# Creating Loan Funds for Start-Up Companies

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Tired of scrambling for one-shot infusions of cash, more and more incubation programs (or their parent organizations) are opting to set up loan funds that will help young companies when banks won't.

These funds can offer a ready solution to a start-up's chronic cash flow problems. And they place control of economic development decisions at the local level. "The money for the loan fund may originate in Washington, D.C., but the [fund manager] decides who receives the cash," says Thomas "Rocky" Wade, former southern district director of the Neighborhood Reinvestment Corporation in Atlanta, Georgia, which works with incubators as part of its community and economic development efforts. Wade is now a Washington, D.C.-based senior program manager with Training and Development Associates Inc., a community development consulting firm.

Generally, these loan funds include flexible terms specifically geared to the needs of local entrepreneurs. Usually limited to amounts less than $25,000, the loans are repaid quickly, using equipment, purchase orders, or receivables as collateral. In many cases, the money then "revolves" to another borrower or sometimes to the same borrower later down the line. These are called revolving loan funds.

The benefits of loan funds targeted at start-up firms extend beyond an incubator's walls. The funds are invested within the community, thus aiding local economic development efforts by supporting businesses and job creation.

But Wade offers perhaps the most compelling reason in favor of loan funds: "The bottom line is, who else ... is going to lend money to these start-up companies? A lot of bankers point out that a $10,000 loan is just as expensive and time-consuming to close as a $1 million loan. Why do the $10,000?"

"We, if not the lenders, have a social obligation to create jobs, retain jobs, and encourage performance among our client companies," Wade continues. "So we do these small deals, even though it may cost us a ton of staff time, because we're the only people who will."

Some loan funds are administered through incubators and others through incubator sponsors. Some target only incubator clients; others are open to non-clients as well. While the eligibility requirements for the loans vary, many incubator loan administrators cite clients' lack of "bankability" as a major factor in starting a loan fund targeted at small firms.

### Details to Consider Before Lending

According to Wade, an incubator or other entrepreneurship support organization should start a loan fund only if it fits in with an overall economic development strategy. "You have to assess the need," Wade says. "Are there other lenders in the community providing start-up business loans? Does your community have a functioning Small Business Administration microloan program? Then maybe you don't need a revolving loan fund. Very rarely have I reached that conclusion, but I still take the time to conduct a needs assessment."

The needs assessment will help determine how the funds will be allocated. Do businesses need equity financing as well as debt financing? Does the need for accessible loans extend beyond the incubator's clients? How much money do these businesses generally need?

Wade notes that the answers to some of the questions may be modified later to meet the requirements of the loan program's funding source. Ideally, he says, a funding source should be approached only after the needs assessment is completed.

"If you don't know what you need the money for, why go after it?" Wade points out. He adds that while the needs assessment is in progress, staff members

also should discuss organizational issues. Staff should also determine who will administer the program, who will oversee the loan process, and whether the program should have a loan review committee. This is also the time to discuss terms of repayment, such as interest rates, loan guarantees, and minimum-maximum loan amounts.

"Sometimes, answering these questions will help you determine that you really don't need or can't afford a loan fund," Wade says. "If you have a small staff – say, yourself and the janitor – can you spend half your time administering a loan fund when you're worrying about building upkeep, tenant problems, and finding enough money to keep your own doors opened?"

If the answer is yes, then it's time to research funding sources. "My contention is that capital isn't a problem in America," Wade says. "Knowing how to get to the capital is the problem."

Wade lists several potential funding sources, including the Economic Development Administration's Title IX Program, the Department of Health and Human Services' Office of Community Service, the National Trust for Historic Preservation, Community Development Block Grants, regional economic development organizations, private foundations, banks, and other lender participation pools formed in response to the Community Reinvestment Act.

To research these sources, check with other incubators, foundation directories, libraries, the Federal Register, plus federal, state, and regional economic development offices. "Knowledge is power," Wade says. "The reason why some people have loan funds and others don't is nothing more than knowing that those funding sources exist. So you can't read enough about where to go to get the money."

### Loan Fund Still Evolving in Birmingham, Alabama

The Entrepreneurial Center, in Birmingham, Alabama, has had a revolving loan fund since 1987. Over the years, the incubator has fine-tuned the loan process to meet the changing needs of its clients.

"When we set up this program seventeen years ago, we knew that one of the most difficult things our client companies would face was financing," says Susan Matlock, president and CEO of the Entrepreneurial Center. "So before we even moved into our facility, we set up a loan fund capitalized through a one-time grant to the Entrepreneurial Center from the city of Birmingham."

The $200,000 seed capital came from Urban Development Action Grant (UDAG) repayment dollars generated by a program that no longer exists, Matlock says. The beauty of this funding source was that it came with very few strings attached. The city simply requested that the Entrepreneurial Center use the money solely for loan-related purposes – not for the incubator's operations or facility needs. The money could, however, be used to meet any legal expenses connected to defaults.

Eager to begin, the Entrepreneurial Center approved three small loans to prospective clients in its first three months of existence. All three defaulted. The businesses never joined the incubator, thus making collection all the more difficult. Matlock says the incubator quickly restructured its loan policies in response to these early disasters. "We recovered our initial losses," she says, "but we had to learn the hard way."

For the past fourteen years, the loan fund has been available only to incubator clients. The fund has grown to $270,000, and the Entrepreneurial Center doesn't even advertise the service to potential clients. "That shouldn't be the reason they want to come into the incubator," Matlock explains.

The loan fund does not contribute to the incubator financially, but the interest generated does cover legal expenses, if necessary. Matlock says that administrative costs are minimal. She explains that her clients are required to write a business plan, allow a credit check, and submit regular financial statements regardless of whether they access the loan fund. Thus, the actual loan application process is simply a matter of filling out a form. Administrative tasks related to the program have been streamlined over the years.

"It just doesn't take that much time," Matlock says. "And the benefit to our clients is absolutely worth it."

Initially, the Entrepreneurial Center had set up a loan committee. Then, following the first three defaults, the incubator's board decided to let Matlock, an experienced banker, review the loans and make decisions herself.

The process works like this: The loans are backed by receivables that are no more than thirty days old.


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A client can pledge up to 80 percent of a receivable against a loan. Payment is due when the client receives payment, or receivables, from the customer. The Entrepreneurial Center charges the prime lending rate plus 3 percent interest on each loan. Generally, the loans average $15,000, and Matlock says she has had very few problems with collections. "Our tenants reborrow constantly," she says. "We've made thirty loans to one client. They want to be able to use the fund again, so they know they need to pay it back quickly."

First-time borrowers are eligible for a receivables loan of up to $5,000, with the understanding that only one receivables loan can be outstanding at any given time. When full payment is received for an existing receivables loan – that is, principal plus accrued interest to final payoff date – only then are first-time borrowers eligible for an additional receivables loan, for an initial period of six months. Loan amounts are incremental, over time, at Matlock's discretion.

While Matlock is proud of the Entrepreneurial Center's record, she notes that the "zero default" rate in recent years raised a red flag. The loan program was established to target risky start-up businesses. If no one was defaulting, then perhaps the Entrepreneurial Center wasn't getting money to the most needy clients. The incubator opted to begin making unsecured loans. This opened up the subject of a loan committee once more.

But Matlock told her board of directors, "Collectively, we will make worse decisions than I will make by myself." Her reasoning: She had a successful multiyear record of administering the loan fund, plus ample experience as a banker. "When you get people sitting on the loan committee that don't have lending experience, you get other considerations coming into the picture," she says.

So Matlock's board of directors granted her the authority to make receivables loans of up to $25,000 to any one client company (except first-time borrowers). Her executive committee reviews the loan process every month, but she does not need their approval to make a loan – an important consideration since many clients need money quickly. Matlock says with her more established clients, she can turn around a loan in an hour.

For the unsecured loans, Matlock has the authority to lend up to $20,000 to any one client for either equipment or working capital. Though the Entrepreneurial Center does require collateral in the form of equipment or personal guarantees, these loans are not backed by receivables. Since they are considered more risky, no more than $50,000 of the total loan fund can be committed to unsecured loans.

Matlock has completed several of these loans, and, so far, the experience has been good. She says she knows her clients extremely well, which decreases the risk factor substantially. The Entrepreneurial Center does a thorough evaluation of a firm before accepting it into the incubator and requires quarterly financial statements from all clients.

"I know an awful lot about them before they've even located in the incubator," she says.

Over the past four years, the Entrepreneurial Center has made seventy-nine loans to its clients, for a total of $798,929.

### In Biloxi, Mississippi, Loan Fund Targets Outside Businesses

The Greater Biloxi Economic Development Foundation, which manages the Gulf Coast Business Technology Center (GCBTC) in Biloxi, Mississippi, administers a city loan fund that has serviced more than forty loans since its implementation in the early 1980s.

The foundation serves all area businesses, not just incubator clients. So far, only nonincubator clients have accessed the fund. "Somebody in-house could apply for a loan," says Adele Lyons, executive director of GCBTC. "But we've never had anybody do that. Usually, our clients find other sources of funding. They're using personal resources or borrowing from family members. Plus, we offer low rent, services, and other programs that allow our clients to use their money for their businesses."

The foundation receives money from the city to cover the cost of the loan-related services it provides. "We have a contract with the city for which we get a management fee annually. This is for managing the incubator, the loan fund, and other programs," Lyons says. Even though incubator clients haven't utilized the fund, the incubator still sees some benefits. Lyons says that the loan fund provides an excellent public relations function for GCBTC. "It is another benefit that we can offer and discuss when we're out in the community," she says, explaining that the presence

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of the fund has added substantially to the incubator's clout in the economic development community and gives the incubator exposure among area businesses.

The $300,000 loan fund isn't a revolving fund but instead is allocated annually as part of the city of Biloxi's Community Development Block Grant (CDBG) program (an initiative of the U.S. Department of Housing and Urban Development). These grants have three main goals: to remove slum or blight, to renovate older buildings, and to create jobs for low- to moderate-income people.

The loan fund addresses the job-creation aspect of the CDBG program, so any businesses accessing the loan fund must be able to show that a certain number of jobs will be created for the targeted population (the number depends on the amount of the loan). GCBTC is responsible for documenting these jobs and thus keeps in close contact with the businesses until they have attained their job creation goal. So far, businesses that have utilized the fund have created more than 130 jobs for low- to moderate-income people in the Biloxi area. On average, GCBTC approves three loans per year.

Companies can request two different types of loans through the incubator. The first is limited to $10,000 and must be repaid in five years. These loans require no collateral. The second is limited to $100,000. Businesses have up to fifteen years to repay these loans, which do require collateral.

The $10,000 unsecured loan is a relatively new offering, launched at the end of 2003. "We hadn't been doing that many loans in the past few years," Lyons says, "so we made changes to add the $10,000 unsecured loans. We hope to see more people looking at these loans." Lyons believes that several factors have contributed to a decline in loan applications. These factors include a slump in new business starts in the Biloxi area following the events of September 11, 2001, and the fact that already-low interest rates make the loan fund's rates less attractive. "The best thing about our program [used to be] that we offered a low interest rate, but lately with interest rates so low, there [hasn't been] much to differentiate us," she says.

Another interesting factor that may have contributed to a decline in loan applicants is a now-defunct rule that did not allow residents of public housing in Biloxi to start or operate businesses out of their homes. "As part of their lease, they could be evicted for starting a business, which really doesn't make sense if you're trying to help these people move off welfare and support themselves," Lyons says.

When the law changed to allow individuals to operate home-based businesses in public housing, it became clear that there was a need for loans for low-income people who do not own homes and who do not have equity to offer as collateral. "Single parents, many who have small children, are starting landscaping, house painting and other smaller businesses that require smaller dollar amounts for working capital and very small equipment," Lyons says. A $100,000 loan that required collateral just didn't make sense, so the city added the new $10,000 unsecured loan.

Both loan applications require that applicants provide a personal financial statement; tax returns and business financial statements for the past three years (if the business already has been operating); a twenty-four-month cash flow projection demonstrating repayment liability; and other information. GCBTC helps applicants with the process. "Applicants need assistance in determining and documenting the use of the loan proceeds," Lyons says. "The two-year cash flow statement is another area where we concentrate our efforts."

The application then goes before a six-person loan committee. Though Lyons is not a member of this committee, she attends the meetings. Her role, she explains, is to offer information, since she has met with the businesses and is familiar with their individual situations. The committee is made up of bankers, business owners, and local professionals.

Lyons and her staff spend five to ten hours each week administering the loan fund, and they often spend much more time assisting potential loan fund clients with the preapplication process.

Because many of the people who inquire about the loan fund are low-income individuals with little or no business experience, assisting clients with the preapplication process can be cumbersome. "The learning curve is pretty big," Lyons says. "Many applicants have difficulty managing their own personal finances – they aren't familiar with banking, personal checking accounts, etc."

Lyons says that even though the loan program requires a fair amount of staff time, the benefits outweigh the costs. But because the work can be time


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intensive, Lyons suggests that before starting a loan program, incubator staff should make sure they have the staff and finances necessary to support it.

"Certainly, give it some thought. Closing loans is time-consuming and can be a real hassle," she says. "On the other hand, it's another benefit that you can use to add depth to your program. But I would certainly want to have the support required to administer it."

### Loan Fund Invests in Inner-City Communities

The Louisville Enterprise Group (LEG) established a revolving loan fund in 1996 to serve entrepreneurs in economically depressed communities in and around Louisville, Kentucky.

LEG saw a need for the loan fund because commercial lenders often were reluctant to make loans to entrepreneurs in some of the markets that the organization serves, says Hosea Mitchell, LEG chief operating officer. And even when commercial lenders were willing to make loans, they often came up short because of their more traditional, strict lending guidelines. "We fill that gap with the revolving loan fund by providing lines of credit and term loans for small to medium-size business entities," Mitchell says.

LEG is the nonprofit community economic development affiliate of Louisville Development Bancorp, a bank holding company with a mission of investing in inner-city communities in Louisville. The holding company's other subsidiaries are the Louisville Community Development Bank and the Louisville Real Estate Development Company. Developing a revolving loan fund completed the organizations' approach to attacking poverty and rehabilitating communities, Mitchell says.

The loan fund was capitalized for $2 million through a combination of city and state dollars and has grown to $2.4 million. Part of the initial funding was a forgivable loan from the city; Mitchell says about $100,000 of the loan is forgiven each year, contingent upon LEG meeting performance goals related to its economic development initiative.

The loan fund focuses on small and medium-size businesses in LEG's investment areas (areas within the city and county that LEG identified as being below the poverty level). Clients of the Louisville Enterprise Center, LEG's mixed-use business incubation program, have utilized the fund's term loans and lines of credit. But Mitchell points out that the loan fund and incubation program work independently of each other. "Just because you are an incubator tenant does not automatically ensure you that you're going to get a line or a loan with us," he says.

Mitchell, who spent twelve years as a commercial banker and also is an experienced entrepreneur, manages the fund's day-to-day operations in addition to his other responsibilities as LEG chief operating officer. He is authorized to lend up to $100,000 with his own signature; an internal loan fund committee reviews applications for loans between $100,000 and $200,000; and the committee reports to the LEG board of directors for any requests that exceed the $200,000 limit, which require full board approval.

When the loan fund was originally conceived, LEG had a full-time loan manager separate from its chief operating officer. But after Mitchell took over as chief operating officer about two years ago, he and the board decided that with the right experience, one person could do both jobs. So they eliminated the loan fund manager position and gave Mitchell oversight for the fund. "For me, that was great because I already had the background, and it was a tremendous cost savings that went right to the bottom line," he says. "At any given time over the years, we've averaged about forty to fifty [active] loans or lines of credit. It just doesn't take a full-time person. I could probably manage comfortably 500-700 lines of credit and/or loans, assuming there wasn't a high delinquency rate, because as long as people are paying me, all we're doing is posting payments each month. It's only when there's an exception to the rule that it becomes very time consuming and laborious."

Through the small business loan fund, LEG offers term loans and lines of credit. Prospective borrowers submit an application that typically includes a current business plan, three years of business financial statements and business tax returns (if the business has been in operation for three or more years), a balance sheet, profit and loss statements, three years of personal tax returns, and a current personal financial statement. Collateral, the personal guarantee of the borrower, and personal equity also are required. "I expect the customer to actually have equity," Mitchell says. "So if you're doing a $100,000 deal, at

minimum I expect you to be able to show me $10,000 in cash or in kind – if you've already done part of the rehab of a building or if you have inventory, I need you to show me those invoices showing how you paid for that."

Interest rates vary according to risk. They depend on how Mitchell is able to collateralize the loan or line of credit and on the applicant's credit history. Currently, rates range from 4 percent at the low end to 11.25 percent at the high end. "We are not frequently going to be competitive with most of the commercial banks, but then again, if you could go to a commercial bank for a loan or line [of credit], you would," he says.

Clients who utilize lines of credit pay interest monthly and can make principle payments along with their interest payments. But at some point by the end of the year, the line of credit must be extinguished. For example, a number of daycare operators are clients of the loan fund. They are paid by the state, but the state is sometimes slow in paying them, Mitchell says. So the daycare operators draw on lines of credit to meet payroll and other expenses while they wait for checks from the state. Once the checks come in, they use that money to pay the lines of credit back down. If by the end of the year they haven't received their December check from the state and are not able to pay off the line, the line might carry into January or February, he adds.

Term loans, on the other hand, are typically used for fixed assets, such as computers and furniture. Clients typically have sixty months to pay off these loans.

Since Mitchell has taken over management of the loan fund, the default rate has been less than 15 percent. But at one point prior to his tenure as loan manager, the default rate was as high as 60 percent. He says that was due in large part to inadequate documentation. What's more, collateral either was not taken, or if it was taken, the liens were not properly perfected, i.e., they may not have been signed by all parties or properly filed at the county courthouse through the county clerk's office. "So when we went to litigate, pursue taking a piece of equipment back,

## CAVEAT LENDER

Small business loan funds can be tricky to administer in that the fund manager must have the diligence of a banker and the daring of a gambler. Rocky Wade, a Washington-D.C.-based project manager with community development consulting firm Training and Development Associates Inc., offers the following tips to help avoid common pitfalls.

**Keep terms flexible.** Each company's financial situation is different. Therefore loan policies should, if funding sources allow, be flexible enough to meet a variety of needs – from the pure start-up to the more mature firm. Lending out money in increments of up to $30,000 at up to 10 percent interest with repayment due in three months to ten years – that's flexibility. Setting a rigid standard of $5,000 increments at 5 percent interest for five years is not.

**Don't abdicate authority.** You'll likely approach bankers, lawyers, and accountants before setting up the loan fund and, later, for sitting on the loan committee. Their experience will prove helpful. But don't trust them to take care of everything, because when you abdicate your role as lender, you abdicate your role as an advocate for your clients.

**Revolve your revolving loan fund.** I've had people tell me, "We've had a $100,000 revolving loan fund since 1978. We haven't lent any money out since 1979." Sorry, but if it ain't revolving, it ain't a revolving loan fund. The idea is to recycle dollars. That fund should be turning over regularly.

**Take risks.** These funds generally target businesses that can't get credit elsewhere. If you've never had a default, then you probably aren't loaning to the people you set up the fund for in the first place.

**Work closely with clients.** Stay on top of the company's situation so you'll know ahead of time when problems arise. It's better to work them through the rough spots then to set up a deal where the company suffers unduly if it falls behind in payments. Remember, your chances of getting repaid go way down if the company fails.


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or do whatever we needed to recoup our money, we couldn't lay claim to [the property] because we didn't have a perfected lien," he says.

LEG has since taken steps to improve its loan process, including offering pre- and post-loan technical assistance. The organization provides this assistance primarily on a one-on-one basis, but LEG also offers workshops on topics in which clients express an interest, such as managing cash flow. Early on, the organization gave out loans to first-time entrepreneurs who did not necessarily have the business skills needed to run successful businesses. "It really didn't help them out a whole lot, and it didn't help us, either," Mitchell says. "So we looked at what we could do to make this win-win. We can provide funding, but we've got to provide other resources so that they legitimately have the chance to be successful."

Since its launch in 1996, about $3.6 million has been disbursed through the loan fund. "Money has gone out, and loans and lines of credit have been paid off and lent back out again," Mitchell says.

He offers the following advice based on LEG's experience: if you're going to invest in a loan fund, make sure a professionally trained person manages it. "In order for us to continue to be helpful to the community, we have to continue to be here," he says. "If money is going out and it's not coming back in, then when the next guy walks in the door with a legitimate, great idea, we have no means by which to help."

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