HCD UNDERWRITING GUIDELINES

This outline identifies the minimum underwriting standards for CDBG programs implemented by HCD Grantees. These guidelines are intended to provide minimum standards for economic development programs. Local jurisdictions, Tribal governments, and Colonias (Grantees) are encouraged to design their underwriting guidelines to address local business needs and priorities within these parameters. Grantees should work with their HCD representative to ensure their program underwriting standards are compliant prior to launching programs or approving projects.

These parameters are aligned with HUD's minimum standards for underwriting economic development programs according to 24 CFR 570.482(e). CDBG funds that are intended to be used for economic development financing must meet the **HCD Minimum Underwriting Standards for Economic Development and Microenterprise Financial Assistance**.

HCD Optional Underwriting Standards are underwriting methods Grantees may use when assessing businesses for eligibility. CDBG funds are investments made by the public and as a result carry with them unique requirements and expectations that reflect public policy values. As a result, the HCD Additional Underwriting Standards defined in this document are considered best practices when implementing economic development programs. The Optional Underwriting Standards defined in this document are not required; however, they may be used by Grantees to evaluate CDBG economic development investments.

HCD Minimum Underwriting Standards for Economic Development and Microenterprise Financial Assistance

HCD requires businesses assisted as part of an economic development activity or microenterprise owners who receive financial assistance (in the form of loans, forgivable loans, or grants) to be evaluated to ensure the project is financially viable and the use of CDBG funds are appropriate. Both HUD and HCD recognize that different levels of review are appropriate when taking into account differences in the size and scope of a proposed project, and, in the case of a microenterprise or other small business, taking into account the differences in the capacity and experience among businesses of differing sizes. If businesses are receiving technical assistance, such as business counseling, financial counseling, etc., they are not required to undergo underwriting prior to receiving technical assistance from the Grantee or their subrecipient.

HCD requires Grantees to review all businesses and microenterprise owners receiving financial assistance within these minimum underwriting standards, per HUD's objectives to ensure:

1. That project costs are reasonable
2. That all sources of project financing are committed

3. That to the extent practicable, CDBG funds are not substituted for non-Federal financial support
4. That the project is financially feasible
5. That to the extent practicable, the return on the owner's equity investment will not be unreasonably high and
6. That to the extent practicable, CDBG funds are disbursed on a pro rata basis with other finances provided to the project

HCD has established the following minimum underwriting for all financial assistance awards to businesses or microenterprises receiving CDBG.

1. Project costs are reasonable

    a. Grantees must review all proposed costs and uses of CDBG funds and determine that the costs are reasonable. This helps the grantee avoid providing too much or too little CDBG assistance. If the budget is overinflated, there could be a waste of scarce public resources or could result in an unreasonably high return on investment from the owner or investors. If the budget is understated, the likelihood of success of the project may be affected, which could impact the project's ability to be completed, meet a national objective, and/or reduce the income available for covering operational costs.

       To determine whether the costs are reasonable, the Grantee should analyze the applicant's proposal against costs of comparable projects, a market analysis and/or industry standards.

        i. For the purpose of reimbursing furniture, fixtures, equipment, supplies, and inventory unit costs at less than $2,000 from a mainstream retailer (e.g. web-based retail, hardware stores, and other suppliers), the grantee may assume that the cost is competitive.

        ii. For the purpose of reimbursing furniture, fixtures, equipment, supplies, and inventory unit costs at $2,000 or more, the business applicant should obtain at least three price quotes and Grantees should use this documentation to support cost reasonableness in the project file

        iii. For the purpose of reimbursing arms-length transactions for rent, utilities, or salary costs, the costs should be documented in a lease, standard utility rate, or as being consistent with other labor costs within the business or within the market.

        iv. For any non-arm's length transaction, the Grantee should evaluate the costs to ensure it is consistent with standard costs within the market area

v. For the purpose of funding construction or real estate projects, business applicants are encouraged to obtain more than one bid and the Grantee should evaluate the costs (in cost estimates or appraisals) by line-item and ensure they are consistent with the local market and standard costs within the area.

2. <u>All sources of project financing are committed</u>

a. Grantees should review all projected sources of financing necessary to carry out the project. The business shall provide documentation that all sources of financing are committed prior to issuing the CDBG award. Grantees should verify that:

i. Sufficient sources of funds have been identified to finance the entire project; and

ii. All sources providing those funds have affirmed their intention to make the funds available.

b. Documentation of all forms of financing – including commitment letters, bank statements, etc. - should be maintained in the project file.

3. <u>Avoid substitution of CDBG funds for non-Federal financial support</u>

a. Grantees should evaluate each applicant business to determine that the assistance is not replacing non-Federal financial support.

b. This provision clearly applies to other public or non-profit funding that may be available and/or was committed prior to the availability of CDBG funding.

c. However, this provision does not mean that applicants should be automatically denied or have their award lowered because they qualify for private loans or other debt, but when reviewing applicants for eligibility, the Grantee should include an analysis for why CDBG funding should be provided to applicants who could otherwise qualify for other private funding sources. That analysis could include a review of the public benefit of the project, the ability for the project to support additional debt, and other similar factors.

d. Documenting compliance with this standard should include determining if an unmet need remains after other considering all other factors, sources and proceeds available.

4. <u>Project feasibility</u>

a. For the project to achieve its intended outcomes and meet a national objective, it must remain viable for at least the term of the loan, the post-award grant conditions and/or until the national objective is met.

b. Determination of feasibility is dependent on the nature of business, financial status of the business, and award amount and structure of Grantee assistance. The project should provide sufficient cash flow to repay debt, cover projected operation costs, and provide a reasonable Rate of Return OR on equity invested.

c. **Operational Feasibility:** Grantees should include a process in their program guidelines for how they will review projects for operational feasibility. Grantees may help businesses or microenterprises develop business market adaptation plans that include developing operational and cash flow projections. Tax returns, income statements, balance sheets and historic cash flow statements can help Grantees understand the business' financial capacity to carry out the proposed project with the CDBG award. The documents should demonstrate the capacity to cover all operational costs and debt payments from available cash flow and liquidity. There are many ways to review the financial capacity of a business, which all help the Grantee determine whether or not the project is feasible over the life of the CDBG award and beyond. Some questions and ways to analyze the financial capacity of a business are included below.

The extent of this analysis can be adjusted to reflect the amount of funding and the size and capacity of the business or microenterprise.

- What is the ratio of current assets to current liabilities? How has this changed over time? Do the numbers demonstrate that the business has enough resources to pay its debts over the next 12 months?
- How much debt does the business currently have on its books?
- What are the terms and conditions of each source? Is there enough net operating income to cover debt service on requested award?
- Does the business and/or owner generate sufficient and steady income to meet its financial obligations? Are cash flows seasonal and if yes, do the high revenue times cover the low revenue times? How has that changed over time?
- Has the business been profitable in the past and if not, how will the CDBG award help the business become profitable or sustainable in the future?
- Does the information in the financial statements tie to the information stated in the tax returns? If not, how significant are the differences and does the applicant have a reasonable justification for the difference?

5. <u>Owner's return on equity is reasonable</u>

a. To the extent practicable, the CDBG assisted activity should provide not more than a reasonable return on investment to the owner of the assisted activity.

b. Grantees should:

i. Document that the owner's return on equity of the CDBG investment will not exceed industry standards and norms by reviewing the business financials and owner equity contributions OR

ii. Demonstrate that CDBG assistance does not exceed net related business losses (when accounting for other related financial assistance) OR

iii. Include another methodology in program guidelines for determining whether the owner's return on equity is reasonable

6. CDBG Funds Disbursed Pro Rata

a. CDBG funds used to finance the activity should be disbursed in proportion to the percentage of the project it funds. One exception is where CDBG funds are allocated for an acquisition activity. The Grantee should prepare a disbursement plan that outlines the projected disbursement schedule factoring in other funding sources and their terms.

b. The CDBG funds are technically "at-risk" until a national objective is met. Grantees are encouraged to structure their awards in such a way that risk is minimized wherever possible. One of the variables to consider when minimizing risk is the timing of when the CDBG funds enter the project. However, there may be practical situations where the project will benefit from having CDBG funds enter the project early in the development. In those situations, Grantees should include the narrative and justification for funding on a non-pro rata basis in individual project files.

Additional Requirements for Business Underwriting

- Sam.gov Unique Entity Identifier (UEI)
  - UEI must be obtained prior to disbursement of CDBG funds
  - Confirmation the business and/or owners are not barred from receiving federal assistance on sam.gov
- Verification that the business does not have federal delinquencies

Documentation Requirements for Business or Microenterprise Activities

- Business plan
- Historic financial statements
- Tax returns (usually prior 3 years)
- Sources and Uses
- Commitment of all Sources
- Pro Forma (usually 12-24 months)
- Disbursement Plan

HCD Optional Underwriting Standards

The HCD Optional Underwriting Standards are not required. Grantees may choose to adopt some or all of these standards in their CDBG economic development program. The HCD Optional Underwriting Standards are broken out into three tiers based on the award received with different requirements in each tier. Grantees may opt to increase or decrease the amounts used in the tiers if they choose to incorporate this approach into their policies for their economic development and microenterprise programs or projects, as applicable. HCD recognizes the capacity and experience of business owners can range. The State has created these three tiers to help Grantees or subrecipients minimize the risk of non-compliance for higher value CDBG projects and reduce barriers of access for critical small business and microenterprise owners.

These requirements can supplement the HCD minimum underwriting standards listed above.

- Tier 1: Award amount is at or above $105,000
- Tier 2: Award amount is below $105,000
- Tier 3: Award is to a microenterprise

Tier 1

Applicants requesting awards at or above $105,000 will be required to provide the following documentation and meet the following underwriting standards.

1. **Business plan**
   a. Market Analysis, business plan, and/or similar analysis that allows the Grantee to review the viability of the projected expansion or new business in the proposed or existing market
2. **Past three (3) years financial statements**
   a. Business and owner(s) financial statements should be provided, including:
      i. Income statements
      ii. Balance sheets
      iii. Cash flow statements
   b. Start-up businesses should provide the following for at least the first 36 months of operation:
      i. Pro forma balance sheet
      ii. Projected income statements
      iii. Cash flow statements
3. **Past three (3) years tax returns**
   a. Business and owner(s) tax returns should be provided

   Note: Personal financial statements and tax returns are required for individuals who own 20% or more of the business.

4. **Sources and Uses**
   a. Sources and uses statement for the project

b. Commitment letters, bank statements, and/or other documentation supporting the firm commitment and/or availability of all funding entities

5. Pro Forma Financial Statement

a. Projected cash flow statements for a minimum of the greater of grant/loan term allowable for meeting national objective requirements OR 24 months after receipt of CDBG funds and once in operation if the project includes rehabilitation or acquisition

6. Debt Service Coverage Ratio (DCR)

To show the repayment will be covered by the projected revenue of the business, the DCR should be calculated. The DCR can be calculated using the applicant's business financials including income projections, bank records, profit and loss reports or owner's equity.

DCR equals the cash flow available for debt service (typically the net operating income) divided by the debt service. The minimum requirements are as follows:

i. 1.25 DCR before investment of CDBG funds
ii. 1.05 DCR after investment of CDBG funds

If the DCR is below 1.05, a global service debt coverage ratio could be considered by the Grantee, but the Grantee should weigh and address the risks with allowing for a lower DCR. Global debt service coverage ratio combines both personal and business income and expenses.

7. Loan Collateral

Collateral should be provided to secure the award and/or lower the risk for the CDBG funds contributed to the project. It is at the discretion of the Grantee if the asset collateralized is a lien on the property with the CDBG funds or other assets owned by the business or its owners. The loan-to-value (LTV) ratio will be calculated to determine the risk of the loan based on the value of the collateral.

a. LTV ratios will vary based on the nature of the asset being financed. The following are generally accepted loan-to-value standards (maximums):

Asset	LTV
Real Estate	60%
Machinery & Equipment	50-75%
Inventory	50-60%
Receivables	75%

8. Personal Guarantee

a. Personal guarantee of full loan amount is required for all owner(s) with 20% ownership interest in the company.

b. Net worth should be analyzed and determined to be adequate for the owners to serve as viable loan guarantors. Grantees should review the guarantor's financial capacity to fulfill the loan obligation. Documentation to review this includes income, liquidity, cash flow contingent liabilities, other projects that are guaranteed by the guarantors, accounts receivable and other debt, and other relevant factors.

Tier 2

Applicants requesting awards below $105,000 will be required to provide the following documentation and meet the following underwriting standards.

1. **Business plan**
   a. Market Analysis, business plan, and/or similar analysis that allows the Grantee to review the viability of the projected expansion or new business in the proposed or existing market
   b. NOTE: this plan may not be as in-depth as the plan required for the Tier 1 awards and Grantees may determine that they want to use activity delivery funds to help smaller businesses refine their business plans
2. **Past three (3) years financial statements**
   a. Business and owner(s) financial statements should be provided, including:
      i. Income statements
      ii. Balance sheets
      iii. Cash flow statements
   b. Start-up businesses should provide the following for at least the first 24 months of operation:
      i. Pro forma balance sheet
      ii. Projected income statements
      iii. Cash flow statements
3. **Past three (3) years tax returns**
   a. Business and owner(s) tax returns should be provided

   Note: Personal financial statements and tax returns are required for individuals who own 20% or more of the business.

4. **Sources and Uses**
   a. Sources and uses statement for the project
   b. Commitment letters, bank statements, and/or other documentation supporting the firm commitment and/or availability of all funding entities
5. **Pro Forma Financial Statement**
   a. Projected cash flow statements for a minimum of the greater of grant/loan term allowable for meeting national objective requirements OR 12 months after receipt of CDBG funds and once in operation if the project includes rehabilitation or acquisition
6. **Debt Service Coverage Ratio**
   To show the repayment will be covered by the projected revenue of the business, the DCR should be calculated. The DCR can be calculated using the applicant’s business financials including income projections, bank records, profit and loss reports or owner’s equity.

Debt Service Coverage Ratio equals the cash flow available for debt service divided by the debt service. The minimum requirements are as follows:

i. 1.15 DCR before investment of CDBG funds
ii. 1.05 DCR after investment of CDBG funds

If the DCR is below 1.05, a global service debt coverage ratio could be considered by the Grantee, but the Grantee should weigh and address the risks with the business owner if choosing to allow for a lower DCR. Global debt service coverage ratio combines both personal and business income and expenses.

7. **Personal Guarantee**
   a. Personal guarantee of full loan amount is required for all owner(s) with 20% ownership interest in the company.
   b. Net worth should be analyzed and determined to be adequate for the owners to serve as viable loan guarantors. Grantees should review the guarantor's financial capacity to fulfill the loan obligation. Documentation to review this includes income, liquidity, cash flow contingent liabilities, other projects that are guaranteed by the guarantors, accounts receivable and other debt, and other relevant factors.

Tier 3: Microenterprises

When providing assistance to microenterprises, Grantees must collect the following documentation and meet the following underwriting standards.

1. **Business plan**
   a. Market Analysis, business plan, and/or similar analysis that allows the Grantee to review the viability of the projected expansion or new business in the proposed or existing market
   b. NOTE: this plan may not be as in-depth as the plan required for the Tier 1 or Tier 2 awards and Grantees may determine that they want to use activity delivery funds to help microenterprises refine their business plans
2. **Past two (2) years tax returns**
   a. Owner(s) tax returns should be provided
   b. Owners may provide more than past 2 years, if helpful for demonstrating a pre-COVID financial trend
4. **Sources and Uses**
   a. Sources and uses statement for the project
   b. Commitment letters, bank statements, and/or other documentation supporting the firm commitment and/or availability of all funding entities
5. **Pro Forma Financial Statement**
   a. Projected cash flow statements for 12 months after receipt of CDBG funds and once in operation

6. **Debt Service Coverage Ratio (DCR)**

   To show the repayment will be covered by the projected revenue of the business, the DCR should be calculated. The DCR can be calculated using the applicant's business financials including income projections, bank records, profit and loss reports or owner's equity.

   DCR equals the cash flow available for debt service divided by the debt service. The minimum requirements are as follows:

   i. 1.15 DCR before investment of CDBG funds
   ii. 1.05 DCR after investment of CDBG funds

   If the DCR is below 1.05, a global service debt coverage ratio could be considered by the Grantee, but the Grantee should weigh and address the risks with the business owner if choosing to allow for a lower DCR. Global debt service coverage ratio combines both personal and business income and expenses.

7. **Personal Guarantee**
   a. Personal guarantee of full loan amount is required for all owners with 20% or greater ownership interest in the business.

Credit History

A 2015 report from the Consumer Financial Protection Bureau found that poor, Black and Latinx people were far more likely to either have no credit history, or so little that they could not get a credit score. According to research from the Urban Institute, majority-Black communities and majority-Indigenous communities have the lowest median credit scores and residents of reservations have credit scores averaging 30 points lower than those in surrounding areas.[1]

Due to the government's historic role in perpetuating these inequities, HCD seeks to mitigate the harm by not requiring a minimum credit score and by stipulating that credit scores cannot be used as a sole eligibility factor for CDBG assistance.

Credit history from a credit report can be used to review existing debt, understand challenges, understand the total debt picture, or to help inform the calculation of debt coverage ratio (DCR). However, credit reports should be supplemented with a review of individual circumstances, drawing on community knowledge and/or an analysis of other reasons for past bankruptcies, delinquent or inadequate repayments when considering creditworthiness of business and microenterprise applicants.

[1] https://medium.com/commonfuture/why-credit-scores-are-racist-da109fcfb300

Documentation Requirements for Business or Microenterprise Activities When Using the Optional Underwriting Standards

	Tier 1	Tier 2	Microenterprises
Business plan	√	√	√
Historic Financial Statements	√	√	
Tax Returns	3 prior years	3 prior years	2 prior years
Sources and Uses	√	√	√
Commitment of all Sources	√	√	√
Pro Forma	36 months	24 months	12 months
Debt Coverage Ratio	1.25 pre-CDBG 1.15 post-CDBG award	1.15 pre-CDBG 1.05 post-CDBG award	1.15 pre-CDBG 1.05 post-CDBG award
Loan Collateral	√		
Personal Guarantee for all owners with >20% ownership	√	√	√