Sandy Creek Partners

CB WEBINAR Series 2020

The Business of Banking

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Habitat Conservation

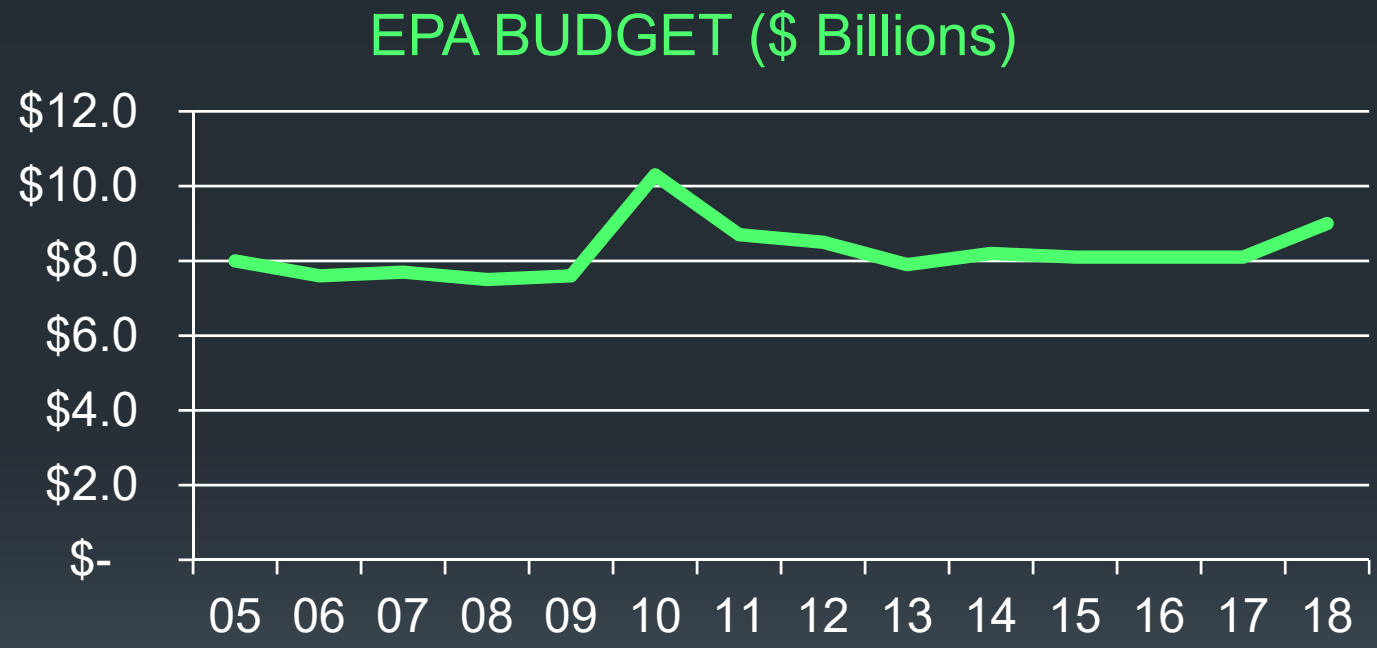
- A public good and a moral imperative
- Government / NGOs have led the way
- Much more conservation to do
- Conservation is expensive
- Where is the needed funding?

Comparative dollars...

- TCF Assets $ 0.5 Billion
- TNC Assets $ 8 Billion
- US FWS Annual Budget $ 3 Billion (= one Naples firm)
- US EPA " " $ 9 Billion
- US Private Equity Funds $ 2 TRILLION of "dry powder"
- US IRA Accounts $ 11 TRILLION
- US Retirement Assets $ 32 TRILLION

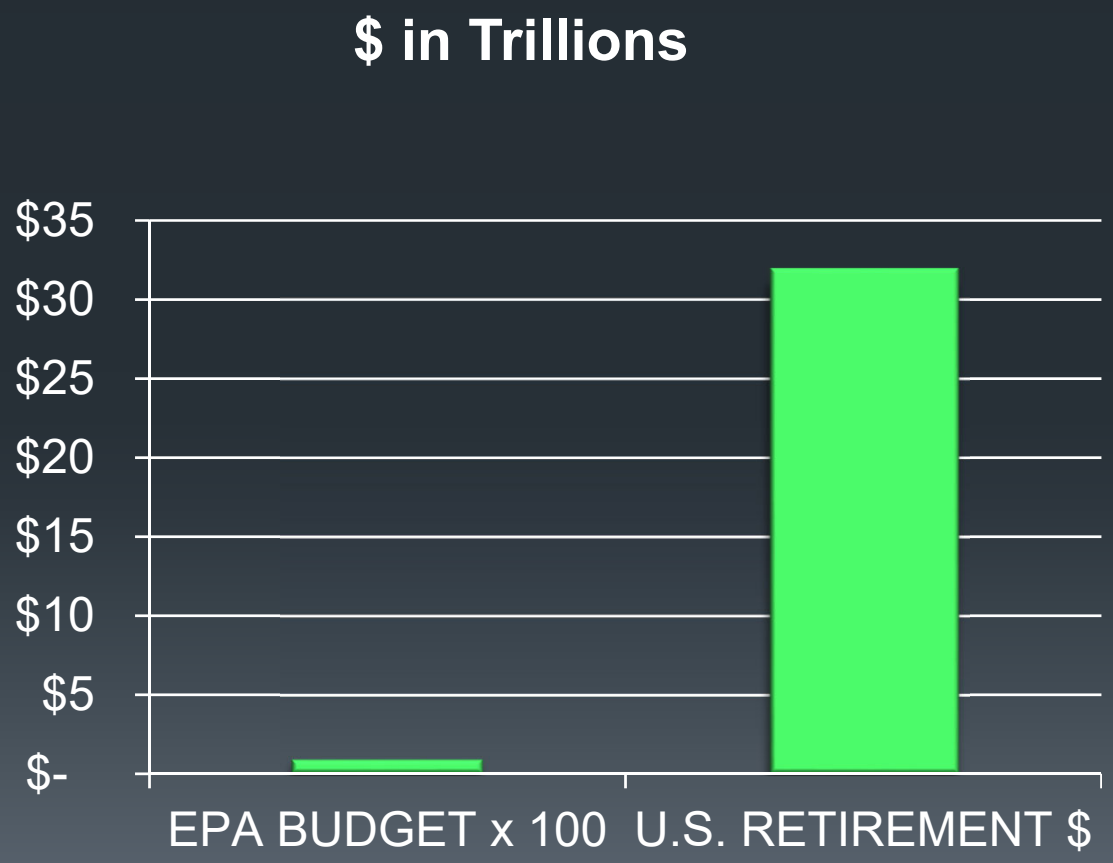
(about 4,000 times larger than TNC Assets)

Comparative trajectory...



By comparison, over this same 12 year period, U.S. Retirement Assets up over 100% to $32 Trillion

Comparative scale...



Private $$: Huge funding source but relatively little "green" investing

- U.S. Pension $$ pouring into "alternative" investments....up from 5% to 28% of assets in past 16 years.
- Of the $7 Trillion invested in Alternative assets, less than one-tenth of 1% (.001) is estimated to be invested in conservation / wetland habitat projects.
- Enormous missed opportunity for conservation.
- QUESTION: if more of this private money is drawn to mitigation, what will likely happen to the amount of advanced restoration and the cost of mitigation?

How to attract more of these huge investment dollars to conservation?

- In many ways this **is** "The Business of Banking"
- Investment dollars fundamentally directed to:

  returns > alternative returns
  (on a risk adjusted basis)

- Bankers must provide competitive returns to obtain funding for conservation...it's their funding source and "cost" of capital
- Note this is one key difference between private bank and non-profit ILF...private bankers must "***rent***" their capital

What are “Returns” anyway?

- Returns are profits the Bank must expect to earn in order to pay investors for the capital provided
- So profits reflect a cost to the Bank for the capital it uses...the “rent” they must pay
- PROFIT is the.....

  RENT that goes to the investor for their capital

What are “risk adjusted” Returns?

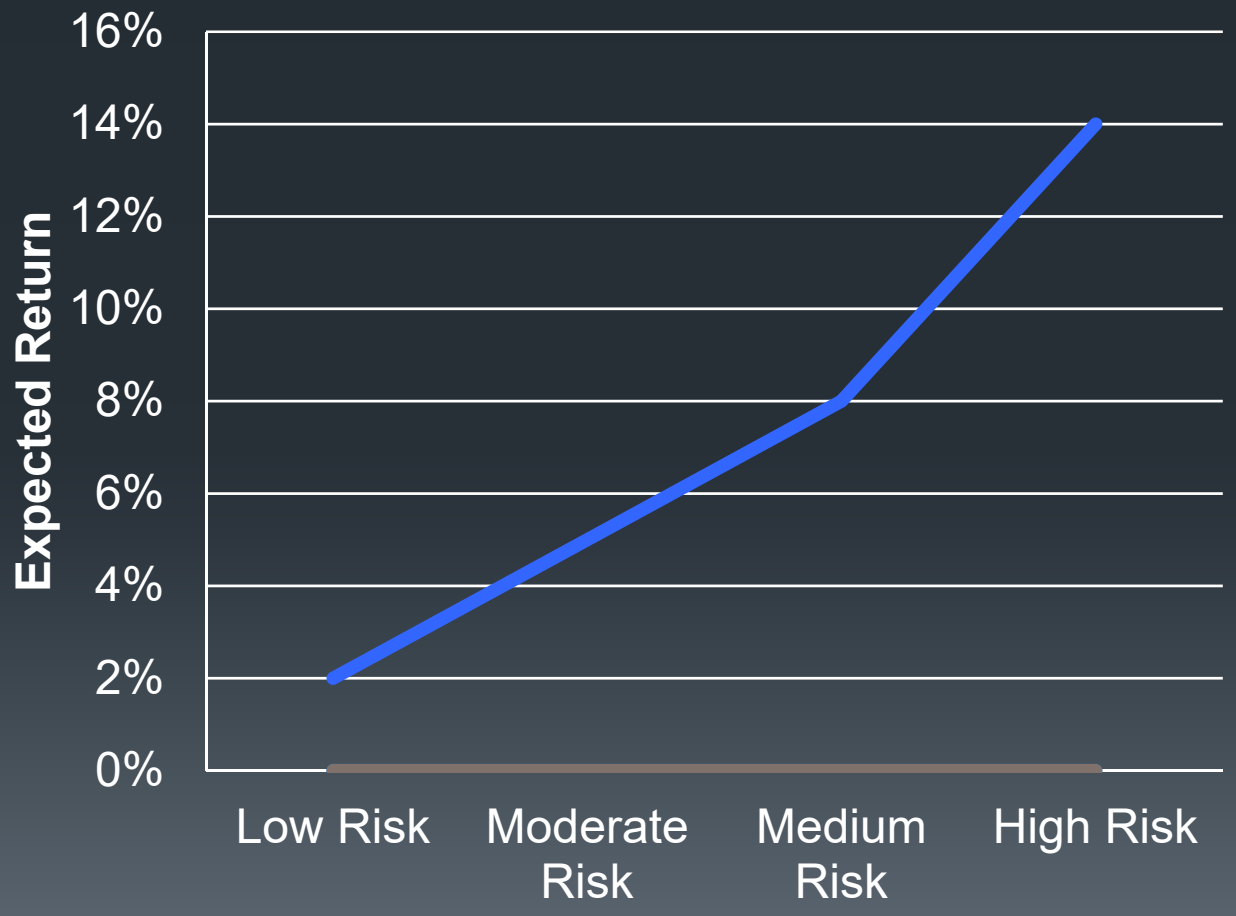
Recognizes the trade-off between
the Return the Investor may expect
and the Risk the Investor must take:

Higher returns require taking higher risk...

Return / Risk Trade-off

	Return	Risk
Mattress:	*0 %*	*very low?*
Money market:	*~ 1 %*	*very low*
U.S. Gov. bond fund:	*~ 3 %*	*low*
Apartment building:	*~ 5 %*	*moderate*
S&P 500 index fund:	*~ 8 %*	*medium*
Fancy-pants PE fund:	*~ 14 %*	*high*

Return / Risk Trade-off

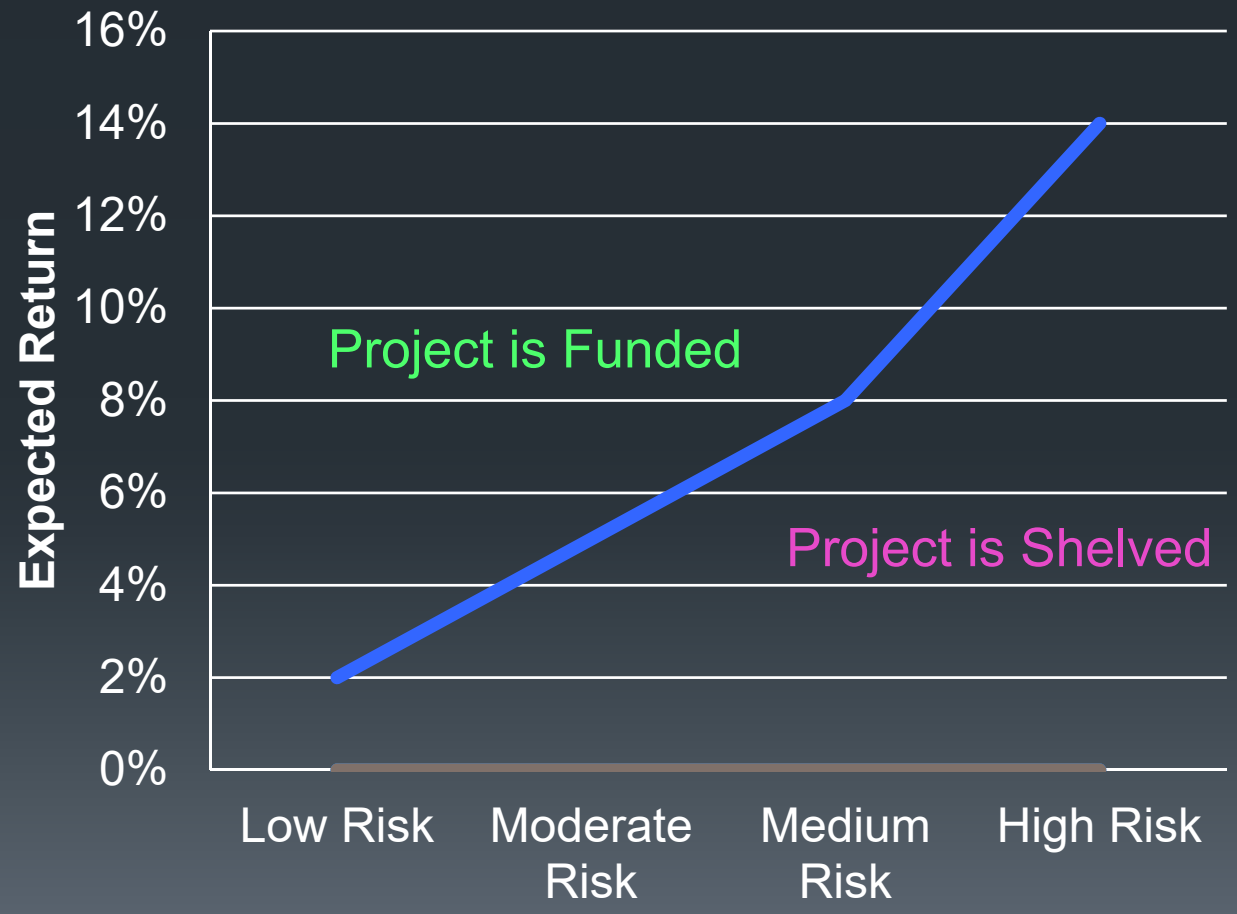


Group exercise...

- What return would you need to invest in a conservation bank?

  Before deciding, what questions would you want the ask?

Cost of Capital: Return v. Risk



How are a Bank's future Returns evaluated?

- How many Credits can the Bank sell and at what Price?

  Supply and Demand analysis

- How soon and at what cost can the Credits be produced?

  Produce a Pro-forma Cash Flow model

  Calculate Estimated Future Returns

- What are the Risks that could reduce the Returns?

Credit Demand

- Past and predicted economic activity
- Private development: residential / commercial / industrial
- Public infrastructure projects
- Regional planning data
- Backlog of unfilled mitigation

Credit Supply

- Alternatives to Bank Credits (ILF, PRM, etc.)
- Other Banks in the Market (Unsold Credits)
- Availability of Inputs to create Supply:
  - ✓Suitable Fee-owned Land at a Feasible Price
  - ✓Capital at a Feasible Rate
- Regulatory Drivers

Risk Drivers for a Bank...

- Permitting outcomes lengthy and uncertain
- Construction cost overruns
- Reduced credit demand: economic downturns, etc.
- Sizeable upfront capital needs, well before returns
  - ✓Cost of land / easements
  - ✓Permitting expense
  - ✓Upfront financial assurances
  - ✓Part and parcel of conservation in advance of impacts

Other Risk "Wildcards"...

- Size of endowment required (cap rates, L/Cs, etc.)
- Service area outcomes, regulatory application, etc.
- Competing against permitted mitigation that (and cost) is not equivalent.

AS RISK INCREASES: Bank conservation project moves closer to being shelved

More Risk = ?

More Risk = Less $$ Invested in Conservation =

Fewer Banks and Fewer Bank Credits

Fewer Bank Credits <u>also means:</u>

More Expensive Bank Credits $$$$

Hypothetical Bank Example...

Size of site: 220 acres
Land price: $10,000/acre

Total # credits: 210
Avg. credit price: $30,000

Years to permit bank: 2
Years to sell credits: 7

Bank Example...

UPFRONT CAPITAL COSTS:

Land Price:	$2,200,000
Due Diligence:	100,000
Entitlement:	400,000
Endowment:	450,000
Other:	150,000
TOTAL	$3,300,000

Bank Example...

ANNUAL CASH FLOW (Straight Line):

Credit sales:	$ 900,000	(30 x $30k)
Less Commissions:	(45,000)	(5% fee)
Marketing:	(20,000)	
Monitoring:	(15,000)	
Maintenance:	(20,000)	
Other:	(50,000)	
Net Cash Flow:	$ 750,000	

Bank Example...

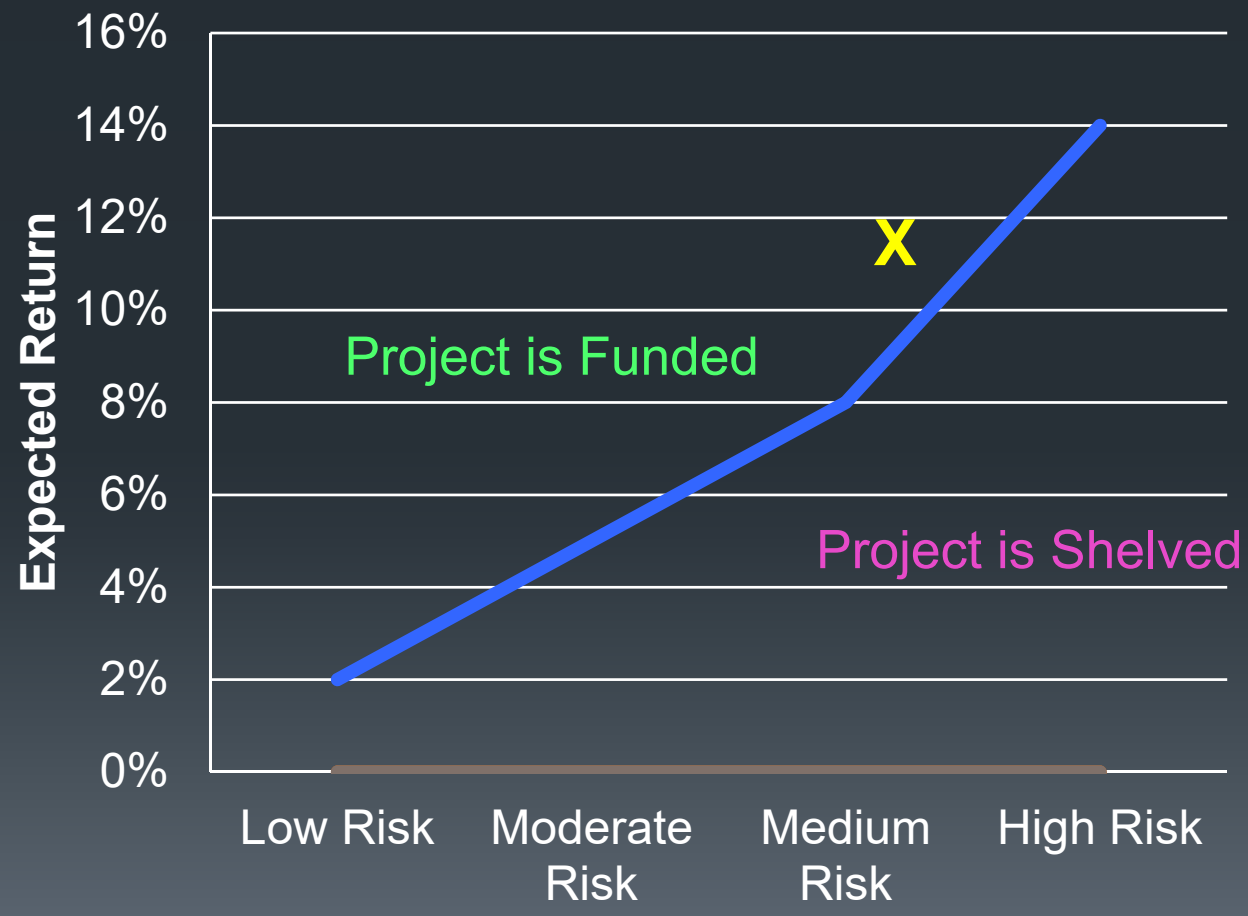
ANNUAL CASH FLOW (Straight Line):

Year 1:	- $ 1,650,000
Year 2:	- $ 1,650,000
Years 3 thru 12:	+ $ 750,000

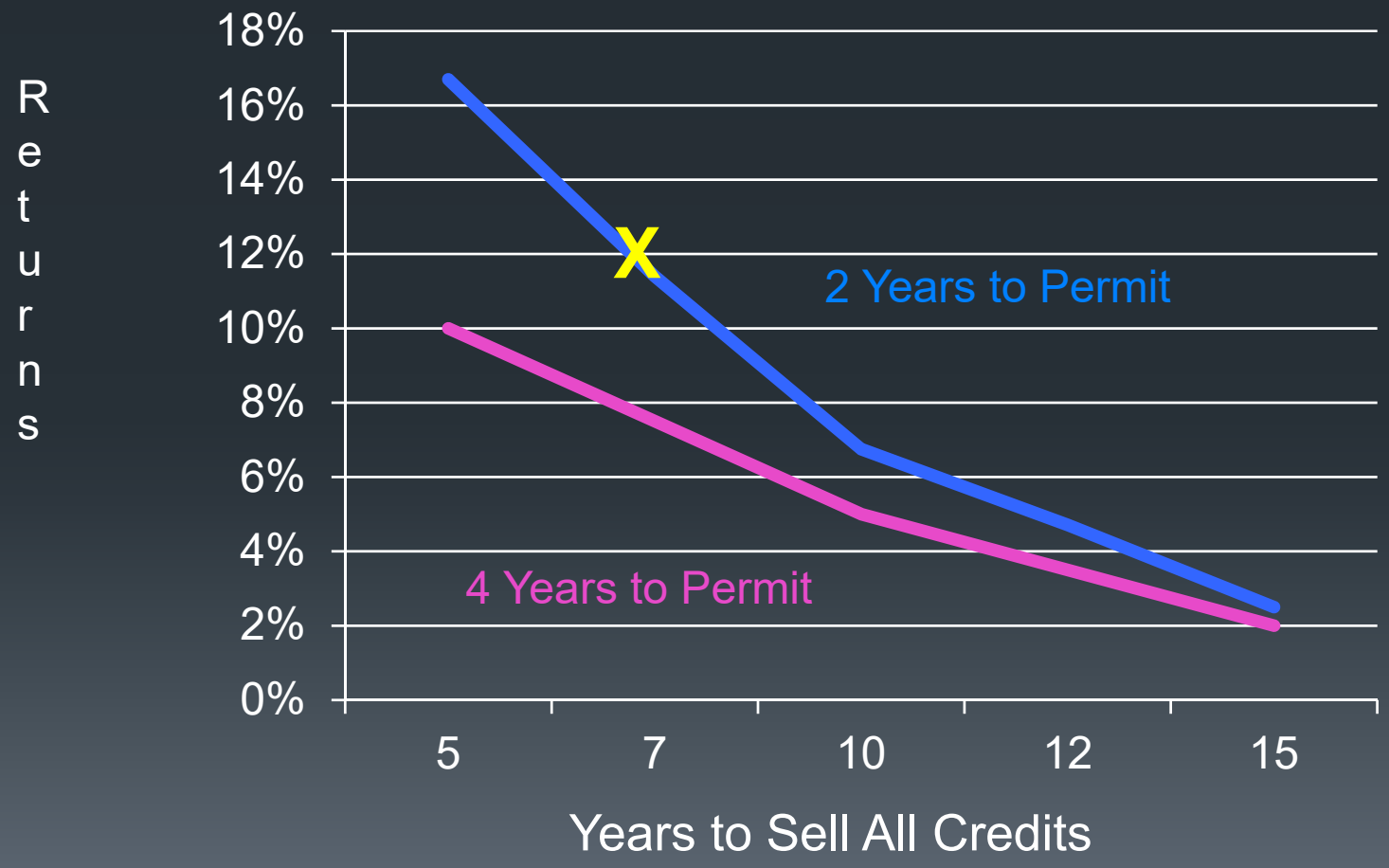
Negative Cash Flow until Year 5
(welcome to banking!)

Return on Capital: 11.4% *(IRR of Cash Flows)*

Cost of Capital: Return v. Risk



Returns are sensitive to time...
(what can delay credit sales?)



Returns are sensitive to price...

Bank Example...Go or No Go?

- Provided the Risk is assessed as Medium, this Bank Project is a “Go” if:

✓Credits All Sold < 7 years

✓Average Credit Price > $30,000

Bank Example...what was the dollar cost of its capital?

Credit price: $30,000 Credits: 210

Capital In: $3,300,000 Capital Returned: $5,250,000

Return on Capital to Investors: 11.4%

Dollar cost of the Bank's capital was $ ____?

Bank Example...what was the cost of its capital?

Credit price: $30,000 Credits: 210
Capital In: $3,300,000 Capital Returned: $5,250,000
Return on Capital: 11.4%

DOLLAR COST OF BANK's CAPITAL was $5.25mm less $3.3mm =

$1,950,000 !! (the profit needed to yield the 11.4% return)

or $9,300 per Credit....***over 30%*** of its Price

KEY TAKEAWAY: *View Bank's profits as one of its necessary costs: no profits, no capital, no bank, no conservation, & fewer and more expensive credits*

$1.95 million class question...

What can regulators do to reduce the cost of mitigation?

"Bring me a rock..."

Business of Banking...

- Conservation could be much greater with better access to Private Capital
- Relatively little Private Capital invested in Conservation to date
- Return / Risk tradeoffs need to be improved by reducing unnecessary, inconsistent Project risks
- Bankers and Regulators can partner in this effort; interests are aligned

The Aligned Interests of Bankers and Regulators

- KEEN UNDERSTANDING OF RISK:

✓Bankers avoid ill-planned, “high wire” projects whose success is risky from conservation perspective

✓ Regulators avoiding creating needless investment risks: clear rules applied equivalently

Aligned interests: *Bankers desire Robust, Predictable, Consistent Regulations...*

- Secret about Bankers is they want regulation....Why? Regulations *create* Credits...both Credit supply and Credit demand.
- Strong, known-in advance regulations produce reliable supply and demand; investors require a reliable business model
- Competition is fine; but post facto changes / non-equivalency / inconsistencies scare private money away from conservation
- To increase market conservation, strong regulations need to be well-developed, applied equivalently....market will increasingly invest

Business of Banking...

- ✓ Partner with Regulators to Lower Needless Risk of High Quality, Advanced Conservation
- ✓ Attract More Private Capital to Underfunded Conservation Needs
- ✓ Produce More High Quality Conservation at Lower Prices

Less Risk = Cheaper & More Capital = More Conservation

Departing Thought to Ponder...

- PREMISE: Conservation in advance of impacts is the *least risky* form of mitigation from a public policy perspective....
- BUT the very same approach, advanced conservation, is the *most risky* form of offset from an investor's perspective....

What are the implications of this?