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American South Real Estate Fund (ASREF)

CONVERGENCE
BLENDING GLOBAL FINANCE

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Executive Summary

The American South Real Estate Fund (ASREF) is a $58 million blended private equity fund investing in real estate projects in low- and moderate-income communities in the southern states of the United States. The Fund aims to support 15 projects across a breadth of real estate asset classes, including residential, office and multi-use developments, and in doing so, contribute to wider infrastructure rehabilitation, community revitalization and long-term local economic development in target neighbourhoods.

ASREF's mandate targets the persistent effects of certain discriminatory policies and lending practices of mainstream financial institutions in the American South since the 1930s. The Fund adopted a dual share class structure to:

- i enable the participation of small private foundations and first-time investors in high-impact real estate projects through Program Related Investment (PRI) instruments and
- ii channel market-rate investments from commercial banks to areas historically underserved by private credit.

ASREF's innovative blend of PRI and market-rate capital demonstrates a series of key learnings regarding the interplay between regulatory frameworks, lenders, and borrower needs, as well as the intricacies of philanthropic involvement in blended finance:

- Blended finance approaches can be strategically deployed to meet the needs of sponsors, investors, and borrowers.
- Policy, legal, and regulatory frameworks must promote the flow of the private sector into development activities.
- Philanthropic investors should more systematically adopt mandates for private sector capital mobilization when appropriate.
- Securing a prominent and experienced anchor investor can significantly improve the efficiency of the fundraising process.

SYNOPSIS

FUND MANAGER	American South Fund Management (ASFM)
FUND VINTAGE	2015
FUND SIZE	$58 million
FUND MANDATE	To invest directly or indirectly in real estate projects to generate long-term community development in low- and moderate-income areas while providing competitive risk-adjusted returns for investors.
PRIORITY REGION	**Ten states in the Southern US:** Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, and Texas
CAPITAL STRUCTURE	*Tier 1 – Class A shares* • $28.85 million *Tier 2 – Class B shares* • $6.5 million (PRI capital) *Targeted Investments* • $23 million
INVESTMENT INSTRUMENTS	• Mezzanine (preferred equity, subordinated debt) • Equity
FUND TERM	7 years
KEY IMPACTS TO-DATE	• 1,917 units affordable housing financed • 56% Area Median Income (AMI) of target population • 336 jobs created/retained

Introduction

The American South Real Estate Fund (ASREF, "The Fund") is a private equity fund targeting real estate investments in low- and moderate-income neighbourhoods in the American South[1]. The Fund was launched by SDS Capital Group, a California-based impact fund manager, and Vintage Realty, a commercial real estate firm operating across several states in the southern US. SDS Capital built a track record in real estate investment over several debt and private equity funds, each engaging a distinct geographic focus or impact mission, from providing supportive housing to individuals experiencing homelessness to stimulating local economic development through the construction of key industrial physical infrastructure. Likewise, Vintage Realty has an established portfolio of multi-family developments spanning 12 communities and over 2,500 units. ASREF targets the longstanding undersupply of capital that has stunted the rehabilitation and development of critical infrastructure, including affordable housing, in low- and moderate-income and minority neighbourhoods.

In the 1930s, key financial institutions and mortgage providers began adopting discriminatory lending practices whereby residents of certain neighbourhoods were refused credit access based on their income level, ethnicity, and/or racial composition, a tactic known as "redlining"[2]. This led to endemic credit shortages in affected communities, most of which were African American. By the mid-1950s and 60s, the scarcity of capital led to a significant deterioration of infrastructure, particularly housing. Over time, the inability to secure funds fuelled the cycle of poverty and embedded, among capital providers, the perception that these neighbourhoods exhibited an unacceptably high level of risk.

With ASREF, SDS Capital sought to increase the volume of capital reaching underserved communities from both private sector and philanthropic sources. SDS Capital identified that while scaled commercial financing sources are fundamental to the financial feasibility of real estate projects, impact-first or risk-bearing capital was also crucial to getting "riskier" or higher-impact projects off the ground. These types of capital, often provided by impact investors and private foundations, were also in short supply. Typically, the limited underwriting capacity of these smaller investors meant they could not meet the investment ticket sizes demanded by real estate development projects or private equity intermediaries when investing via traditional impact investment instruments (Mission Related Instruments or MRIs). Similarly, the high transaction costs associated with smaller commitments also made managing a fund comprised of such investments economically unfeasible.

SDS Capital and anchor investor, the John D. and Catherine T. MacArthur Foundation ("MacArthur"), addressed these investment barriers for private foundations by employing a tiered, blended finance fund structure that allowed foundations to participate through Program Related Investment (PRI) instruments. PRIs are concessional financial instruments unique to private foundations and charities in the US and deployed as impact-first investments, typically on below-market terms *(see Box I for an outline of PRIs)*.

Tranching ASREF into Class A shares and Class B shares (PRI) did three things;

- i it created an investment vehicle tailored to the needs of private foundations that deploy PRIs, enabling them to fund real estate development in low- and moderate-income communities;
- ii it enabled private foundations to participate without jeopardizing market risk-adjusted returns for Class A shareholders; and
- iii it enabled ASREF to raise more capital by creating a fund that would generate attractive returns for investors seeking both impact and market rates of return.

1 The American South (or southern United States) refers to a geographical and cultural area of the United States that spans from the Atlantic Ocean in the east to the eastern border of the state of New Mexico in the west, the Gulf of Mexico in the south, and the southern border of Pennsylvania in the north. It comprises 16 states in total, plus the federal district, the District of Columbia.

2 Redlining originated in the 1930s. The Home Owners' Loan Corporation, a federal government entity designed to refinance home mortgages to prevent foreclosures, created "residential security maps" for over 200 American cities to indicate the riskiness of real estate investment. The highest-risk neighbourhoods were classified as "Type D" and color-coded red on the maps (hence redlining). Many of these areas were considered low-income and were predominately African American. The rating system greatly influenced the lending activities of mainstream financial institutions, who deemed Type D neighbourhoods as ineligible for credit.

Program Related Investments (PRIs) – Overview

Program related investments (PRIs) are a type of financial instrument specific to US-based private foundations that are explicitly invested to further the impact mandate of the entity, with all potential financial returns or value appreciation considered ancillary.

Under the Internal Revenue Code (IRC) of the US Tax Code, private charities and foundations are subject to excise taxes if underlying investments jeopardize the carrying out of any of its core mandates. Such investments are termed imprudent investments. PRIs enable foundations to circumvent the prudency standards and deploy investments that may be considered imprudent (invested at a below-market rate, invested in high-risk opportunities). Additionally, PRIs can be applied to the tax code standard that requires at least 5% of private foundation endowment assets be deployed to charitable programming in order to maintain their 501(c)3 tax exempt status. The IRC outlines three tests that must be met for an investment to be classified as a PRI;

- (i) the primary exempt purpose test,
- (ii) the no significant investment purpose test, and
- (iii) the no political purpose test.

(i) PRIMARY EXEMPT PURPOSE TEST

The primary exempt purpose test contains two parts. First, the investment must significantly further the foundation's exempt, or core purpose activities. Second, the investment must be such that it would not be deployed except for its potential to further the foundation's core mandate.

(ii) NO SIGNIFICANT INVESTMENT PURPOSE TEST

No significant purpose of the investment can be the production of income or capital appreciation. The aim of the investment must prioritize impact generation, with expected financial returns considered an ancillary outcome. This test is automatically satisfied if the PRI is provided on concessional terms. Most PRIs from private foundations are priced on a below-market basis, typically between 0-15%. PRIs are not precluded from receiving market-rate returns. Market-rate return PRIs can pass muster if any factors differentiate the investment from one typically made by a purely profit-seeking investor, such as perceived higher risk or limited collateral.

(iii) NO POLITICAL PURPOSE TEST

The investment cannot influence legislation or intervene in any public office.

Determining PRI eligibility requires a legal opinion to verify all PRI tests are satisfied.

PRIs are often deployed to charitable organizations but can be deployed to for-profit borrowers. When invested in Limited Partnership (LP) structures, like ASREF, the downstream investments must also be monitored to ensure PRI obligations are met. All PRI investments have redemption rights. In the event that PRI capital is allocated to non-PRI conforming projects through the fund, the PRI provider has the right to request reimbursement of their investment.

Box 1: Program Related Investments

Design & Fundraising

CONCEPT

ASREF sought to generate community development impact across four key modalities:

- (i) The revitalization / stabilization of low- and moderate-income areas through the attraction and retention of businesses that employ the local population.
- (ii) Local economic development through the creation of permanent jobs.
- (iii) The creation and development of essential community services through improved public and private spaces.
- (iv) The creation of affordable housing.

Recognizing the opportunity ASREF could offer to commercial banks, the Fund aimed to have 100% of the portfolio aligned with the Community Reinvestment Act (CRA) criteria. The CRA is federal legislation passed in 1977 to address the discriminatory lending practices of commercial banks and encourage major financial institutions to meet the credit needs of all demographics in their service areas *(Box 2)*. Here, SDS Capital specifically targeted mid-sized commercial banks with substantial enough CRA obligations but lacking the functional capacity to initiate CRA transactions in-house, particularly their CRA investing requirements. While large capitalization banks possess the capacity for internally managed CRA direct lending / investing portfolios, mid-sized commercial banks are generally more willing to invest through CRA-focused financial intermediaries and innovative structures that allow them to shift the investing burden outside the firm.

ASREF was also able to offer a higher rate of return than alternative CRA-eligible community development investment schemes. For example, CRA-motivated investors in Low-Income Housing Tax Credits could expect yields between 3.5-6%, while ASREF projected a targeted yield consistent with market-rate value add real estate funds [3].

Community Reinvestment Act (CRA) – Overview

The Community Reinvestment Act was enacted in 1977 to:

- (i) encourage commercial banks to more equitably meet the credit and capital needs of all borrowers in their respective communities, regardless of demographic identifiers, and
- (ii) combat discriminatory lending practices, such as "redlining", that prevented access to capital for particular individuals based on demographic identifiers including, income level, race, and ethnicity.

The Act arose because of the common practice in the financial services sector to restrict lending in low- and moderate-income neighborhoods.

All commercial banks in the United States that receive Federal Deposit Insurance Corporation (FDIC) insurance are required to meet their respective CRA obligations (based on assets under management). The FDIC and the Office of the Comptroller of the Currency (OCC) evaluate commercial banks against their CRA requirements based on lending, investment, and client service tests. A number of financial instruments and general activities offered by banks can be considered as CRA-eligible, including direct and indirect loans or investments into low- and moderate-income neighborhoods. FDIC and OCC assessments produce public performance ratings. Low performance ratings may impact regulators' future decisions regarding mergers and acquisitions involving the bank or may restrict the bank's ability to expand into new communities.

Box 2: Community Reinvestment Act

3 Low Income Housing Tax Credits (LIHTCs) was created by the Tax Reform Act federal legislation in 1986 to spur greater levels of private equity investment in low-income housing developments. Authorized State and local LIHTC-issuing agencies provide tax incentives to private investors in exchange for equity in qualifying projects.

FUNDRAISING

ASREF was launched in early 2015 with a targeted size of $75 million to $125 million. At the outset of fundraising, SDS Capital was not intending to structure the fund using blended finance. However, SDS Capital encountered fundraising challenges, and there were concerns that ASREF might not achieve its minimum $30 million first close, much less the target capitalization. As a small private equity fund manager, SDS Capital had difficulty attracting capital from commercial banks.

An alternative potential investor pool was comprised of private foundations. ASREF's impact modalities aligned with the missions of private foundations focused on affordable housing and social and racial justice, however prospective foundations encountered investment roadblocks.

Private foundations invest the bulk of their endowments in traditional market instruments to maintain and grow the asset corpus, and thus grow the size of their philanthropic programming. To the extent that these foundations make impact investments, PRIs are used to prioritize impact creation over returns. Additionally, from a portfolio management perspective, PRIs count towards the tax code standard that requires at least 5% of private endowment assets to be paid out to charitable purposes. Most small foundations, however, lack the capacity, experience, and expertise to source, structure, and manage PRIs. For ASREF, this became a central barrier to sourcing private foundation participants. Such foundations were also prevented from investing through an MRI and / or traditional investment instruments, given the Fund's minimum investment requirement. A brief outline of MRIs is provided in Box 3.

MRIs vs PRIs

Mission Related Investments are common financial instruments used by private foundations that:

- (i) seek market-rate risk-adjusted returns while
- (ii) furthering the impact mandate of the foundation.

Unlike PRIs, MRIs have no legal definition and therefore are not explicitly governed by the IRC. However, MRIs are still subject to similar "prudency" standards, in that investments cannot jeopardize the continued existence of the foundation's core functions (i.e., taking on excessive financial risk). Where PRI standards enable foundations to circumvent the tax implications of imprudent investments, MRIs balance impact generation with financial return to grow endowment assets.

MRIs are drawn from the foundation's endowment or corpus assets and make up about 1% of foundation investments. To maintain their 501(c)3 tax exempt status, private foundations are required to allocate at least 5% of corpus assets to charitable programming. Unlike MRIs, PRI allocations can be applied to the 5% payout requirement. The remaining ~95% of endowment assets are invested through traditional market instruments.

Finally, MRIs take the form of many financial instruments, including direct equity, debt or mezzanine investments into companies or projects, or intermediated investments through funds. Conversely, PRIs are generally limited to below-market rate instruments.

Box 3: MRI vs PRI comparison

A turning point in ASREF's fundraising occurred in 2017, following SDS Capital's introduction to the MacArthur Foundation at the Mission Investors Exchange. The MacArthur Foundation had a strategy to extend the reach and effectiveness of the impact investing field. It saw ASREF as a value-add opportunity to mobilize smaller private foundations that traditionally faced barriers to investment in private equity funds. MacArthur pursued a syndicated investment that would bring together a consortium of private foundations investing through PRIs with the goal of creating an investment opportunity for new or first-time PRI investors.

A syndication would enable the individual foundations to meet the investment ticket threshold of ASREF and overcome the high transaction costs that made individual participation financially unfeasible.

However, MacArthur faced a series of obstacles in executing the syndication. First, there were regulatory barriers for a foundation acting as a financial intermediary on behalf of other foundations. Second, there were potential liability issues for MacArthur if it were to perform due diligence on behalf of other foundations.

At the proposal of MacArthur, SDS Capital restructured ASREF as a blended fund, adding a subordinated PRI tranche to allow for private foundation investment. Given MacArthur's experience with PRIs, the foundation played a key role in the redesign of the Fund. ASREF was tranched into two share classes;

- i Class A shares (commercial tranche) and
- ii Class B shares (PRI tranche).

Class A shares, offering a yield consistent with market-rate value add real estate funds, were marketed towards private sector investors, specifically commercial banks seeking CRA-accredited investments at market-rate returns, with Class B shares offering a return capped at 4% and geared towards impact-seeking private foundations deploying PRI capital. Critically for SDS Capital, the blended finance structure turned ASREF into a financially feasible investment for private foundations and unlocked a key funding source. SDS Capital was also strongly committed to the inclusion of PRI capital, encouraged by the enhanced impact it would allow the Fund to tap into, such as greater allocation to low-income neighbourhoods and the ability to fund lower-yielding but higher-impact investments sponsored by non-profit developers.

The PRI tranche allowed the MacArthur Foundation and other foundations to directly invest in ASREF rather than through a syndicated structure. By allowing smaller PRI investors to invest directly, the regulatory issues and potential liability risk to MacArthur involved in a syndicated structure could be removed. This enabled the Mary Reynolds Babcock Foundation (MRBF) and one other private foundation to directly participate in ASREF.

ASREF presented an attractive investment opportunity for MRBF that coincided with the foundation's racial equity mandate. MRBF initially sought MRI participation in ASREF, given the procedural simplicity relative to PRI instruments, but the creation of ASREF's PRI tier provided MRBF an inroad to invest. While MRBF possessed PRI investing experience, including through financial intermediaries, the foundation did not have real estate exposure in its PRI portfolio nor a track record investing in private equity funds. The MacArthur Foundation's anchor role, first in introducing the blended finance structure and then extending practical investment guidance, was fundamental to MRBF closing its largest-ever PRI investment to date, at $1 million.

The introduction of PRI capital into ASREF did present two main challenges, however. First, there was a risk that commercial investors would perceive the higher risk and lower returns of the PRI tranche as a potential risk to their goal of receiving market-rate returns. Given the Fund's pro rata (i.e., proportional) allocation strategy, the inclusion of lower-yielding PRI-qualifying investments into the portfolio could effectively dilute the Fund's expected returns. Second, there was the risk that the lower returns allocated to PRI investors would subsidize the market rate investors and thereby violate PRI requirements.

To address the first issue, the Fund's new tiered structure facilitated a distribution waterfall which capped yields to Class B investors at 4% to protect expected Class A shareholders from the potential diminished returns of PRI projects. The waterfall structure is outlined below *(Figure 1)*.

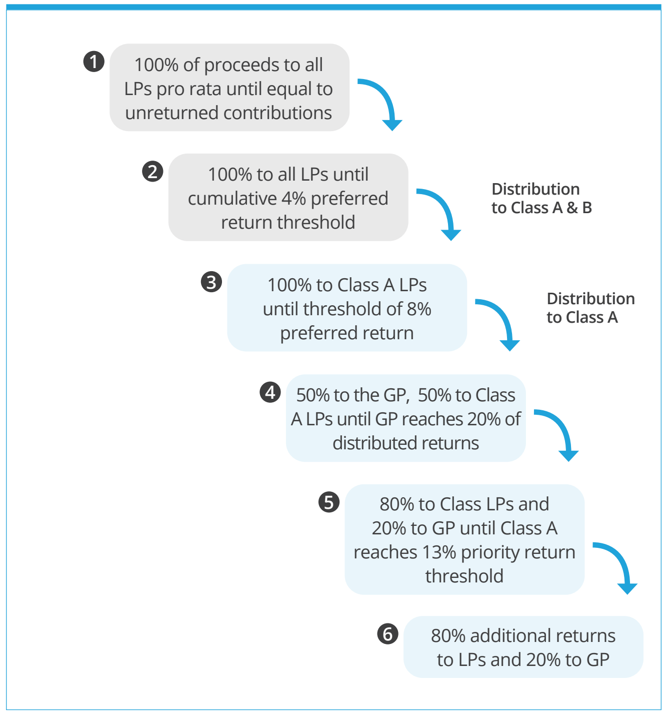


Figure 1: ASREF's distribution waterfall

Then, to ensure the Fund's PRI capital was being sufficiently allocated to high-impact PRI-eligible projects, SDS Capital also devised a PRI Investment Percentage Test. The test required that the percentage of capital allocated to PRI-eligible projects must equal or exceed the share of Class B shares of the Fund's total paid-in capital.

SDS Capital paired the PRI Investment Percentage Test with the PRI Evaluation Process to validate that ASREF's Class B capital would meet PRI requirements. Designed with the guidance of the MacArthur Foundation, the PRI Evaluation Process was an advance approval process determining the PRI eligibility of investee projects prior to the actual disbursement of capital from the Fund. SDS Capital selected Adler & Colvin, a law firm focused on non-profit representation, tax exemption law, and PRI verification experience, as its *PRI Professional*. In this role, Adler & Colvin would evaluate and verify potential projects for their alignment with the tax code's PRI tests, adapting the traditional legal opinion process. For MRBF, who lacked the expertise and exposure to real estate development, SDS Capital's capacity and commitment to carry out both the PRI Investment Percentage Test and PRI Evaluation Process was a critical draw to invest in ASREF. The PRI Evaluation Process is outlined in greater detail in the *Investment Criteria* section below.

Finally, from SDS Capital and Vintage Realty's perspective, the MacArthur Foundation's investment acted as a vote of confidence for the Fund's management, and expected impact and returns. The size of MacArthur's investment reinforced this positive market signal; the foundation committed $7.5 million, tranched into $4 million in Class A (MRI) capital and $3.5 million in Class B (PRI) capital, making them one of the Fund's largest investors. Following the MacArthur Foundation's involvement, SDS Capital was able to secure new commitments from commercial banks and closed the Fund in 2019 at a total size of $58.35 million.

Capital Structure

ASREF is a $58.4 million dual-tiered blended finance fund comprised of Class A shares ($28.9 million) and concessional Class B shares ($6.5 million). ASREF also includes $23 million in Class A Targeted Investments from three commercial bank investors. A breakdown of the Fund's capitalization is provided in *Table 1*.

Investor	Capital class	Commitment Size (USD millions)
Commercial Bank	A	5
	A	10 *(Targeted investment)*
Commercial Bank	A	5
	A	3 *(Targeted investment)*
Commercial Bank	A	5
	A	10 *(Targeted investment)*
Investor	A	0.5
Investor	A	3
Investor	A	3
Investor	A	3
MacArthur Foundation	A	4
ASFM Sponsor Investor	A	0.254
ASFM GP	A	0.1
Sub-Total		**51.85**
MacArthur Foundation	B (PRI)	3.5
Mary Reynolds Babcock Foundation	B (PRI)	1
Private Foundation	B (PRI)	2
Sub-Total		**6.5**
Fund-Total		**58.35**

Table 1: ASREF fund structure and capitalization

Class A LPs consist primarily of small- and mid-sized commercial banks seeking (i) expected returns commensurate with the market rate for mezzanine debt investment in real estate development and (ii) fulfillment of their CRA lending requirements. The MacArthur Foundation was the only foundation to participate in the Fund's Class A tranche. The current projected net yield for Class A shareholders is within the range targeted by ASREF. Class B shares were created to allow for the financial participation of private foundations through PRI instruments. The current projected yield for Class B shareholders is 4%.

ASREF's pro-rata allocation strategy meant that including PRI projects in ASREF's portfolio increased the perceived risk for Class A investors seeking market-rate returns. To overcome this challenge, PRI commitments to ASREF were priced on concessional or below-market terms. Again, it is important to note that while PRI investments are expected to have below market-rate returns, actual returns may vary depending on investment risk. With returns to PRI investors capped at 4%, Class A investors could expect a higher overall return (primarily generated by the non-PRI portfolio projects). Likewise, lower expected returns among Class B investors provided adequate downside coverage to Class A shareholders, given the higher unsystematic risk of PRI projects.

Investors that made a minimum $5 million investment in the ASREF Feeder Fund had the opportunity to form a "Targeted Investment", a separate tranche of capital that invests alongside feeder fund investments in the specific geographic areas of the targeted investor's choosing (outlined in the investors side letter). The Targeted Investment offers many of the same features as a co-investment. Targeted Investments are primarily intended for banks that need additional investment in their specific CRA assessment areas. The split between ASREF Feeder Fund capital and Targeted Investment capital is determined in good faith by the GP. The economic terms of the Targeted Investment (management fee, waterfall, etc.) match the feeder fund's economic terms. All Targeted Investment funders are also Class A LPs.

Legal Structure & Governance

ASREF acts as a feeder fund under a master-feeder structure *(Figure 2)*. The ASREF Feeder Fund, LP is a Delaware Limited Partnership formed in 2017. The purpose of ASREF Feeder Fund, LP is to invest directly or indirectly through mezzanine and equity instruments into real estate projects throughout the targeted ten-state fund footprint with the intent to generate community and / or economic development. With the exception of a single portfolio investment, all investments are made directly or indirectly via the American South Real Estate Fund (master fund). The American South Real Estate Fund is a Delaware limited partnership formed in 2015 which shares the same purpose as the ASREF Feeder Fund, LP. The master fund has four Class A LPs: the ASREF Feeder Fund, LP, and three commercial banks. ASREF Feeder Fund, LP assets (Class A and Class B share capital only) are invested into the master fund with proceeds disbursed to portfolio investments. The remaining master fund assets are commercial bank "Targeted Investments". Targeted Investments are invested by the American South Real Estate Fund alongside the ASREF Feeder Fund, LP capital at the discretion of the GP.

ASREF Feeder Fund, LP is managed by ASFM GP, LLC (the General Partner) and American South Fund Management, LLC (the Manager), who jointly share the investment and other operational responsibilities of the Fund. The American South Real Estate Fund (master fund) shares the same General Partner and Manager. American South Fund Management, LLC is a 50/50 joint venture between SDS Capital Group, a California-based fund manager focused on investing in economic development, and Vintage Realty, a Louisiana-based commercial real estate firm.

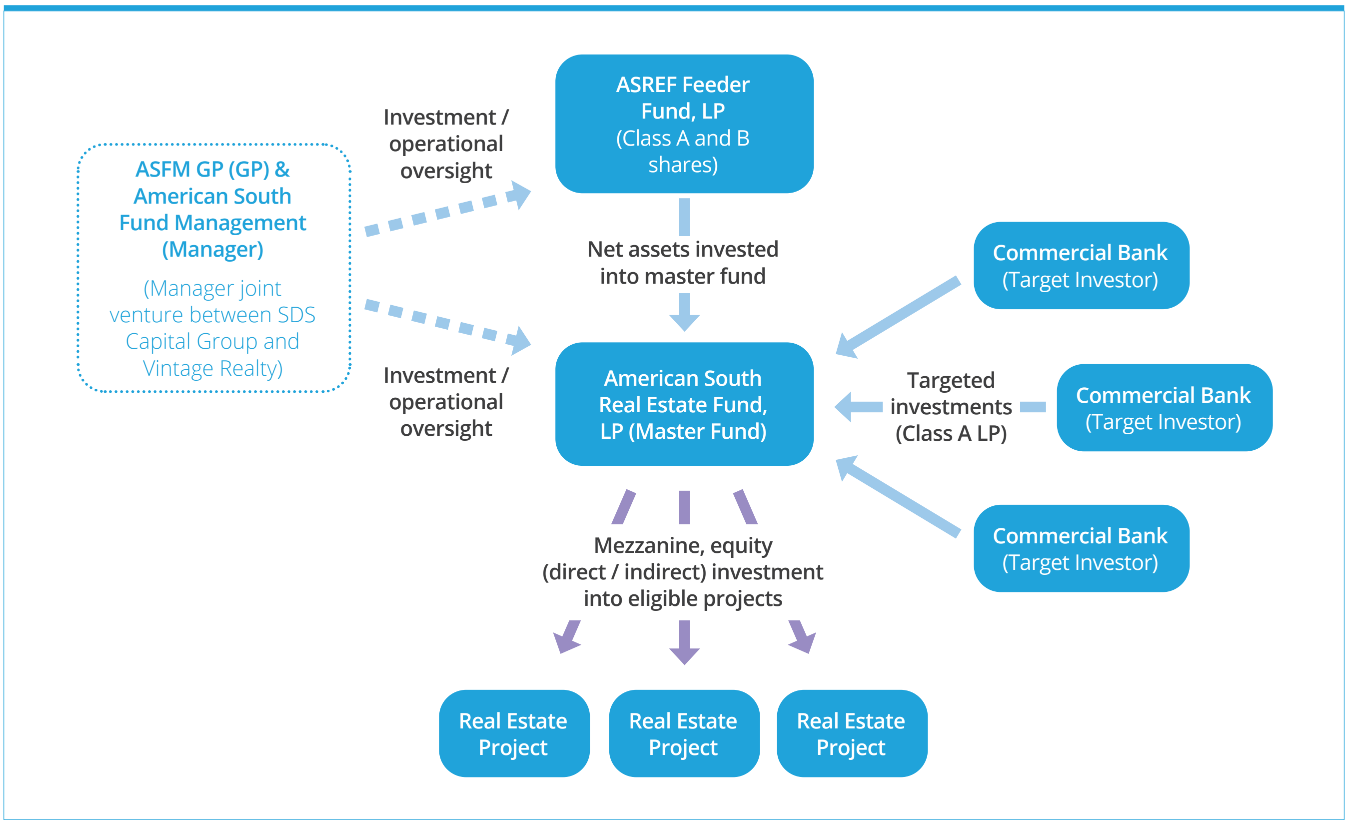


Figure 2: Legal architecture of American South Real Estate Fund

Operations

INVESTMENT CRITERIA

ASREF's investment mandate centers on developing affordable residential and commercial real estate projects in low- and moderate-income neighbourhoods to facilitate economic development in communities underserved by mainstream investment while generating market-rate financial returns for its Class A investors.

The Fund's geographical remit targets secondary and tertiary cities in 10 states in the American South[4]; Alabama, Arkansas, Florida, Georgia, Louisiana, Mississippi, North Carolina, South Carolina, Tennessee, and Texas. Historically, communities in the targeted region have contended with the discriminatory investment practices that led to the creation of the CRA. There has also been an enduring scarcity of alternative types of capital (impact investment) in these communities.

Eligible investee projects span six sub-types of real estate assets;

- (i) multifamily;
- (ii) office-use;
- (iii) mixed-used office / retail;
- (iv) mixed-use multifamily / retail;
- (v) hospitality; and
- (vi) industrial.

ASREF primarily targets redevelopment rather than greenfield projects due to the shorter expected absorption periods[5].

ASREF uses Area Median Income (AMI) as the primary determinant of the affordability of the underlying projects. AMI refers to the median household income of a region's household income distribution. The CRA classifies low income as an area with a median household income 50% or less than the overall region's AMI. Moderate-income areas are those with an AMI 51% to 80% of the overall region's AMI. ASREF targets the creation of units affordable for those with incomes at or below 80% of AMI.

PRI SPECIFIC INVESTMENT CRITERIA

When sourcing PRI projects, ASFM sought specific transaction characteristics that would easily meet the tax code safe harbours for PRI eligibility, such as projects sponsored by charitable or non-profit entities and opportunities that could maximize impact generation (lower AMI levels). However, to the fund manager's surprise, a limited pipeline of investable projects matched these criteria. Most charitable and non-profit sponsor organizations did not meet ASREF's underwriting capacity requirements and / or lacked the internal expertise to execute the projects within an appropriate timeline. In fact, ASREF withdrew participation or exited a project prior to completion due to sponsor-related underperformance in two PRI investments and one MRI investment.

Another issue concerned the cost of ASREF's capital for borrowers seeking to deliver projects with a very high level of impact (50% AMI and under). Despite lowering projected (IRR) expectations for PRI transactions, ASREF pricing remained expensive for many borrowers, given risk premiums due to non-performance risk.

The PRI Evaluation Process allowed ASREF to meet the PRI tests by satisfying other charitable prerequisites deemed sufficient under the tax code. For example, the primary exempt purpose test could be met by demonstrating the project's wider economic and neighbourhood revitalization impacts, including job creation and the return of industry to the area. Likewise, the lower expected IRR of an investment into a PRI-eligible project could enhance the "charitable" intention of the investment. There may also exist exogenous factors that increase the charitable purpose of the underlying project, including government policy or regulations that dictate the level of affordability the project must deliver.

Naturally, the PRI Evaluation Process increased the complexity of the Fund's investment process and was an onerous procedure for the PRI Professional, Adler & Colvin. As a market-returns seeking fund, ASREF still had a fiduciary responsibility to all investors, despite investing in high-impact PRI projects. The need to balance these competing interests further complicated the PRI Evaluation Process.

4 Secondary cities fall below primary cities on the urban hierarchy on the basis of population, geographic size, function, and economic importance. Tertiary cities follow on from secondary cities across the same characteristics. Secondary cities receive less investment attention than primary cities, with tertiary receiving an even smaller share, leading to less infrastructure development and shallower markets.

5 Absorption period in the context of real estate development refers to the amount of time it takes between the start of an investment and the generation of leasing income.

The stages of the PRI Evaluation Process are as follows:

- i ASFM identifies a potential PRI-eligible transaction and provides the PRI Professional (Adler & Colvin) with requisite investment details, generally outlining returns potential and projected impact (e.g., job creation, % AMI affordable housing, community revitalization pathways).
- ii PRI Professional evaluates the transaction according to the IRC and underlying PRI tests (primary exempt purpose test, no significant purpose test, no political purpose test).
- iii ASFM and PRI investors evaluate the PRI Professional's opinion.
- iv PRI Professional responds to outstanding issues, factors in any investment adjustments to the evaluation, and provides a final assessment on whether the investment qualifies as PRI.
- v At the end of each fiscal year, ASREF must deliver a PRI report to relevant investors.

The PRI Investment Percentage Test was an additional facet of the Fund's investment strategy that safeguarded the PRI eligibility of each private foundation investment. Tests were conducted one year after each PRI commitment to the Fund was finalized and thereafter annually after the final closing date of the Fund to update PRI investors on ASREF's performance against the minimum PRI disbursement requirement. At full fund capitalization, at least 12% of ASREF's paid-in capital was to be allocated to PRI projects. ASREF fully invested all PRI capital in 2021.

INVESTMENT PROCESS

ASREF invests mezzanine debt and / or equity capital in eligible real estate projects in its targeted region. The project pipeline is sourced and assessed by ASFM. Following the project due diligence phase, projects are selected for investment. Capital is called from Class A and B shareholders in the ASREF Feeder Fund, LP, and targeted investors, which then passes through to the master fund, the American South Real Estate Fund, LP. Assets are disbursed from the master fund to real estate projects. For PRI projects, the PRI Evaluation Process must be performed, and PRI status confirmed, prior to any disbursement of capital.

SDS Capital also devised an impact methodology that is incorporated throughout the investment process for all investments. The objective of the methodology is to appropriately determine the potential impact generated through investment, confirm CRA eligibility pre-investment and ensure strong measurement, reporting, and verification of impact outcomes post-investment. The methodology analyzes five overarching areas of impact:

- i economic;
- ii fiscal;
- iii economic development;
- iv community and social; and
- v environmental.

Figure 3 illustrates how the impact methodology is integrated into the stages of investment:

Pre-investment → **Public welfare & CRA assessment**
- At initial underwriting, impact fit of investment assessed against fund mission
- If public welfare fit and CRA eligibility is confirmed investment process continues

At-closing → **Information collation**
- Interviews conducted with sponsor, development teams, local governments and community stakeholders to help determine community needs and projected project impacts

Post-close → **Economic & fiscal impacts**
- SDS Capital uses IMPLAN[6] to incorporate projected economic and fiscal impacts into impact reports

Post-stabilization → **Impact updates**
- ASREF provides quarterly impact reports to investors

Figure 3: The integration of ASREF's impact methodology into the investment process

6 IMPLAN is a computer-based modeling system used by public agencies, non-profits, and research organizations to map flows of economic activity between sectors in a specified region to determine the dollar value of goods and services.

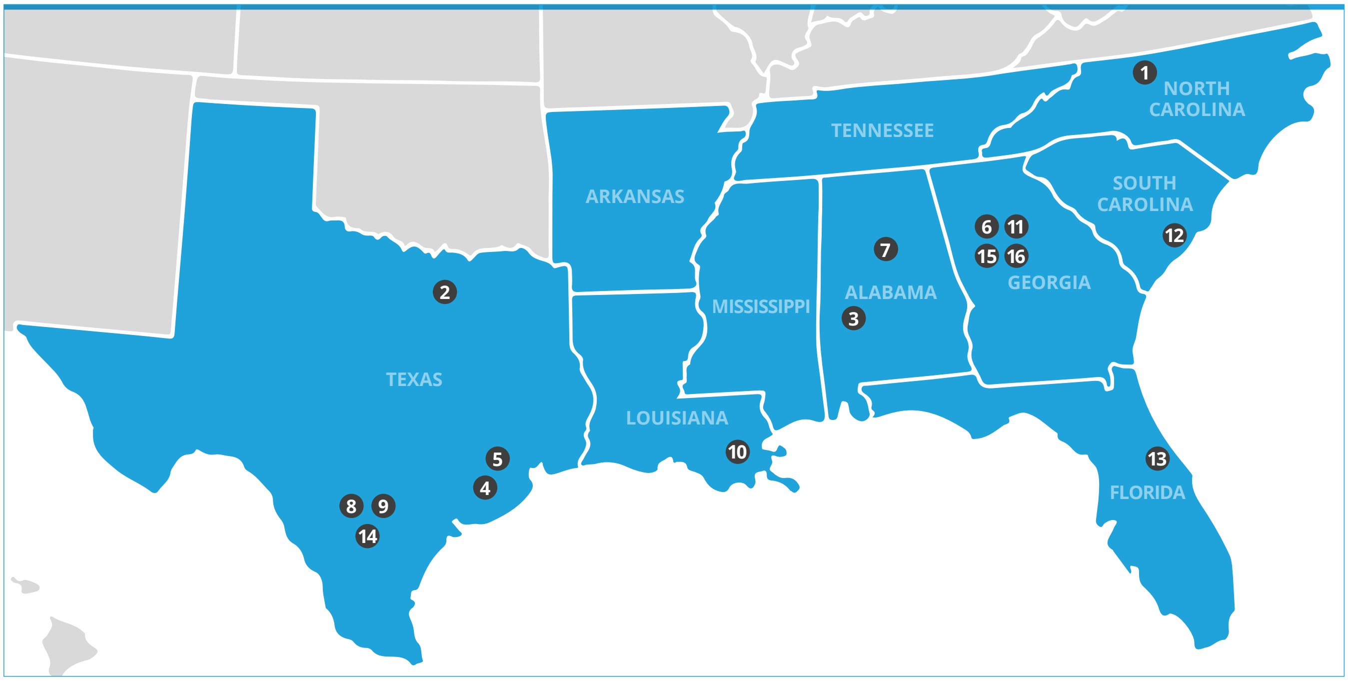


Figure 4: Investment activity across 10 targeted states

ASREF has invested in 15 real estate projects across seven of its 10 targeted states *(Figure 4)*. At the time of writing, ASREF exited eight investments, with three investments fully or partially exited early due to the lack of sponsor capacity to perform or the result of a project redesign that no longer aligned with ASREF investment criteria. Two of these three projects were PRI-eligible.

Multifamily developments have been the asset class of focus for ASREF, comprising over 70% of investments.

	Project	Asset type	Location	PRI	Investment Date	ASREF Commitment Size (USD)
1	Chatham Hill	Office	Winston-Salem, NC	N	Apr 18	~1M
2	Lancaster Rd.	Office/Retail	Dallas, TX	N	Jan 19	~2.1M
3	St James Hotel	Hospitality	Selma, AL	N	Mar 19	~3.4M
4	Park View	Multifamily	Houston, TX	N	Apr 19	~3.9M
5	West Park	Multifamily	Houston, TX	N	Aug 19	~4.9M
6	The Langston	Multifamily	Atlanta, GA	N	Aug 19	~4.6M
7	Kelly Hotel	Hospitality	Birmingham, AL	N	Dec 19	~3.4M
8	Friedrich Lofts	Multifamily	San Antonio, TX	N	Aug 20	~7.9M
9	Friedrich Lofts			Y		~3.5M
10	VPG New Orleans	Multifamily	New Orleans, LA	N	Dec 20	~2.8M
11	1200 Mobile	Multifamily	Atlanta, GA	Y	Apr 21	~2.6M
12	The Preserve at Ridgeville	Multifamily	Charleston, SC	N	May 21	~7.0M
13	The Preserve at Flagler Beach	Multifamily	Flagler Beach, FL	N	June 22	~2.8M
	Withdrawn Investments					
14	Brooks Industrial One	Industrial	San Antonio, TX	N	Sep 18	~3.3M
15	Wheat Street	Office	Atlanta, GA	Y	Jun 19	~35K
16	The Front Porch	Multifamily	Atlanta, GA	Y	Aug 20	~700K

Table 2 – ASREF portfolio summary

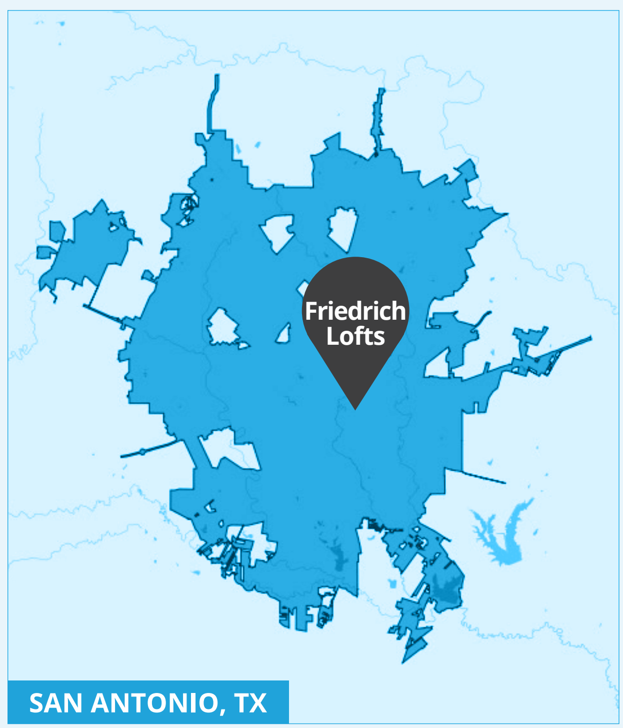
Investment example – Friedrich Lofts, San Antonio, Texas

The Friedrich Lofts project involves a $70 million redevelopment of a former manufacturing complex in a historic African American neighbourhood in San Antonio's East Side into a 347-unit multifamily housing development. The industrial site had laid vacant since the early 1990s. The project was structured as a public-private partnership between Provident Realty Advisors (PRA), a real estate developer and investment firm, and the San Antonio Housing Trust Public Facility Corporation (SAHT), a municipal corporation focused on the revitalization of San Antonio's low- and moderate-income neighbourhoods and downtown area.

The site was of high priority for development for multiple reasons. The area was characterized by high rates of unemployment (13%) and low AMI (47%), with more than two-thirds of residents in the neighbourhood living below the poverty line. The site presented an opportunity to improve the availability of affordable housing - an essential aspect of poverty alleviation. The neighbourhood was also part of a wider municipal effort to restore the major corridors to San Antonio's Central Business District, bringing investment and commerce to the downtown core and the surrounding communities. The Friedrich Lofts site could kick-start that process in San Antonio's East Side and spur broader economic development, signaling to businesses the new availability of investment capital in the area.

PRA encountered difficulties identifying appropriate investors. The project was considered to have elevated construction risk, including the need for environmental remediation of the site. The project also carried a degree of political risk connected to the potential gentrification implications of the development. While there was no shortage of interested capital, particularly among private equity firms, the cost of available capital far exceeded what was feasible for the borrower. High capital costs would jeopardize the project's impact potential, necessitating an increase in unit prices.

The Friedrich Lofts project was ASREF's only dual-tranched market-rate / PRI investment. ASREF was drawn to the project because of the balance between revenue potential and impact generation. The project carried with it a tax abatement stipulation that required additional affordability requirements. At least 50% of the units were to be affordable at 80% AMI (CRA eligible), while 14 units were to be designated at 60% AMI or lower. The remaining units were priced at market. The Fund extended a $3.5 million mezzanine PRI loan as bridge funding until permanent construction debt was secured. The bridge loan was vital in that it enabled project development activities to continue and improved project bankability, easing the sponsor's fundraising pressures and enhancing the prudence of ASREF's commercial equity investment. ASREF's $7.9 million in Joint Venture equity was still considered expensive by the project sponsors, and ASREF's proposed investment size would necessitate SAHT ceding some of its shares in the project. However, the sponsors deemed the community impact outcomes outweighed the ownership and affordability implications. Project financing was closed in late 2020, and ASREF's PRI mezzanine loan is expected to be wholly retired in 2023. Construction is expected to be completed in 2025.



Box 4: Friedrich Lofts Investment

IMPACT METRICS

The primary dimension of ASREF's impact mandate is poverty alleviation in low- and moderate-income communities through better access to affordable housing. The Fund uses rental rates relative to AMI as the principal indicator to track against this objective. ASREF's impact mission also includes stimulating community-wide economic development through the financing of critical real estate projects. Housing and employment creation metrics were devised to identify the types of housing units created and jobs created to capture the Fund's contribution to higher and more stable incomes. Finally, ASREF has the commitment to promote racial equity through its investments to improve the availability of affordable capital in communities historically underserved due to discriminatory lending practices. This includes tracking the proportion of ultimate recipients according to racial demographics and the share of minority-led project sponsors. Table 3 provides an aggregate summary of ASREF's impact across its primary impact metrics.

	Impact Metric	Class A Transaction Totals*	Class B Transaction Totals*
Poverty	Poverty Rate	36%	31%
	AMI	54%	54%
	Unemployment Rate	17%	13%
Community Demographics	Minority Population	73%	95%
	African American Population	50%	28%
Jobs	Direct Operations Jobs Created/Retained	328	8
	Indirect Jobs Created	67	3
Housing	Housing Units Created	1,530	387
Fund Totals *			
	Low- and Moderate-Income Affordable Housing	71%	
	Workforce Housing	19%	
	Developers are African American	3/13	

Table 3: Averages of the 15 census tracts across ASREF's portfolio

*Some figures include projected data given pending ASREF exit

Follow-on Structure

SDS Capital and Vintage Realty launched ASREF II in 2021 and achieved a first close of $28 million in the summer of 2021. The follow-on fund expects to raise between $150 - $250 million at full capitalization, committing between $7.5 - $20 million per investment through similar financial instruments as ASREF I.

ASREF II is set to adopt a comparable impact investment strategy to its predecessor, targeting the creation of affordable housing and commercial real estate assets to facilitate economic development in low- and moderate-income neighbourhoods in the American South, including CRA-eligible projects. The second fund will not be structured as a blended finance fund; ASREF II will have a single-class structure comprised entirely of commercial capital. The key reason behind the decision was the intention to attract pension funds and other large institutional investors that require market rates of return to participate. The fiduciary responsibilities of pension funds necessitate internal investment policies that prevent participation if a transaction has particular characteristics that increase its perceived risk profile. This may include the key deal elements, such as a non-profit project sponsor, sometimes required for PRI eligibility. Likewise, it was deemed that the inclusion of PRI capital elevated the complexity of ASREF I's investment operations beyond what was likely feasible for large-scale investors, as deploying the PRI capital within a tight time frame proved challenging. SDS Capital and Vintage Realty did consider that a sufficiently sized PRI tranche, anchored by a prominent investor like the MacArthur Foundation, could justify the additional complexity introduced by a blended structure. However, there were concerns that an adequate amount of PRIs could be secured. The MacArthur Foundation specifically could not participate in ASREF II due to shifting investment priorities. Finally, the impact performance of ASREF I confirmed that a wholly commercial fund could still produce an exceptional degree of community impact. In ASREF II, American South Fund Management aims to grow impact generation by raising more total capital and disbursing to a greater number of projects rather than increasing the share of very high impact projects (60% AMI or lower) in its portfolio. As of March 2023, ASREF II is capitalized at $114 million and has financed six projects totaling 1,475 housing units with 84% affordable at less than 80% AMI.

Key Insights

Blended finance approaches can be strategically deployed to meet the needs of investors, sponsors, and borrowers.

First, re-structuring ASREF as a blended finance fund mitigated the investment risks associated with PRI projects, exposing commercial bank capital to opportunities typically beyond their traditional portfolios. That is, tranching ASREF into Class A and B shares brought PRI-eligible projects into the Fund's remit. Secondly, blended finance made the Fund economically feasible and helped close out the fundraising process. Even while ASREF aligned with commercial bank CRA obligations, there was still insufficient appetite from this investor class to wholly capitalize the Fund. Blended finance was required to pivot ASREF's strategy to secure private foundation capital and launch the Fund. Finally, blended finance enabled ASREF to meet the capital demands of both market-rate and PRI projects.

Challenges did arise, however. Incorporating Class B shares increased complexity for investors and the fund managers, by adding the PRI Investment Percentage Test and PRI Evaluation Process to the investment procedures. In terms of fundraising, soliciting commitments from an entirely new investor class required SDS Capital and Vintage Realty to consider potential new issues, PRI disclosure standards. Allocating capital also met with new challenges, for example, the inadequate pipeline of PRI projects delivered by capable project sponsors able to take on commercial debt. Similarly, ASREF financing remained expensive for some PRI borrowers, given ASREF's return on investment (ROI) expectations.

SDS Capital's commitment to ASREF's impact mandate ensured these challenges did not jeopardize the Fund's ROI nor its development potential and shows the value of a strong and experienced manager in this respect. However, a cost-benefit analysis weighing the additional responsibilities for the fund manager of a blended finance structure against the potential impact and capital mobilization upside should be considered. Likewise, certain asset classes may necessitate adapting returns criteria to meet unique capital cost requirements. This is particularly important in investment scenarios where the borrower has typically relied on concessional or public funding sources and is transitioning to market financing. Finally, like any returns-seeking investment vehicle, blended finance structures can still restrict an investment's impact potential if capital is too costly for borrowers.

Policy, legal and regulatory frameworks must promote the flow of private sector and impact investment to development activities.

Two key pieces of legislation were at play for ASREF and its investors – the Community Reinvestment Act (CRA) and the Internal Revenue Code (IRC). Designed to overcome the discriminatory lending practices of mainstream financial institutions during the 1960s and 1970s, the CRA explicitly intends to increase the availability and affordability of private credit to historically underserved communities. This type of "push" factor has unlocked critical sources of capital.

Blended finance funds like ASREF, which offer risk mitigation benefits to Class A investors through subordinated and higher-risk share classes, act as "pull" factors by creating investable assets that appeal to private investors. However, blended finance funds rely on an adequate supply of concessional or risk-bearing capital. Restrictive regulations, such as the PRI principles in the IRC, stifle the availability of below-market, impact-seeking investments. As evident in the investment processes of ASREF, determining PRI eligibility is highly contextual, leading to little standardization in the approval process. The PRI principles also add significant complexity to the investment process, requiring the creation of bespoke frameworks like ASREF's PRI Evaluation Process.

The added steps often put sizeable PRI investments beyond the feasible capacity of most private foundations and deter exposure to new asset classes and impact modalities where there is less familiarity. With fewer conditions and prerequisites attached to concessional capital, there is also a greater likelihood of attracting key investor types, particularly institutional investors. A regulatory and legal environment more attuned to the financial additionality aspects of risk-bearing capital like PRI can help increase its availability in the market. A greater supply of concessional philanthropic and public capital can also enable the creation of blended funds with a higher share of concessional investment to serve the specific cost of capital limitations of high-impact project developers.

Philanthropic investors should more systematically adopt mandates for private sector capital mobilization where appropriate.

The mandates of private foundations are highly diverse and can be highly specific. Each participating foundation in ASREF found linkages between the Fund's investment strategy and its own impact mission. For example, MRBF was drawn by ASREF's impact on racial equity in the target region, and a core rationale to invest for the MacArthur Foundation was the generation of financial additionality. Community and real estate development in the American South was contending with the longstanding scarcity of commercial credit and impact investment to CRA-eligible projects. In areas served only by small commercial banks or overlooked by the mandates of impact-oriented investors, "CRA deserts" emerged.

ASREF presented an innovative solution; a fund that:

- (i) met the needs of CRA investment-seeking commercial banks;
- (ii) delivered increased amounts of capital to community development projects underserved by private sector investors; and
- (iii) did so while generating market-rate returns.

By enabling private foundation participation through the restructuring of ASREF into a blended finance fund, the MacArthur Foundation not only catalyzed investment into the Fund, but in doing so, allowed the Fund to reach financial close and begin allocating capital. Moreover, private foundations can apply similar strategies to target increased private sector investment flows specifically, through the strategic deployment of risk-bearing capital into blended finance structures, whether through PRIs or other concessional instruments. Philanthropic investors, with their ability to invest through both commercial and concessional instruments, occupy a unique position in blended finance. A wider commitment from this investor class to integrate private sector mobilization objectives into their investment mandates would also see private foundations effect more significant impact aligned with their mandates.

Securing a prominent and experienced anchor investor can improve the efficiency of the fundraising process.

Blended finance has yet to enter the mainstream investing or borrowing activities of many investors, fund managers, and users of capital. Attracting a well-known investor with experience in the field accelerates and improves the efficiency of the fundraising process and supports transaction design. For SDS Capital, the MacArthur Foundation's participation demonstrated to the market the viability of ASREF's investment and impact strategy at a time when the fund manager was experiencing difficulties attracting commitments.

For new market-based approaches, a prominent anchor investor can be crucial to transitioning opportunities from near-bankable to investable assets. Large investors are perceived to have substantial investment expertise, rigorous investment procedures, and strong monitoring capacity, factors that help ensure prudency of opportunities pre-investment and adequate governance and oversight post-investment.

Convergence commonly observes this trend following the investment of Development Finance Institutions and Multilateral Development Banks into less proven transaction structures. Moreover, smaller investors on occasion can receive trickle-down benefits, including shared due diligence and underwriting, from more experienced investors. Investors with past blended finance experience also possess valuable knowledge of the different investment expectations across investor types. This can be informative with regard to transaction design. For example, MacArthur's understanding of PRIs and the investment constraints of smaller private foundations helped influence and inform the restructuring of ASREF into a dual-tiered fund.

CONVERGENCE
BLENDING GLOBAL FINANCE

CONVERGENCE is the global network for blended finance. We generate blended finance data, intelligence, and deal flow to increase private sector investment in developing countries.

BLENDED FINANCE uses catalytic capital from public or philanthropic sources to scale up private sector investment in emerging markets to realize the SDGs.

Our **GLOBAL MEMBERSHIP** includes public, private, and philanthropic investors as well as sponsors of transactions and funds. We offer this community a curated, online platform to connect with each other on blended finance transactions in progress, as well as exclusive access to original market intelligence and knowledge products such as case studies, reports, trainings, and webinars. To accelerate advances in the field, Convergence also provides grants for the design of vehicles that could attract private capital to global development at scale.