Date: January 31, 2014

To: Leonard Bauer, City of Olympia

Fr: Michelle Morlan, NDC

RE: Business Revolving Loan Funds – financing options

As part of our ongoing assistance in providing technical support to advance Olympia's economic development goals, we have prepared this memo to talk about potential options for sourcing a fund to establish a Revolving Loan Fund (RLF) to provide financing to economic development efforts. These are meant for discussion purposes only. We are happy to follow up with more specific detail as the City considers these options.

Since Washington State's constitution places severe limitations on a City's ability to provide financing to private for profit entities with the prohibition on lending aid and credit, local funds cannot directly be used to provide financing to businesses or development activities of private for profit entities. The City does have the ability to use federal funding sources to the extent the activities meet the eligibility and use requirements of those federal sources. The City's recent creation of a Section 108 Guaranteed Loan Fund and past use of CDBG-sourced Façade improvement programs are two such examples.

However, Section 108 has limitations which do not make it a workable tool for the creation of an RLF. First, Section 108 loans do not "revolve". Instead, the specific project must be qualified to meet the eligibility and national objective criteria and the loan structure requires repayment of the loan back to HUD. Once repaid, any re-lending would require a separate review and qualification process that would be subject to HUD approval through the same process as the original Section 108 loan. Any additional loan would also be subject to the City's 108 loan capacity at the time of the new loan.

Second, a Section 108 loan made to a for-profit or nonprofit entity for the purposes of re-lending does not satisfy the national objective requirements nor does it meet the public benefit standards, since the actual recipient business is not known at the time. Third, under 24 CFR Section 570.203(c) as referenced in the Section 108 guidelines, a City could make a Section 108 loan to a business that provides economic development services in connection with other eligible economic development activities. However this stops short of permitting that business from lending or re-lending to other borrowers.

<u>City-initiated Options – CDBG RLF:</u>

Many communities use CDBG funds to source an RLF, either through a City-managed program or one carried out by a third party. Such programs typically succeed as revolving funds to the extent that the fund can be appropriately sized, targeted to a certain credit profile, and have guidelines in place to ensure the proper level of underwriting, limitations on risk, established loan loss reserve requirements and other parameters to ensure it functions as intended. NDC teaches a 3-day course in how to design successful RLFs using CDBG as a source. *A detailed description of the course curriculum is attached.*

Dependent on the amount of CDBG available however, the Loan Fund may not be big enough to create a meaningful impact. Typical Loan Funds created with CDBG provide loans ranging from $1,000 to $50,000 in size. Many CDBG RLFs are set up as microenterprise funds. While the smaller loan size and other regulatory parameters can make this a good fit, loans to start-up or microenterprise businesses more often lead to higher loan loss rates or reduced impacts if the business cannot become viable. If administered well, these programs can make their greatest impact by providing much-needed technical assistance and training to start-up businesses. Such support is critical to help businesses access the next level of capital support. Beyond the initial support of a one-time CDBG allocation, loan repayments can be retained and used as CDBG program income to slowly grow the RLF over time. The City could consider a 5-year plan to build up to a reasonable RLF size through a combination of annual allocations of CDBG plus allocations of Program Income from other CDBG loan repayments. The drawback of a CDBG-only fund is of course the need to maintain compliance with the multitude of regulations. For this reason, any revolving loan fund that expands beyond microenterprise is often combined with other sources that can help expand the Fund size and provide off-setting sources to lessen the impact of CDBG requirements. This also has the benefit of providing greater flexibility in the types of businesses that can be assisted. Because the City is limited in the sources it can directly lend, a combined-source RLF is typically going to be easier to administer by a third party entity.

<u>Third-party administered RLFs – with leveraged CDBG:</u>

CDBG can also be used as a source of seed capital combined with other sources or guarantee programs to further expand the impact of a City's investment. Some communities have been able to create a revolving fund that expands the capacity of CDBG in much the same way that the Section 108 program (without the Section 108 limitations). For example, NDCs affiliate entity, the Grow America Fund, is a nationally licensed SBA 7(a) lender. In some NDC client communities, we have created place-based small business revolving loan programs using the GAF model. Essentially, with CDBG as the source for leverage, the place-based program is able to generate other lending investment that receives the 75% SBA guarantee, while the CDBG represents the unguaranteed portion of the fund. Thus the loan fund capitalized with a $200,000 CDBG is leverage at a rate of 4:1 (minimum) to create an $800,000 RLF. *More detail on how GAF works is provided in the attached.*

If the CDBG funds are administered by a third party RLF, certain parameters need to be established to ensure CDBG-related compliance and documentation. The CDBG standards are only met once the actual loans to businesses are made, so the City needs to establish a mechanism to advance funds on an as needed basis for the fund. Depending on how the CDBG capitalization is set up, the repayment of loans under the RLF may or may not be subject to Program Income rules.

<u>Third-party administered RLFs with other capitalization:</u>

NDC's affiliate GAF has also established place-based lending programs using capitalization from other sources that may be generated from economic development activities. For example in a handful of communities where we have provided New Markets Tax Credits to a project, our client community may require that a portion of the NMTC equity be paid back to the City or directed to GAF for use as a capital source for a small business loan fund. In one case, a large project development paid the fee as a special impact fee in exchange for off-setting support to the development that was provided by the City, such as a low interest loan or grant for infrastructure improvements or provision of development bonuses. *A detailed example of this structure is attached.*

These are the primary options for establishing a Revolving Loan Fund. Depending on the specific scope or goals of the Fund, we can discuss these or some combination of these options at your convenience.

Attachments:

NDC Training Course Curriculum – ED405
NDC Grow America Fund™ Overview
Financing Structure Diagram – NMTC Transaction

ED405-Revolving Loan Funds and CDBG Compliance

Description

Many communities, in the face of increasingly limited funding sources for business expansion and development projects, have created local revolving loan funds. RLFs complement scarce public and private financing by recycling funds and leveraging private dollars. HUD’s Community Development Block Grant (CDBG) program is a significant source of RLF capitalization. However, use of CDBG means complying with requirements of the Housing and Community Development Act. NDC’s three-day RLF course teaches a process for effectively designing public loan portfolios, analyzing credit and collateral, closing and documenting loans, portfolio servicing and management, innovative workout strategies, complying with CDBG requirements and more. Specific topics include:

Revolving Loan Fund Design
- Identifying local needs and RLF goals
- Organizational structure and capitalization
- Quantifying the level of financial risk
- Operating policies and procedures
- Marketing the RLF to borrowers and bankers
- Deal structuring and subordination

Credit and Collateral Analysis
- Using credit analysis to assess company operations and debt capacity
- Cash flow lending
- Personal financial statements

Closing and Documenting Loans
- Designing a loan monitoring and servicing system
- Using a loan classification system
- Protecting collateral

Workout Strategies
- Innovative workout strategies
- Lien positions in bankruptcy
- Liquidation and foreclosure

CDBG Compliance
- Low and moderate income benefit
- Job tracking
- Underwriting requirements
- Davis-Bacon
- Program income issues
- Project administration
- Micro-loan requirements
- Program reporting

GAF OPERATING PHILOSOPHY AND RESULTS

Small businesses are one of the major economic engines in low income communities, creating jobs and investment, and building entrepreneurship and community wealth. Offering economic development loans that are properly structured to meet the needs of the business permits local small businesses to reach their full growth potential.

The Grow America Fund (GAF) is the nation's only U.S. Small Business Administration's licensed small business lending company (SBLC) owned and operated by a nonprofit organization. GAF was established in 1992 when General Electric Capital donated its SBLC license to NDC, a national 501(c)(3) not-for-profit organization engaged in economic development in low income communities.

GAF is a Department of Treasury certified Community Development Finance Institution (CDFI) and Community Development Entity (CDE) under the New Markets Tax Credit Program. GAF also met the rigorous criteria for designation as a Preferred Lender by the SBA and can make small business loans guaranteed by SBA up to $5 million. Preferred Lender status allows GAF to approve loans without SBA concurrence, the only SBA approval required is for business and loan eligibility. The Seattle Foundation invested $1 million in GAF in 2010, to make small business loans in Seattle and King County. The Cleveland Foundation selected GAF to be the CDFI lender for the Living Cities Integration Initiative and the Ford Foundation selected GAF to manage their investment in small business lending in Cleveland.

Loan proceeds may be used for any business purpose including: working capital; machinery and equipment; and, acquisition, construction, or renovation of physical plant (land and building). GAF structures loans to provide the maximum benefit to small businesses, by offering lower rates and often 100% financing on the project. GAF currently offers its loans on the following rates and terms:

- Amount: $100,000 to $2.0 million
- Rate: Interest rates range from prime minus .50% to prime plus 1.5%; the typical rate is about prime rate plus .75%; rates may be fixed or floating. In the past 12 months, rates range from 2.75% to 4.75%.
- Maturity: Maturities are 7-25 years, based upon the life of the assets acquired with the loan proceeds. The average term in the last 12 months has been 14.5 years.
- Collateral: Generally the assets of the business or assets acquired with the loan proceeds.
- Guarantees: Personal guarantees of principals owning 20% or more of the small business.
- Fees: GAF charges no fees to a borrower; however an SBA guarantee fee is assessed.

GAF operates in more than 40 communities across the nation, from Tacoma to the Commonwealth of Puerto Rico. With a portfolio of 464 small business borrowers and loans totaling $154 million, GAF has created a nationally recognized track record for:

- tailored financing with flexible terms,
- effective, individualized counseling and mentoring for the borrower, and
- low portfolio loss rates

GAF's mission simply is to foster entrepreneurship, and to create jobs and investment in low income communities by making growth capital available to healthy and expanding small businesses that invest and create jobs in their communities. GAF carries out its mission by:

- partnering with NDC client communities (NDC Community Partners) and NDC Investment Partners to create a flexible and responsive small business development loan fund
- working with and lending to small businesses and entrepreneurs that have or are developing the capacity and ability to succeed, to repay debt, and to create permanent private sector jobs based in the local community
- structuring and tailoring financing that meets the needs of the small business, rather than the needs of bank shareholders or bank regulators
- offering loans with the lowest possible rates of interest, and
- providing patient capital and counseling that helps a small business borrower and entrepreneur through difficult times.

Impact:
In addition to its SBA 7(a) Preferred Lender status, GAF is also a certified Community Development Financial Institution (CDFI) and is required to make 60% of its loans in low income communities and to minority borrowers. GAF has always exceeded this requirement. For example, over the past five years 84% of our loans have been made to minority owned businesses or businesses located in low income neighborhoods. Approximately 10% of our borrowers are start-up businesses that have been in business for less than two years. GAF tracks all loans based on the census tracts of the business, and reviews locations for population in poverty, LMI status, and levels of unemployment indicators.

	GAF Loan Amounts	Number of Loans	% CDFI	Total Jobs
2008	$ 6,967,000	15	80%	342
2009	$13,861,091	25	92%	534
2010	$16,637,955	33	79%	941
2011	$10,444,500	24	79%	586
2012	$24,890,240	39	93%	1332
	$72,800,786	136	85%	3735

One of the hallmarks of GAF is our strategy to offer financing that is well-structured to meet the needs of the borrower and can be repaid. Too often, poorly structured financing offered to a borrower prematurely does the borrower and the community more harm than good, and leaves behind a borrower caught in a quagmire of financial and legal problems. GAF makes every effort to keep interest rates to the small business as low as possible; currently rates are in the 3-4% range. We believe that by keeping interest costs as low as possible for the business, we are affording them a sustainable financing mechanism with which to grow their operations. This helps reduce their annual costs and increases the likelihood of their success.

A second hallmark of GAF is our ability to provide counseling and technical assistance to the small business while it is a borrower. While providing technical assistance is very labor intensive, our mission is to build the economic fiber of the community by assisting small businesses to grow and prosper in the community, leaving behind a thriving business after the loan has been repaid.

For example, one of our borrowers, the Hughes Group, had an option to purchase a property with significant environmental problems. The Hughes Group, a minority owned business located in Tacoma, is a government logistics contractor. We worked with the owner of the company for over a year and helped the owner review environmental reports and state permitting for the site they wanted to purchase. They ultimately realized the site would be very expensive to remediate and we then provided financing once they found a new location.

This one-on-one counseling is a truly distinguishing characteristic of GAF and we offer it without cost to each borrower. When surveyed by our Community Impact Specialist, all of GAF borrowers in Tacoma stated that they felt our counseling and technical assistance were the most valuable part of their relationship with GAF, more important than the attractive rates we offer. The City of Tacoma evaluated GAF as follows:

"GAF's lending activities within the City of Tacoma have had a very positive impact on the business community and this impact goes beyond simply making the loan. GAF has provided much needed financial guidance and project support to all of our Grow Tacoma Fund borrowers,"

For small businesses that do not receive financing, the capacity building assistance guides them through the due diligence process to understand why they are not a candidate for financing and what they need to complete to be able to receive loan capital.

Track Record:
We believe GAF has a nearly unparalleled track record in growing and nurturing small businesses borrowers. Our low default rate speaks to the success of our borrowers in maturing into businesses that can be conventionally financed.

The Farm Credit Administration, the federal agency that audits GAF on behalf of the Small Business Administration (SBA) and in effect is GAF's regulator, has summarized GAF lending activities as follows:

"GAF continues to effectively manage its high risk portfolio and fulfill its SBA lending mandate to provide capital to small businesses that are unable to obtain credit elsewhere. Lending controls and loan servicing actions were not only effective in maintaining credit risk at its current manageable level, but they also had the added benefit of helping less financially able businesses succeed."

The SBA Guarantee:
As noted previously, GAF is unique in that it provides SBA 7 (a) loans which come with a federal guarantee on loans up to $5,000,000. The benefit of the SBA guarantee is that it reduces the risk for our lenders and investors. Because the risks are reduced with the guarantee, we can pass along our lower borrowing costs to the small businesses in the form of lower interest rates.

The SBA guarantee is a guarantee against loss. When a loan goes into liquidation, GAF moves against collateral to reduce the loan's outstanding balance. After the liquidation of collateral, a loss is calculated. The SBA reimburses GAF for 75% of this loss. For smaller loans, the SBA guarantee presently is 85% on loans less than $150,000.

The SBA guarantee pays 75% of the loss incurred in a default. Assume, an original loan is $1 million to purchase a building and machinery & equipment (M&E) valued at $1 million, and the unguaranteed portion is $250,000. Assume the borrower amortizes the loan to $700,000 before defaulting. If GAF liquidates collateral and realizes $700,000, or more, GAF will suffer no loss. If GAF realizes (say) $600,000 from the collateral, GAF's loss will be $100,000. The SBA will reimburse GAF $75,000, and the net loss is $25,000, about 2.5% of the original loan amount.

GAF Capitalization:
NDC Investor Partners are CRA motivated (Community Reinvestment Act) lenders that invest in NDC mission related activities. For the most part, NDC Investor Partners are bank-owned CDCs that have known and invested in our mission related activities for 20 years or more. No Investor Partner has ever suffered a financial loss from investing into our activities.

Our Investment Partners include:

- Bank of America
- JP Morgan Chase
- Morgan Stanley
- US Bank
- Key Bank
- 5th / 3rd Bank
- Bank of New York
- Barclay's Financial
- PNC Bank
- Wells Fargo Bank
- Sun Trust Bank
- Citizens Bank

NDC Investor Partners provide very attractive financing to GAF. Because GAF has an outstanding track record with the SBA and because the NDC Investor Partners are financing only the SBA guaranteed portions of each loan, their risk of financial loss is very low. GAF normally borrows at LIBOR plus 100 basis points (bp), to which we typically add a small spread to help cover servicing costs. GAF's goal is to produce successful borrowers and to create jobs, not a large volume of loans or profits. Loan origination, servicing and technical assistance customized to each borrower is costly and time intensive. GAF's operating costs are routinely subsidized by NDC as part of our public purpose mission.

NEW MARKETS - HISTORIC TAX CREDITS LEVERAGED EQUITY STRUCTURE

Investment Fund Level						
	City RDA Loans (1.15% / 20 yr term)		4,296,000			
	Developer Loan (1% / 7 yr term)		89,000			
	Investor Equity (Combined RTC & NMTC Equity)		2,865,000			
	QEI					**7,250,000**
	Tax Credits available to investor (at 39% of QEI)			2,827,500		
CDE Level						
	CDE Load	3.5%				253,750
	QLICI (NMTC Loans to Project)		**6,996,250**			
	Net Benefit Calculation					
QALICB Level						
	QLICI Loan A (represents City leverage loan)		4,296,000		62%	
	QLICI Loan B (represents Developer Loan)		89,000			
	QLICI Loan C (represents Net Equity)		2,611,250		38%	
	Less Transaction costs					
	City Fee to Capitalize Small Bus. Loan Fund		250,000			
	Capitalized Reserve (for Asset Mgmt)		257,625			
	Transaction Legal Fees		250000			
	Net-Net Benefit from NMTC Equity		**1,853,625**	26% of total project costs		
	(including all NMTC-related costs)					
	Total Project Development Cost Excluding NMTC costs		**6,845,048**			
	Total Project Sources:					
	City RDA Loans		4,296,000			
	Developer Leverage Loan (Cash Spent to date)		89,000			
	Net NMTC-RTC Equity fm. Investor		1,853,625			
	Developer Equity		606423			
	Total Project Sources:		**6,845,048**			

Prepared by National Development Council