank's own extended history of raising capital and investor relations.

7.3 **ShoreCap's Portfolio:** Shorebank's experience demonstrates that development finance groups, such as Shorebank, can comfortably accommodate subsidiaries, like community banks, that have mission focused products that are tested and commercially viable as well as other subsidiaries whose products are as yet commercially unproven or that require ongoing subsidy. ShoreCap is designed to replicate this "portfolio" at the fund level, with a target portfolio that is more diverse than is typical for such international funds. Specifically, ShoreCap intends to make roughly half its investments in microfinance institutions and half in small business banks. As a general matter, small banks are more familiar and more attractive to many investors than microfinance institutions, and there is evidence that such institutions are attractive to strategic investors in particular. ShoreCap can point to two examples with which Shorebank has been directly involved where new strategic investors have sought out small business banks, and in one case, bought out sponsoring shareholders at remunerative prices. There are no comparable examples to date in the microfinance industry.[17]

7.4.1 **Local capital markets:** ShoreCap believes that meaningful efforts to expand access to capital must focus to a significant extent on penetrating local capital markets. An obvious starting place is debt and, in the case of banks, local deposits and interbank markets. It is important to keep the goal of local common equity in mind, however, as this will be the base for long term, stable institutional growth. To this end, ShoreCap will assist portfolio companies to design equity and quasi-equity instruments, such as TPS and Perpetual Preferred Shares, that offer local investors solid returns and reliable liquidity, while qualifying, as necessary, as a portion of Tier 1 capital under international bank capital standards.[18] Such instruments can serve as a bridge to local equity markets, introducing an institution to local investors and establishing a track record of performance.

---

[17] There are cases of microfinance institutions in ProFund's portfolio where one of the original investors has or is likely to buy out other shareholders. It is also hoped that similar purchases may take place in IMI's portfolio.

[18] International standards allow for up to 25% of Tier 1 capital to be comprised of these and similar instruments; national practice may vary, however.

7.4.2 In addition to such instruments, another means of establishing a track record of commitment to investor liquidity is for an institution to institute a well structured program of *share buybacks* out of net income. For example, a set proportion of net income over a certain level could be set aside for buybacks each year, with management setting a price that offers a moderate return. Weighed against the positive signal that such a buyback program sends to current and prospective investor is the fact that this strategy has the obvious disadvantage of constraining the investee's ability to grow.

7.5 **Strategies for preserving control:** In many cases, management's commitment to attract capital to fund future growth while generating liquidity for shareholders is compromised because of fears of a loss of control. Such concerns are magnified in double or triple bottom line institutions, where management and founders may legitimately fear that new investors will inevitably skew the emphasis towards financial returns at the expense of social and environmental objectives. ShoreCap is prepared to work with management to mitigate these concerns, using such instruments as non voting common and super-voting shares.

Techniques for keeping management focus on investor liquidity:

- Accelerating dividend rate;
- Management share in upside on liquidated shares;
- Realistically structured puts

Techniques for encouraging liquidity at the level of the investment fund or company:

- Strong incentives to managers to achieve high level of distributions;
- Ongoing management efforts to attract fresh investors to expand capital and replace exiting shareholders.

7.6 **Public Offerings:** For some institutions, particularly some small business banks, public offerings may be a viable option once a track record of performance has been established. In some cases, in fact, sale of a significant proportion of commercial bank shares to the public is mandated by the regulatory authorities within a few years of chartering. And in other cases, a small business bank may be one of the leading financial institutions in the country, with its shares sought after as capital markets liberalize. For the most part, however, ShoreCap does not expect public offerings to be a reliable means of raising new equity for micro and small business oriented financial institutions for the foreseeable future, for the reasons discussed above.

7.7.1 **Expanding the pool of investors:** While the combination of these specific instruments or initiatives is likely to maximize the liquidity of equity in the near term, an equally important medium term strategy – both for ShoreCap and the entire industry – is to contribute to the broadening of the overall pool of investors familiar with and attracted to investments in regulated micro and small business institutions. Investment funds and companies such as ShoreCap have a critical role to play both in educating investors about their portfolio companies as well as providing technical support and advocacy for initiatives, such as tax incentives, that facilitate the flow of funds into the their target sectors from individual or non-strategic investors.

7.7.2 As noted above, experience with respect to strategic investors – typically understood to be financial institutions or groups with an interest in regional and/or sectoral expansion – is mixed: encouraging with respect to small business banks, unexpectedly challenging with respect to microfinance institutions. In any case, ShoreCap and other funds must continue to act as advocates for these institutions, making the case that diversified financial groups can gain from incorporating regulated small business and microfinance institutions into their portfolios. This must be an ongoing process of education and information. The recent decision by ABN-Amro to create a microfinance subsidiary in Brazil with support from Accion International and actively explore similar initiatives in other countries may be evidence of increasing interest by some large banks in the microfinance sector. The goal is to attract more such strategic investors both at the investment company level and at the level of individual investments, by supporting them with information and expertise. Based on Shorebank's experience in Eastern Europe and the Former Soviet Union, ShoreCap expects to make special efforts to engage second tier financial groups with regional ambitions.

7.7.3 Another candidate is the "socially responsible" investment community, in particular large institutions that are already active in socially responsible investment in their home countries. Over a somewhat longer time horizon, efforts must be directed at local institutions and individuals who may constitute an indigenous socially responsible investor pool in the future. ShoreCap expects to be quite active, working with others, in devising initiatives to mobilize greater socially responsible investment, both in the home countries of its portfolio companies as well as in "investor" countries with a view, ultimately of creating a true "secondary market" for the equity ShoreCap holds and the institutions it has nurtured.

7.8.1 **Management Commitment and Incentives:** While all these measures will help, as a general matter it is nevertheless critical that managers of both microfinance-oriented and small business oriented institutions be committed to generating liquidity for investors. ShoreCap intends to employ two approaches to ensuring this commitment. First, the importance of investor liquidity will be a central part of the selection and negotiation process, and must be reflected in the strategic orientation of the portfolio company. Prospective portfolio companies must be able to fully reconcile their development impact goals with financial performance, and have clear plans for securing any external subsidy required for less remunerative initiatives, such as R & D, outreach, or non-financial support to clients.

7.8.2 Second, once a meeting of the minds has been achieved at the strategic level, investments will be structured at the front end to maintain management focus on providing liquidity to investors and pursuing ongoing efforts to expand access to capital. Features can be incorporated which provide an effective penalty if exit is delayed or an effective bonus when exit is achieved. Among the features with which Shorebank has experience or is exploring are:

> *Escalating dividend rates* make equity or quasi-equity progressively more costly after an initial period has elapsed, giving management strong incentives to plan for timely liquidation (see box).
>
> *Put options* that are carefully structured to be both realistic from the standpoint of what the institution can absorb, and financially attractive by programming progressively higher price multiples.
>
> Providing *positive incentives* to management whereby, for example, a declining proportion of capital gains on shares sold are shared with the portfolio company. For example, ShoreCap might commit that for each of its shares sold in the Years 5-7 after the initial investment, a predetermined proportion of capital gains would be contributed to an ESOP, with the proportion diminishing over time.

Escalating dividend rates

In a recent transaction structured by a Shorebank managed fund, a $1,000,000 investment was made in a commercial bank in the form of non-cumulative, perpetual preferred stock. The terms provided for the fund to receive an equivalent value of common stock for any annual period starting in Year 1 that the bank does not pay a cash dividend on the perpetual preferred stock investment, initially set at 6%. After 9 years, if not redeemed the dividend rate on the preferred stock will increase to a rate of 450 basis points over the 10-year U.S. Treasury Note index priced on the day prior to the conversion date with a floor of 9% and a ceiling of 15%.

7.9.1 **Summary:** ShoreCap plans a multifaceted approach to achieving investor liquidity and access by portfolio companies to adequate new capital to support growth. This will start with an intense pre-investment exploration of a comprehensive capital strategy with institutions which ShoreCap sees as promising candidates. If an effective strategy can be agreed, ShoreCap will then design investment instruments to encourage a continuous management focus on liquidity, and will work with management to design instruments to facilitate progressively greater access by institutions to local capital markets. ShoreCap will help management mitigate potential conflicts between attracting fresh capital and preserving institutional character, and will support management efforts to develop capital conserving growth strategies.

7.9.2 At the same time, ShoreCap will actively participate in efforts to expand the pool of potential investors over the medium term. Special efforts will focus on strategic investors, who will be kept apprised of ShoreCap's portfolio and educated about

opportunities in the sector, and the socially responsible investment community, both local and international.