CDFA Impact Investing White Paper Series

SMALL BUSINESS DEVELOPMENT & IMPACT INVESTING

*Unlocking the Potential for an Impact Investing & Development Finance Agency **Small Business Development Collaboration***

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Unlocking the Potential for an Impact Investing & Development Finance Agency Small Business Development Collaboration

One of the largest challenges faced by small businesses has always been and continues to be access to capital in order to operate, grow and create jobs. While the nation is recovering from the recession, the availability of capital for small businesses has generally not recovered. This is due to the sluggishness of the economic recovery and the decline in the number and activity of community banks (a major source of small business expansion capital). The FDIC estimates that 53% of small businesses get their loans from community banks, yet the number of such banks declined by 28% between 2000 and 2014.

Helping small businesses find other sources of financing is important for a number of reasons. First, small businesses have traditionally created the largest percentage of new jobs of any sector on an annual basis. Second, the demand on small businesses by major customers and suppliers requires that small businesses have adequate capital so that they can scale and meet these demands. And third, small businesses tend to benefit the local economy in a much more direct way than larger businesses do. These primary reasons, among others, make small business investment and capital access expansion an important public purpose for development finance agencies.

The purpose of this Small Business Development & Impact Investing White Paper is to document the potential of a collaboration between Impact Investors and high performing Development Finance Agencies (DFAs) to fill the capital gaps facing small businesses and to accelerate DFAs as a major source of capital to enable small businesses to grow, create jobs and spur economic and community development.

The Importance of Small Business to the Economy

Small businesses are among the most important sectors of the U.S. economy, creating almost 3 out of every 5 jobs and providing millions of individuals and families with living wages. For the purpose of this white paper, a small business is defined as an enterprise employing less than 500 employees and generally has a 50% ownership controlling factor. These are two common factors that the federal and state government use to define small business. Further:

- There are 27.9 million small businesses and 99.7% of all employer firms in the U.S. are small businesses[1].
- Almost half of the nation's private sector workforce is employed by small businesses (approximately 120 million people).
- 14.6% of small businesses are minority owned, 36% are women owned, and 9% veteran owned.

Small businesses have had **a difficult time recovering from the recession,** in part because of the lack of access to affordable capital.

- Since the recession, the number of business closures has exceeded the number of business startups, depressing the small business part of the economy[2].

[1] Inc Magazine, December 2014
[2] U.S. Census Bureau, 2016

- The number of small business loans has been fairly stagnant since major reductions immediately after the recession. In 2015, $599 billion in small business loans were provided by conventional lenders, roughly the same as in 2005[3]. Likewise, in 2015, $24.3 million in small business loans were made, roughly the same as in 2007[4].

- There has been a decline in the number of community banks, a major source of financing for small business working capital and expansion[5].

- While there has been a modest increase from the Small Business Administration in guaranteed loans, the capital access gap continues to be problematic, particularly in the nation's distressed communities.

Because of their unique positioning in the development financing business, Development Finance Agencies provide an opportunity for collaboration with impact investors on increasing the availability of impact investment for small business.

WHAT IS A DEVELOPMENT FINANCE AGENCY?

Development finance agencies (DFAs) can be either public or quasi-public/private authorities that provide or otherwise support economic development through various direct and indirect financing programs. DFAs may issue tax-exempt and taxable bonds, provide credit enhancement programs, and offer direct lending, equity investments, or a broad range of access to capital financing mechanisms. DFAs can be formed at the state, county, township, borough or municipal level and often times have the authority to provide development finance programs across multi-jurisdictional boundaries.

Examples of development finance agencies include:

- Industrial development authorities, boards or corporations
- Economic development authorities, corporations or councils
- Special purpose authorities (port, transportation, parking, development, energy, air, water, infrastructure, cultural, arts, tourism, special assessment, education, parks, healthcare, facility, etc.)
- Local and community development authorities, corporations or institutions
- Departments of development or commerce and finance authorities, divisions, or departments within state and local government
- Business development corporations, centers or districts
- Development and redevelopment authorities, commissions or districts

Learn more about DFAs online at www.cdfa.net.

1. DFAs have a track record of supporting small business finance through a wide range of financing tools.

Because of their experience and skillset, DFAs are creative and experienced in providing the capital that small businesses need to grow. Many DFAs also serve as small business lenders through various federal programs, such as the SBA 504 and 7(a) programs, the Community Advantage Program, local revolving loan funds, and a wide range of public/private partnerships in their communities.

- **Bond Financing:** To the extent a project or business is eligible, DFAs will use traditional bond financing, which generally consists of long term, fixed rate financing for anywhere between 75% and 90% of a project. Bond financing can either be taxable or tax-exempt, depending on how the bond proceeds are used. Bond financing is more applicable for larger size real estate or industrial projects rather than day to day operational or capital needs of businesses. In particular, bond financing has been highly successful in supporting small to midsize manufacturing through the highly popular but under-utilized industrial development bond (IDB)

[3] FDIC Banking Profile, 2014
[4] FDIC Banking Profile, 2014
[5] FDIC Banking Profile, 2014

program. In addition, many DFAs operate bond reserve funds or pooled bond programs that raise capital for lending to small businesses directly. Bond interest rates are market-based and based on the borrower's credit rating, so they remain highly competitive among investors.

- **Direct Lending:** DFAs are frequently direct lenders that operate myriad loan programs. Typically a DFA will participate at 40% to 60% of a total project cost, often subordinated to conventional bank financing of a like amount. Direct loans can have interest rates ranging from significantly below market to market. This transaction is typical for DFAs that are SBA 504 Certified Development Companies, Community Development Financial Institutions, Rural Intermediary Lenders, etc. In addition, DFA direct lending is extremely diverse. For instance, thousands of revolving loan funds exist to address underserved markets such as minority and woman owned businesses and geographically disadvantaged communities. The variations within the DFA direct lending space are unlimited but strained by fund capitalization options.

- **Loan Guarantees:** Because most DFAs are not regulated lenders, loan guarantees are more typically used to mitigate risk barriers of the bank that is engaged to co-lend alongside DFA loans, usually through the U.S. Small Business Administration or the U.S. Department of Agriculture. Guarantees can cover up to 90% of a project cost. Recently, with the establishment of the SBA Community Advantage Program, some DFAs have started making SBA guaranteed loans in amounts less than $250,000. However, DFAs are not required to use guarantees through federal instruments and many DFAs with strong balance sheets provide direct guarantees to loans alongside bank financing.

- **Microenterprise Lending (Microlending):** DFAs engaged in microenterprise lending (microlending) are making loans between $5,000 and $50,000, for new or existing small ventures. Typically, these microenterprises have fewer than five employees and capital needs of less than $35,000. Microlending can have higher than market interest rates, since most microenterprises are non-bankable borrowers and have significantly higher risk profiles. However, many microlending programs provide a pathway to conventional debt access and flexible terms to support long term small business development and growth. Most microlending programs include major and mandatory technical assistance programs (usually in partnership with the local Small Business Development Center) that assist businesses with management, marketing or financial issues. The need for funds for capitalizing microlending programs is undeniable and at a critically low point nationally.

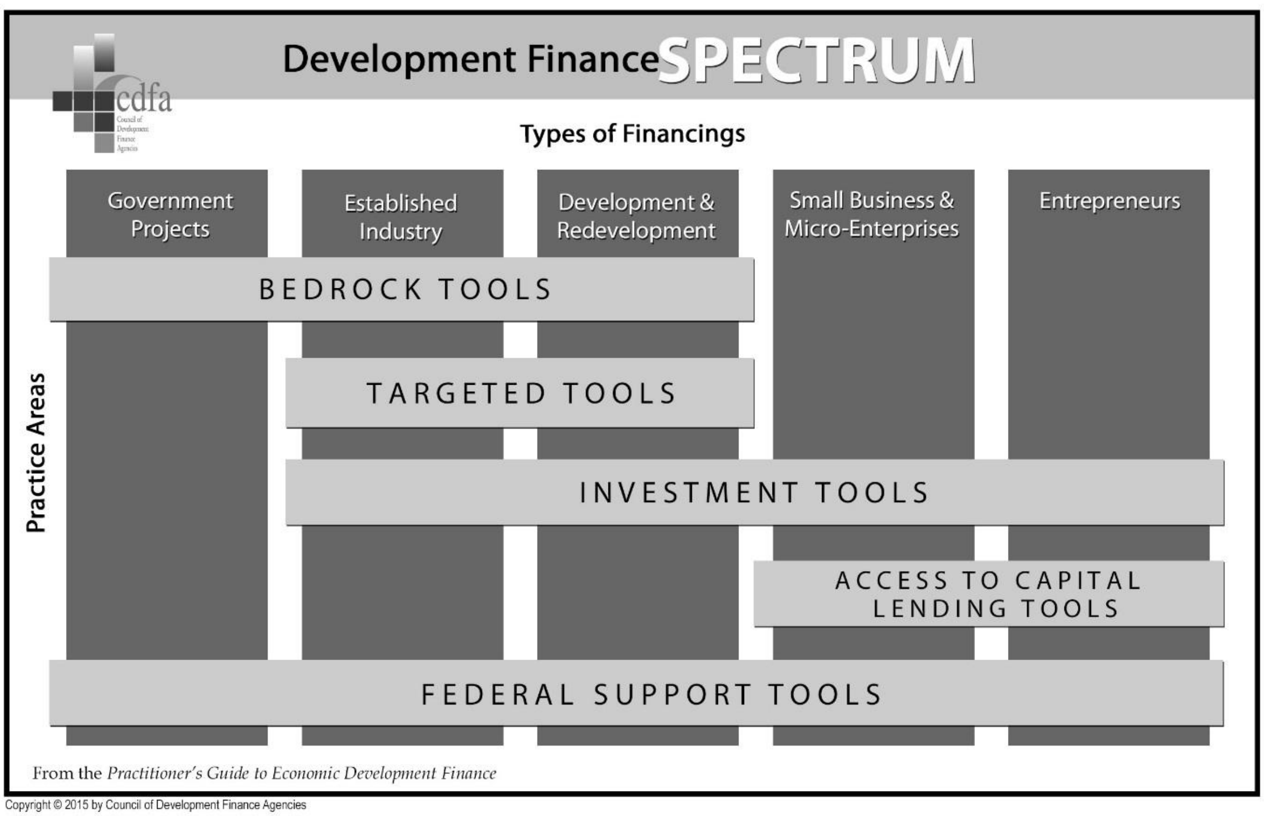
- **Tax Increment Financing:** DFAs frequently finance project infrastructure through the redirection of specific tax revenue to support public purpose needs such as roadways, sewer and water, connectivity, and power and much more. This process, called Tax Increment Finance (TIF), is the most popular form of targeted area finance nationwide. While TIF is generally prohibited for private small business finance, it is often used to build the necessary infrastructure for supporting small business investment. For instance, TIF is used to finance the development of industrial park infrastructure to attract, retain and expand manufacturing companies.

- **Capital Access:** State level DFAs are very active in state sponsored capital access efforts. These programs offer a unique suite of options such as loan loss reserves, collateral support, capital access programs (CAP), loan participation and early stage capital lending. These programs are extremely unique and highly successful as they accomplish two important missions. First, they leverage private dollars. Secondly, these programs are state specific which means that no two programs are alike. Programs are designed to address the very specific and very unique issues of each state. They allow for private capital to be unlocked and deployed locally because they are not beholden to a strict template of terms and conditions. The emergence of this model over the past decade has become a predominate best practice in the DFA sponsored small business lending landscape.

2. **Because of their involvement in local economies, DFAs have supported many different types of communities and organizations in their business activities.**

   Because they are tied into the economic development stakeholders in their communities, DFAs provide financing to support a wide range of specific projects, borrowers and communities, many of which are part of local and regional strategic plans. These can include:

   - Small business development including entrepreneurs, start-ups and microenterprises
   - Minority and woman owned businesses
   - Immigrants and refugee owned businesses
   - Business with religious limitations on lending/borrowing
   - Energy efficiency installation and generation (solar, wind, geothermal)
   - Distressed areas and/or regions in both rural and urban areas
   - Façade improvement for retail, restaurant and revitalization
   - Historic neighborhood redevelopment and revitalization



3. **DFAs can use and leverage funding for their small business programs from both public and private sources giving them flexibility when determining risk and return goals. This also allows a DFA to be an active risk lender in the community thus reducing the associated risks that can act as a**

barrier to financing from banks and lending institutions.

DFAs can access funding from a variety of sources, including:

- **Equity:** Resources from the DFA balance sheet can be used to fund operations and to provide at-risk loans.

- **PRI:** Program Related Investments from impact investors and other philanthropic organizations, typically loaned to the DFA on a long term, low, fixed rate basis. Sometimes provided as a grant with stipulations on use and impact returns.

- **Borrowed Funds:** Shorter term loans from conventional or foundation lenders, typically used to fund projects prior to their being sold in the secondary market.

- **New Markets Tax Credits:** DFAs are providing leverage financing for larger real estate projects ($20 million and above) matched with NMTCs that are sold to investors, primarily banks. Projects tend to be higher risk, and located in distressed census tracts. NMTCs are also frequently used to establish pooled lending funds specifically designed to target small businesses.

- **Community Development Financial Institutions:** DFAs that are also CDFIs have utilized funding to provide initial capitalization for loan funds, loan fund loss reserves, and technical assistance and operating capital.

- **Property Tax Levies:** Some DFAs are supported by locally approved tax levies that provide funding for DFA activity, which can include financing for economic development and small business projects.

- **Local and State Government:** DFAs often receive assistance from government and nonprofit organizations to support loan fund capitalization and operating funds.

4. **DFAs are experienced in measuring the impact of their investments in small businesses over an extended period of time and can use that to improve their financial performance. Based on a CDFA study of over 100 DFA revolving loan funds for small businesses, the average default rate for small business RLFs is between 3-6%. This represents a lower default rate compared to numerous other small business access to capital programs.**

DFAs are experienced in assessing the impact of their investments in a wide range of areas, depending on the policy rationale for a particular investment or funding sources. These measures include:

- **Job Creation and Retention:** Impact on full time permanent private sector employment, temporary construction employment, and indirect employment in sectors benefiting from the project.

- **Total Capital Investment:** Total investment in land, building, machinery, infrastructure, etc. for an entire project, not just the portion financed by the DFA.

- **Leverage:** Total investment provided by private sector lenders (banks, bonds, equity) that is leveraged by the DFA investment.

- **Community Impact:** Revitalization of targeted neighborhoods, including specific projects that serve as catalytic anchors for broader scale neighborhood improvement. Growth in targeted businesses such as small, minority or women owned businesses.

- **Individual Impact:** Improvement in wages and benefits, employment status, family income of individuals who are employed in financed projects. Plus social and societal improvements through the elimination of blight, crime, poverty and the improvement of the environment.

Impact Investing, DFAs & Small Business Investment

A collaboration between impact investors and DFAs can help expand capital available to small businesses at a time when the conventional market has been constrained. DFAs can expand their service to distressed and low-income communities, improve and increase their business investments, and support catalytic projects in a number of ways that are consistent with typical foundation terms and conditions, including such ideas as:

- Credit enhancement through guarantees, loss reserve accounts, collateral support, etc. for loans or loan funds that have community benefit but need additional support.

- Recapitalization of existing, performing loan fund portfolios of DFAs that can bring new capital to lending programs.

- Purchase, through private placement, specific loans (short term loans, bonds, TIF bonds, etc.) for “story bonds” that demonstrate unique or transformative investments.

- Direct financing that is extremely flexible and forgiving (i.e. lower rates, longer terms, subordination to senior debt, etc.) to overcome conventional lender reluctance. Also, direct financing or purchasing short term loans, including construction loans, that have long term placement options.

Conclusions & Next Steps

The opportunity for collaboration between impact investors and high performing Development Finance Agencies (DFAs) to fill the capital gaps facing small business is endless. Through DFAs, impact investors can become major sources of capital for small businesses that will enable them to grow, create jobs and spur economic and community development.

While thorough, this paper only scratches the surface of this potential collaboration. Further review and pilot programs are needed to fully understand and engage philanthropy and traditional development finance. Foundations and impact investors looking to support small business economic development should consider partnering with their local DFA to create programming and opportunities that further explore and unlock capital access potential.

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Council of Development Finance Agencies | www.cdfa.net
CDFA is a national association dedicated to the advancement of development finance concerns and interests. CDFA is comprised of the nation's leading and most knowledgeable members of the development finance community representing hundreds of public, private and non-profit development entities. Members are state, county and municipal development finance agencies and authorities that provide or support economic development financing programs as well as a variety of non-governmental and private organizations including bankers, underwriters, attorneys, financial advisors and other organizations interested in development finance. Formed in 1982 with the mission to strengthen the efforts of state and local development finance agencies fostering job creation and economic growth through the use of tax-exempt and other public-private partnership finance programs. Today, CDFA has one of the strongest and most influential voices in the development finance industry.

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The Kresge Foundation | www.kresge.org
The Kresge Foundation is a $3.6 billion private, national foundation that works to expand opportunities in America's cities through grantmaking and social investing in arts and culture, education, environment, health, human services, and community development in Detroit. In collaboration with our nonprofit, public, private and philanthropic partners, we help create pathways for vulnerable people to improve their life circumstances and join the economic mainstream. "Creating opportunity for low-income people is a hallmark of our work at The Kresge Foundation," says Rip Rapson, president and CEO. "Our programs reflect the inflection points where we think we can actually make a difference in the life trajectories of people who are poor, disadvantaged or underserved in fundamental ways."