Yale University

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents (Series 1) Browse by Media Type

2020

Raising Core Equity Capital for Community Development Banks - A New Capital Model

George P. Surgeon

Laurie J. Spengler

Darrin L. Williams

Radek Halamka

Nathan Pittman

Follow this and additional works at: https://elischolar.library.yale.edu/ypfs-documents

Recommended Citation

Surgeon, George P.; Spengler, Laurie J.; Williams, Darrin L.; Halamka, Radek; and Pittman, Nathan, "Raising Core Equity Capital for Community Development Banks - A New Capital Model" (2020). *YPFS Documents (Series 1)*. 10484.
https://elischolar.library.yale.edu/ypfs-documents/10484

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents (Series 1) by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.

Raising Core Equity Capital for Community Development Banks — A New Capital Model

Insights from Southern Bancorp's Capital Campaign

By: George P. Surgeon, Laurie J. Spengler, Darrin L. Williams, Radek Halamka, and Nathan Pittman[1,2]

Southern Bancorp's mission is to create economic opportunity in rural and underserved communities by providing responsible and responsive financial products and services that balance profits with purpose.

INTRODUCTION

Despite the unprecedented grants and debt capital that government agencies, private companies, and individuals have provided to support the economy in the wake of the Covid-19 Pandemic, its impact on the low-wealth communities served by Community Development Financial Institutions (CDFIs) has been devastating, and it is only getting worse. Historically, these communities have had limited access to capital and credit. Investments – public, private and philanthropic – simply do not flow to them, especially underserved rural areas. Many of these communities have large minority populations, who have suffered disproportionately from serious illness and death as a result of Covid-19. For these economies to recover, and hopefully to prosper, they will require the support of CDFIs and other mission focused lenders who are proximate with and who understand these communities. Community Development Banks (CDBs) will be on the front-lines leading the rebuilding efforts post Covid-19, providing the financial tools and services needed by local businesses and households to recover and to regain a foothold in the formal economy that allows them to thrive.

Community development banks will be on the front-line rebuilding communities post Covid-19.

Southern Bancorp, Inc.'s (Southern) recently concluded capital campaign offers critical insights into how the community development banking sector can galvanize support from private investors to raise core equity capital to meet the needs of low and moderate income communities and individuals in a post Covid-19 world.

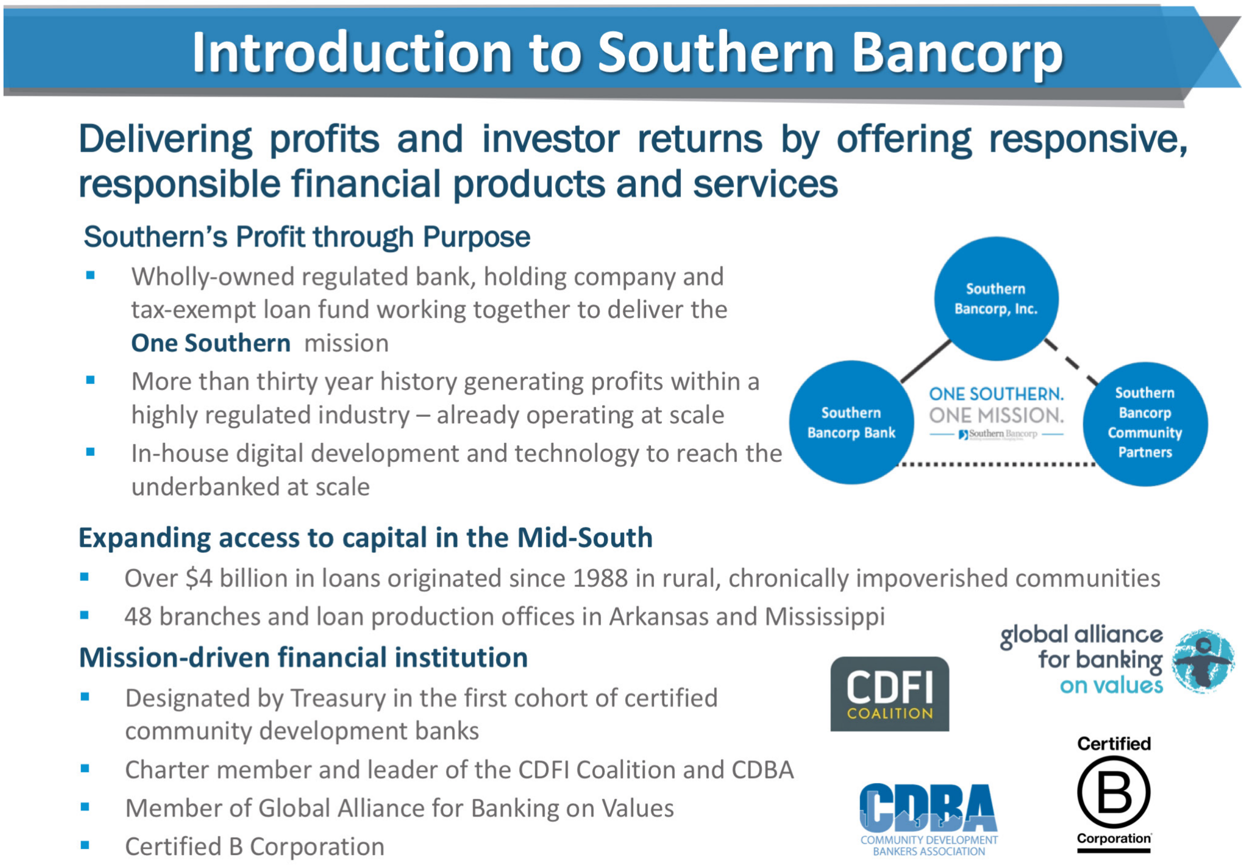
Then-Governor Bill Clinton and Hillary Clinton helped found Southern in Arkansas in 1990, and their experience with a bank capitalized explicitly to serve low income and rural communities in part inspired legislation – the Riegle Community Development and Regulatory Improvement Act of 1994 – that created the Community Development Financial Institutions Fund (CDFI Fund) in the US Treasury Department.

Southern was one of the first companies certified as a CDFI. The Fund has since provided more than $3.4 billion to CDFIs across the country. These CDFIs have in turn leveraged The Fund's investments to make loans and equity investments in small and growing businesses, households and individuals in un(der)served communities across the country.

Raising private equity capital for CDBs, however, has been and continues to be a challenge. It is likely to be even more difficult post Covid-19. This was borne out by Southern in its recent capital campaign. Nonetheless, Southern raised $34.7 million in new common equity in the capital campaign concluded at the end of 2019, at a time when other CDBs saw little demand for their common equity offerings. However, achieving this required creating a new capital model, based on extensive consultation with prospective investors. To succeed, Southern had to simplify its capital structure, install mechanisms to preserve the company's mission, and, most important to investors, commit to and adopt policies to ensure current financial returns and long-term liquidity with exits for its shareholders. By sharing its experience, Southern aims to encourage adoption of new norms for CDB equity offerings that can spur additional investment in CDBs at a time it is needed more than ever before.

BACKGROUND & CONTEXT OF SOUTHERN'S CAPITAL RAISE

New executive management at Southern began considering a capital campaign in 2013. By then, Southern had built an impeccable record of investing in low-wealth rural communities in the Mid-South, resulting in an "Outstanding" rating on its 2015 Community Reinvestment Act (CRA) Examination[3]. It had grown to more than $1.1 billion in total assets by year-end while being steadily profitable — including throughout the 2008-09 financial crisis - earning $8.7 million in 2013. However, much of the company's growth had been capitalized by an investment from the U.S. Treasury's Troubled Asset Relief Program (TARP) in 2009



Introduction to Southern Bancorp

Delivering profits and investor returns by offering responsive, responsible financial products and services

Southern's Profit through Purpose

- Wholly-owned regulated bank, holding company and tax-exempt loan fund working together to deliver the **One Southern** mission
- More than thirty year history generating profits within a highly regulated industry – already operating at scale
- In-house digital development and technology to reach the underbanked at scale

Expanding access to capital in the Mid-South

- Over $4 billion in loans originated since 1988 in rural, chronically impoverished communities
- 48 branches and loan production offices in Arkansas and Mississippi

Mission-driven financial institution

- Designated by Treasury in the first cohort of certified community development banks
- Charter member and leader of the CDFI Coalition and CDBA
- Member of Global Alliance for Banking on Values
- Certified B Corporation

CDFI COALITION
global alliance for banking on values
CDBA COMMUNITY DEVELOPMENT BANKERS ASSOCIATION
Certified B Corporation

that ultimately grew to $33.8 million in equity through the Treasury's Community Development Capital Initiative (CDCI Investment) in 2010.

How structure can constrain growth and impact

While the initial pricing and regulatory treatment of the CDCI Investment were highly favorable, these terms carried a cost: the coupon would increase from 2% to 9% in August 2018, and the CDCI Investment restricted important aspects of the company's operations, including its ability to pay dividends or other kinds of financial returns to its common shareholders. The restrictions on providing common dividends were particularly problematic, given Southern's long-standing failure to provide returns "of" or "on" capital to its existing long-term equity investors, some of whom required exits after having held shares for decades.

In 2014, the phased implementation of Basel III regulations obliged Southern to meet new capital standards tied to the ratio of tangible common equity to risk-based assets (CET1 Capital Ratio). By 2019, Basel III would require Southern to maintain a minimum CET1 Capital Ratio of 7.0%; at year-end 2013, Southern's CET1 ratio was 4.23%. While Southern's Capital Ratios at FYE 2014 exceeded all Basel III minimum capital requirements for 2014 and 2015, its financial forecasts and strategic plan indicated that it could meet the new CET1 capital standard of 7.0% at year-end 2019 only if it retained essentially all its future earnings and employed a "no growth" balance sheet business strategy.

Realizing these limitations, Southern management prioritized pre-payment of the CDCI Investment. But their 2014 financial forecasts indicated that Southern would be able to redeem only part ($23.7 million) of the CDCI Investment before the coupon jumped from 2% to 9%, preventing Southern from taking advantage of strategic acquisition opportunities and continuing to increase the volume of its community development lending and investment in low-wealth communities.

PREPARING FOR THE FUTURE

In late 2015, Southern engaged Laurie Spengler and her colleagues at Enclude Capital Advisory UK Limited, now known as Palladium Impact Capital Limited (Palladium), an impact investment bank, to help address these challenges. Southern's partnership with Palladium began with a review of the company's strategic plan and capital structure, resulting in clarification of the intended use of capital campaign proceeds and the creation of a financial model consistent with Southern's business strategy, a model balancing liquidity and profitability with mission preservation.

When the capital structure reassessment began, Southern had six separate classes of common stock authorized, each with different voting, dividend, and liquidity rights, as well as three classes of preferred stock outstanding, totaling $38.3 million (including the CDCI Investment) and three issuances of Trust Preferred Securities (TRUPs) totaling another $17.4 million. Southern's "capital stack" required simplification and clarification if new investors were to be engaged. Additionally, Palladium advised that officers and directors should themselves invest, to show confidence in the company's future financial prospects.

Early stakeholder and market feedback shaped game plan

The Palladium team's final recommendations incorporated observations of current investors and board members as well as interlocutors in a series of "testing the waters" interviews. These external interviews were undertaken to gauge the attraction of Southern's mission and business plan, the perceived adequacy of Southern's current and future financial returns, and the anticipated market receptivity to a Southern equity offering.

"Testing the waters" interviews with investors provided key insights into how the capital campaign would be structured and managed.

Among the key findings from the stakeholder and "testing the waters" interviews with a wide range of investors, asset managers, investment advisors, and investment bankers were:

- The "how", rather than the "why", of Southern was its distinguishing strength among CDBs. Southern needed to demonstrate the resilience of the low- and moderate-wealth rural communities it served. Conventional investors focused on profitability needed convincing that investing in communities abandoned by other banks could indeed benefit margin, as well as mission
- Regular common dividends would be essential, but dividend yield was less of a concern as long as it was not de minimis. Skepticism was strong as to whether CDBs would commit to and consistently deliver common dividends, because the field lacked any track record of doing so.
- Return "of" capital would be an overarching concern. As expressed in interviews: "Liquidity trumps return for many social impact investors; it is "all about exit liquidity." Multiple mechanisms, each providing some level of liquidity, would be necessary to generate sufficient cash for investor exits. Creating a vehicle that would enable board, management, and employee ownership would similarly be critical.

Return "of" capital is an overarching concern for investors.

THE WAY FORWARD

By the end of 2016, Southern's management and board committed to the following steps:

- Retiring the full amount of the CDCI Investment as a necessary precursor to a capital campaign;
- Simplifying Southern's capital structure to make its shares more appealing to a larger base of new investors;
- Providing shareholder liquidity and predictable, steady current return through quarterly common stock dividends, regular share repurchases, and creation of a KSOP to create demand for new shares and to provide a vehicle for officers and employees to become shareholders;
- Ensuring the preservation of Southern's mission by becoming a benefit corporation; and
- Raising up to $50.0 million in common equity to provide Southern with a sufficient regulatory capital cushion to make strategic acquisitions, to facilitate organic growth, and to establish ongoing future access to the capital markets.

Liquidity and return - Combining tools to establish a credible liquidity offering

Southern's founding investors had been very patient. They had invested to prove the viability and impact of community development focused banking. They were prepared to be patient — but not permanent — shareholders, and Southern had so far failed to provide them with exits for their investments. While mission or purpose-driven investors may take a long-term view, they need assurance of exit options.

Drawing on the experience of fellow Global Alliance for Banking on Values member Triodos Bank in The Netherlands, Southern and Palladium hypothesized that once assured of the availability of liquidity, Southern's mission-oriented investors would be less likely to avail themselves of it. Southern aimed to construct a sufficiently robust liquidity plan to assure investors that they could "get out" if/when needed, while allowing Southern to maintain its primary focus on balance sheet growth.

The Palladium and Southern teams determined the following combination of mechanisms as most appropriate for Southern:

- Implementation of a solid dividend plan,
- Regular share repurchase opportunities, and
- Creation of a KSOP.

The foundation of the liquidity plan was payment of quarterly common stock dividends that increase over time. The initial dividend payout rate was set high enough to be meaningful to investors but low enough that Southern had room to increase the dividend over time and could foreseeably continue to pay dividends even during periods when earnings might be soft.

Share repurchases complement the common dividends. Share repurchases have the advantages of facilitating shareholder exits — a return "of" investment — and can be managed to fluctuate with earnings or with the need to retain earnings to support ambitious organic and acquisition asset growth.

Once assured of the availability of liquidity, investors are less likely to avail themselves of it.

Creation of a KSOP was the final structural innovation. KSOPs are qualified retirement plans that combine an employee stock ownership plan (ESOP) with a traditional 401(k) plan. With a KSOP, a company matches some part of employee contributions with stock rather than cash. For Southern, the KSOP also facilitated officer and employee ownership of company shares. Southern forecast about $250,000 in annual corporate funding for the KSOP, and employees can contribute to the KSOP from payroll deferrals as they would for their 401(k) accounts. Total annual KSOP funding for share purchases was thus anticipated to be approximately $400,000. Planned quarterly common dividends and regular share repurchases together made the KSOP attractive to employees.

Mission preservation

The overarching concern throughout the capital planning process was mission protection. As with liquidity, several mechanisms were explored; the following were implemented:

- Becoming a legal benefit corporation[4] and being certified as a B-Corp by B Lab[5]. Legal benefit corporation status provides long-term mission alignment and value creation, as benefit corporations are required to consider the impacts of their actions on society, the environment and their employees in addition to profitability. The B-Corp designation signals to the world that Southern seeks to meet the highest standards of verified social impact performance, transparency and legal accountability to balance profit and purpose.
- Increasing Southern's visibility as a mission-driven company. The more Southern is viewed as a mission-driven company, the more its shareholder base would be expected to align with its mission in a process of self-selection.
- Tying management incentive compensation to the proper balance of margin and mission. Incentive compensation for senior management should be designed to prioritize mission targets while recognizing and rewarding the financial performance imperative.

Raising $50 million in new common equity

The $50 million common equity goal was straight forward while including some lee-way. Financial forecasts indicated that with a $50 million raise, Southern could redeem the CDCI Investment by year-end 2017 and build its capital ratios to levels that would allow it to be considered "Well Capitalized" by the regulatory authorities. Internal guidance used by the Palladium and Southern teams was to raise as close to $50 million as possible from new investors with a baseline of at least $30 million.

Southern and Palladium focused the capital campaign on "impact investors", both institutional (large and regional banks, insurance companies, foundations with endowments of more than $1.0 billion) and non-institutional (high net worth individuals, family offices, foundations with endowments of less than $1.0 billion). The capital raise was limited to "accredited" investors as defined in Rule 501 promulgated under the Securities Act of 1933 with a minimum purchase per investor of $250,000 to assure investor suitability. The offering was made under an exemption from registration under Rule 506 of Regulation D of the Securities Act of 1933.

RESULTS OF THE CAPITAL CAMPAIGN

A private placement memorandum was released in July 2017. The price was set at 130% of the tangible book value of the company's common stock. Subsequently, the price was updated each calendar quarter to reflect the tangible book value per share as of the end of the preceding quarter. A first closing occurred in December 2017, and the marketing period extended through year-end 2019.

More than 100 screened investors were solicited during the campaign. At its close on December 31, 2019, Southern had raised $34.7 million in new common equity capital from 36 investors.[6] All directors and executive officers of the holding company and the Bank became shareholders. Between the first quarter of 2017 and year-end 2019, Southern paid 11 quarterly common dividends, with the per share common dividend increasing every quarter. Southern sponsored two share repurchases in 2019 totaling $8.0 million. A KSOP created in 2017 invested $1.9 million in Southern common shares by year-end 2019, with 92% of all eligible Southern employees participating in the KSOP.

REFLECTIONS ON THE CAPITAL RAISE — WHAT WORKED AND WHAT DIDN'T

With the benefit of hindsight, Southern and Palladium have a number of insights from this capital campaign:

- *The Offering*: To succeed, Southern had to simplify its capital structure, install mechanisms to preserve the company's mission into the future, create a more robust shareholder communications function, and, most importantly, to introduce vehicles to ensure current financial returns and long-term liquidity with exits for its shareholders.
  - » Scepticism about exits from community development banks ran across investors types. Equity capital is almost impossible to raise without a highly specific and realistic exit strategy.
  - » Patient capital is not permanent capital. Exits as well as current financial return need to be available to all investors — including mission-aligned and impact investors.
- *The overall capital campaign*: The market was not ready for an equity offering like Southern's. The 'hangover' of uneven performance of the community development banking sector combined with the lack of precedent liquidity events resulted in market hesitation and a slow sales cycle.
  - » The initial goal was to have a first closing in the third quarter of 2017 and conclude the campaign by the end of the first quarter of 2018. The first close, however, did not occur until year-end 2017 and the campaign did not close out until year-end 2019. While $34.7 million was a significant raise, it is short of $50 million.
- *"Impact investors" are not uniform*:
  - » Institutional "impact investors" generally compare private placement bank equity returns with private equity returns and do not view community bank equity investments as a distinct asset class. They tend not to weight the demonstrated lower volatility of bank equity investments in setting

"Impact investors" are not uniform.

financial return expectations and making investment decisions.

» The proclivities of non-institutional "impact investors" are difficult to generalize, but it is clear that, as a group, they have not fully embraced 'banking' even when banking and financial services are framed as 'fundamental market infrastructure for an impact economy'. Most non-institutional "impact investors" have highly particularistic investment objectives and themes that do not generally align with the goals of CDBs serving local communities with needs that cut across business segments and themes. Most sought higher financial returns than Southern could appropriately provide given its real economy banking model. There was little distinction between asset classes with different levels of risk and volatility.

Credibility and capacity of the management team were critical in investor decision making.

» Non-institutional "impact investors" tend to rely on external financial advisors to source and underwrite their impact investments. As such, these financial advisors play an exceptionally strong gatekeeper role. In the Southern capital campaign, these managers expressed a preference to invest in funds to diversify risk for their clients. They were without exception unwilling to underwrite the Southern offering, even when their clients explicitly requested that they consider a potential investment in Southern.

- *Mission protection and measurement*: The KSOP resonated with all investors as a powerful mechanism for expanding employee empowerment. The KSOP was also viewed as a legitimate tool for creating liquidity for exits by investors.

  » Benefit corporation legal status and B Corp certification resonated as good for mission protection but, by themselves, were neither critical nor detrimental to the investment decision.

- Sales and Marketing: Credibility and capacity of the management team were critical in investor decision making. The management team's ability to "sell the story" to investors was also essential. A site visit to Southern and its markets "sealed the deal." There is simply no substitute for seeing the difference Southern is making in low income rural communities, and in having the markets come to life for investors in conversation with customers and borrowers. Every prospective investor who made a site visit invested in Southern or in Southern Bancorp Community Partners, Southern's tax exempt affiliate.

CONCLUSION

This paper has traced the evolution and successful implementation of a new capital model for community development banks as pioneered by Southern. This new capital model allowed Southern to succeed in the largest capital campaign in its history. Although the market was unprepared for an equity offering like Southern's and the campaign took longer than planned and raised slightly less than the targeted amount, it has laid the groundwork for Southern and other community development banks to access the capital markets and raise larger amounts of core equity capital in the future. As we face the urgent task of rebuilding local communities emerging from the Covid-19 crisis, CDBs like Southern are essential actors, providing capital to support small businesses and households to reboot local economies. We strongly hope that sharing Southern's experience will prompt investors to participate in capitalizing CDBs, and will help other CDBs raising capital to meet escalating demands from the markets they serve.

Endnotes

1. George P. Surgeon is President and CEO of GSJ Advisors, Ltd. Laurie J. Spengler is CEO of Courageous Capital Advisors, LLC and formerly CEO of Enclude Capital Advisory UK Limited, now known as Palladium Impact Capital Limited. Darrin L. Williams is Chief Executive Officer of Southern Bancorp, Inc. Radek Halamka is Associate Director of Palladium Impact Capital Limited. Nathan Pittman is Senior Vice President, Policy & Communications, of Southern Bancorp, Inc.

2. The authors would like to thank the following for their contributions to this article: Collins Cook, John Olaimey, Jan Piercy, and Christopher Wewers of Southern Bancorp, Inc.; Karama Neal and Nancy Sullivan of Southern Bancorp Community Partners; Steven van Weede of Palladium Impact Capital Limited; and David Korslund.

3. Southern has maintained an “Outstanding” CRA rating in its last three examinations (2015, 2017 and 2019).

4. “Benefit corporation” is a form of business organization allowed by the majority of US state governments. Directors and officers of benefit corporations operate with the same authority as in traditional corporations, but are required to consider the impacts of their decisions not only on shareholders, but also on a broader group of stakeholders, including employees, customers, the community and the local and global environment. Most states require benefit corporations to file an annual report detailing their progress towards achieving social and environmental goals.

5. Upon application to B Lab, benefit corporations may become certified in recognition of their commitment to the public benefits identified in their articles of incorporation. (Traditional “C” and “S” corporations may also be certified by B Lab but must commit to convert their charters to become “benefit corporations” within a clearly set timeframe.) B Lab is a “nonprofit that serves a global movement of people using business as a force for good. B Lab’s initiatives include B Corp Certification, administration of the B Impact Management programs and software, and advocacy for governance structures like the benefit corporation.” According to B Lab, a B Corp Certification “measures a company’s entire social and environmental performance. The B Impact Assessment evaluates how your company’s operations and business model impact your workers, community, environment, and customers. From your supply chain and input materials to your charitable giving and employee benefits, B Corp Certification proves your business is meeting the highest standards of verified performance.”

6. The total includes the July 2017 conversion of the WK Kellogg Foundation preferred shares into common stock.