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UFT
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Micro-finance in Opportunity Zones

Driving Economic Growth and Stability using the Micro Enhancement CPC™

Prepared by UFT Commercial Finance, LLC

Written by Joanne Marlowe

Micro-finance in Opportunity Zones:

Driving Economic Growth and Stability using the Micro Enhancement CPC™

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Background

As part of the Tax Cut and Jobs Act, sweeping changes were initiated that are designed to drive long-term private sector investment in economically distressed areas around the country. These areas have been designated as Opportunity Zones. At its heart, this initiative is intended to spur entrepreneurship, enable new projects or business enterprises, spawn redevelopment of real properties, and help provide capital for business expansions in these zones. It does so by providing Federal Tax incentives to private investors that are willing to apply their capital gains from other investments that have appreciated in what is a historically vibrant economy into any of the thousands of long-term investments located in designated Opportunity Zones throughout the United States. In return, the investor's capital gains tax will be deferred and returns generated from the Opportunity Zone investment over a 10-year investment horizon will be tax-free.

Although a very attractive proposition, as a practical matter, many private investors are not inclined or able to identify or evaluate direct investment opportunities in Opportunity Zones. They seek the efficiencies of accessing these tax benefits through indirect investment vehicles, such as investments in qualified opportunity funds ("QOFs"). QOFs are hedge or investment funds that have a stated strategy of focusing their investments in projects and businesses located expressly in Opportunity Zones and then passing the tax benefits of those investments through to their respective fund investors.

Since the passage of the legislation creating this new investment opportunity, countless QOFs have been established or are currently in the process of being established. Many of those are actively soliciting investment from qualified investors. As large pools of investment capital build, QOFs are working to identify suitable projects and enterprises in which to invest. Due to the nature of the legislation, real estate-based projects tend to be a cornerstone focus of QOFs. Not too far behind are investments in existing commercial businesses that are looking for capital and are already operating in or are willing to expand into Opportunity Zones. Both of these types of investments have the potential to act as "Lightning Strike Projects" — projects that can electrify local economic activity and jolt a community into action with new growth opportunities.

Generally, these projects breed follow-on second tier economic activity as new jobs bring with them wages that are circulated locally. This becomes the foundation of an economic cycle that can uplift local residents and improve the quality of everyday life in the community. There is no doubt that this activity is

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all good. However, it isn't enough. It is only a first step. Micro-finance and targeted small business lending in local businesses in the wake of a "Lightning Strike" is critical to not only sustaining economic growth, but stabilizing and even galvanizing a community.

A Conductor for Economic Energy

Each Opportunity Zone is like a small town. Fundamental to how towns have historically come to life is the occurrence of a Lightning Strike event. That could take the shape of the discovery of gold or silver in the area, the development of a transportation hub when new track is laid in a rail system, or something as simple as the opening of a single manufacturing plant that provides jobs to a large section of the local population. In each case, the commercial activity starts, the jobs come, employees have money to spend, community begins to grow, and, with the coming of cohesive critical economic mass in the town, the local bankers move in.

Bankers make the second tier of community growth and stability possible. When the local entrepreneurs from within the community saw the need for the general store, the small diner, the local pub, the barber shop, the tailor shop, or the bed and breakfast, it was the neighborhood banker that was there to provide the capital to make those vital secondary businesses possible. It is these second stage businesses that spark ancillary economic activity that continue to conduct the economic energy of the Lightning Strike Project even after the impact of the original "strike" has reached its maximum effect in the community.

Similarly, as Opportunity Zones and the corresponding tax benefits attract large investors and QOFs to engage in landscape-changing Lighting Strike Projects, mechanisms need to be strategically put in place to provide the means necessary to ignite the entrepreneurial spirit that fosters the second stage of economic evolution in the community. Successful local entrepreneurs are those that are able to identify a need, create a business around it, prove and refine the skills and systems needed to make that business viable, and then access the means to make their vision a reality. Once a business gains traction, it becomes another catalyst in that second-tier economic machine that brings stability, breeds entrepreneurial growth, and strengthens a middle class, all of which come together to ultimately build a community.

What is financially required to complete this economic circuit in an Opportunity Zone? It may not take much in terms of dollars and cents, but almost every business needs a financial boost at some point. Ironically, that boost can oftentimes be hard to find because the dollar amounts are too small to be of interest to most lenders or investors. Sometimes community development funding or even the Small Business Administration can play a role, but when that isn't available or the business doesn't have the credit history to qualify using conventional metrics, the only place to turn is private investors, which brings with it its own challenges.

Although seemingly counter-intuitive, when a business's growth capital requirements are legitimately small, investors have little economic reason to engage — even when the business's

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success is likely. In simplest terms, the possible investment rewards to be generated by a local business are by nature of a limited scope and not substantial enough to offset an investor’s time and costs of studying the opportunity. In many cases, there is a high degree of likelihood that the small business opportunity the investor passed up could succeed. With that would-be success, a very good livelihood could have been created for the business owner, his or her family, and the business’s key employees. Unfortunately, that scale of business doesn't harbor enough investment upside to engage an investor that doesn’t have a personal interest in the success or failure of the business. As a result, the investor won’t even invest its time in considering the proposition. It is at this critical moment in a business’s life that most business owners rely on “friends and family” fundraising. That is, raising small amounts of money from many people close to the entrepreneur in the community that want to see the business or business owner succeed.

Opportunity Zones are rife with members of the general population that do not have investable capital. If a business owner doesn’t come from a community in which a sufficient amount of investable capital is available, “friends and family” funding is simply not there. Absent the infusion of a relatively small amount of capital, the business may continue, but the flow of economic current that the business could have produced will be weakened, or, worse yet, cut off if it is forced to close its doors. If given access to just a few additional resources, these businesses can amp up their activity and produce the type of energy needed to sustain the local community. To make this happen, a new approach that invites private capital to invest in what can be life-changing business opportunities for the people involved is needed. The answer comes in the form of a technologically-enabled finance system that has been successfully implemented on foreign shores for the last several years — micro-finance lending.

A Different Look at Lending

Micro-finance is a proven model that relies upon thin-file agile and cost-effective algorithmic credit analysis to efficiently reach a determination to lend or not to lend. This system relies upon a variety of social data feeds to determine the habits and likelihood of collections of a credit or loan when there may be little conventional data available as to repayment history with regard to a particular person or entity as “borrower”. What that means is that credit applicants who may lack credit history or may even be generally “unbanked” are evaluated in reliance upon what a traditional investor or banker may deem unconventional data points. These may consist of social media patterns, bank account data (for those that have bank accounts), and other informative data that may largely be drawn with the applicant’s consent from mobile phone records and other online activities related to the principals behind the business as well as the business itself.

In recent years, algorithmic micro-lending platforms have been successfully utilized in isolation by small specialty lenders as the basis to underpin quick-turnaround, low-cost underwriting. These platforms have found a home in many developing nations, where they have proven that delivering loans as small as $100 to aspiring entrepreneurs produces bursts of localized energy that can electrify small communities. Moreover, they do so with remarkably low default rates and

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reasonable profit margins. As one moves up the scale to apply this same system in economically distressed regions of more developed countries, micro-finance lending begins to look more like commercially-linked personal loans that perhaps bump up against the threshold of low-volume small business loans, ranging from a few thousand on up to tens of thousands of dollars. When considering how to most significantly impact and uplift the citizenry and businesses located in Opportunity Zones, micro-finance and competently targeted small business lending are central to creating true economic stimulus that will produce sustainable results.

Bringing Micro-finance On-shore

The success of thin-file micro-finance lending in faraway lands, with its lower default rates and higher returns, is neither a product of alchemy nor is it wishful thinking. Thin-file underwriting technology de-prioritizes the conventional metrics that banks and financial institutions have used for years in assessing credit worthiness of a borrower or likelihood to pay. Instead, this alternative view looks beyond the hard numbers into the behavioral characteristics and profile of the principals behind the proposed obligation in order to reach a determination as to "intent to pay" and only then assesses ability to pay. The determination of intent-to-pay leverages off of data gathered from on-line community interactions as extrapolated from social networking and similar alternative market data points in order to establish behavioral patterns and likely repayment models associated to specific borrowers. This on-line profile-building exercise for the potential borrower's principals means in practical terms that applicants that have limited banking or credit history may still have a legitimate opportunity to qualify for loans to build a new business or move an existing business to the next level.

This type of alternative approach to thin-file credit underwriting has sound data to support its viability and suits the characteristics of the population of potential borrowers in Opportunity Zones. Many of the potential borrowers in these zones, like borrowers in frontier economies, have limited conventional credit data available for analysis, which historically using conventional underwriting parameters has generally made them poor credit candidates.

This methodology, once programmatically initiated across a few select pilot Opportunity Zones, will aid in refining the core data points that will assist in accounting for cultural and behavioral differences between foreign versus U.S. domestic applicants. Those refinements should position this lending strategy as an effective tool to fuel second-tier entrepreneurial businesses in economically distressed communities. Further, when closely coordinated with the broader agenda for the U.S. government's implementation plan to revitalize Opportunity Zones, this micro-finance program will fill a vital need for private capital to enter Opportunity Zones at a "Main Street" level.

This strategy will be diversified across geographic location, industry focus, and borrower profile. It will enjoy granularity of individual loan sizes and a loan profile consistent with the best in localized "impact investment". These factors combined should manifest a highly diversified, low concentration portfolio lending strategy with relatively low portfolio-wide default rates. When coupled with the tax benefits inherent in Opportunity Zones, there is little doubt that this strategy will prove compelling to investors. But, the

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key differentiator that stands to set this micro-finance investment profile apart is not found in the strategy itself, but in how the investment can be positioned in an investor’s portfolio using a “cashless” investment vehicle – the Micro Enhancement CPC.

Cashless Investing in Opportunity Zones

The Micro Enhancement CPC is part of a new credit asset class developed by UFT Commercial Finance, LLC (“UFT Commercial”) in direct response to the credit meltdown of 2008. It is known as the Master Credit Participation Certificate™, or “CPC™”. The suite of CPC products is comprised of 26 different CPC types that span the yield curve and readily enable the standardized fractionalization of almost any credit type. It is not a credit derivative, but is presented across a common platform through which investors around the globe can reliably purchase standardized units of "credit" for investment purposes. CPCs™ are a more fungible, transparent, resilient, and liquid alternative to traditional bond issuances and a far-superior next-generation solution for the reliable distribution and trading of credit than that which is available in the market today. Currently, there are CPC products available to address the needs of a variety of credit markets, including trade and receivables finance, mid-market commercial lending, construction finance, mezzanine debt, revenue participation transactions, alternative investments, performance bonds, fund investments, and even private equity. Although the CPC is new and, by comparison to well-trodden credit-debt products at market, still in its infancy, the need for a product like the CPC is clear.

The Micro Enhancement CPC™ is a part of the UFT Commercial suite of Enhancement CPC™ products and the Enhancement CPC is a subset of the broader CPC product platform. All Enhancement CPCs permit investors to position almost any type of credit investment in their portfolios in a completely unique and previously unavailable manner.

The Micro Enhancement CPC™ provides the first-ever “cashless” option for investors to gain exposure to high-impact micro-finance loan portfolios. This means that these types of loans can now be used to yield enhance an investor’s holistic portfolio strategy without needing to displace any portion of an investor’s pre-existing portfolio. This is made possible because the investor acquires an Enhancement CPC by offering its purchase consideration in the form of a standby letter of credit that credit enhances the target micro-loan portfolio. The letter of credit is not intended to be drawn except primarily upon a default of the underlying loans, so for as long as the underlying investment is performing, all returns paid to the investor constitute a yield enhancement to the investor’s portfolio. The use of a letter of credit allows the investor to figuratively lay the Micro Enhancement CPC atop a portion of its existing portfolio without displacing or disturbing any preexisting investments in its core portfolio. This permits an investor to fold in its exposure to the Opportunity Zone-linked micro-loans with virtually no opportunity cost, giving them greater patience for longer duration transactions. That ability to stand patiently and wait for the underlying investments to mature and perform makes them an ideal fit for the long-term, multi-year horizon indigenous to Opportunity Zone investments.

Additionally, when investing in a Micro Enhancement CPC, an investor need not move its capital into the United States from a non-US jurisdiction in order to make an Opportunity Zone investment. This fosters a

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completely new method for Opportunity Zones to attract investment support internationally with less innate transactional friction while still permitting the investor to enjoy the flow-through of the related tax benefits. The advent of a vehicle that permits international investors to introduce investments into their portfolios without moving capital from their home jurisdiction opens the doors to better achieving the goal of making investments in Opportunity Zones a *truly global* investment proposition.

Action and Conclusion

If the world's economic community is being invited to invest in Opportunity Zones and participate in the unprecedented economic growth that we are seeing in the United States today, it is critical that all possible routes to investment are opened. This means reaching beyond solely the recognition of QOFs as the primary point of investment entry to Opportunity Zones. The United States would be well-served to implement policies that foster additional, reliable and standardized vehicles for direct investment in these distressed economic areas by investors around the globe. The Enhancement CPC is one such vehicle that (i) increases an investor's available investment capacity, (ii) reduces portfolio friction by minimizing opportunity costs, (iii) generates uncorrelated yield enhancement, and (iv) facilitates cross-border investments with greater ease.

In collaboration with the Department of Housing and Urban Development ("HUD"), UFT Commercial is willing to engage in a coordinated pilot of an Opportunity Zone Micro-Finance Program. Using the Micro Enhancement CPC as a central component for global distribution, UFT Commercial proposes to originate these micro-finance loans, either directly or via affiliated participating banks, and sell them into the private sector.

To make this possible, our immediate goal is to gain recognition of the Enhancement CPC for purposes of direct investment in Opportunity Zones. This will raise investor confidence that a "cashless" point of entry to the proposed Micro Finance Program will carry with it all expected tax benefits. Ultimately, our collective goal with HUD is to demonstrate the value of high-impact micro-lending in Opportunity Zones toward stabilizing long-term economic results in revitalizing these communities.

For more information about the CPC:
www.uftcf.com

UFT Commercial Finance, LLC
2121 Waukegan Road, Suite 100
Bannockburn, Illinois 60015
United States of America
contactus@uftcf.com

Joanne Marlowe is a Director of UFT Commercial Finance and a structured product specialist. She has been instrumental in the design of a variety of credit-linked products in the trade and commercial finance sectors.