



Utilizing Capital Resources to Grow Urban Businesses

A Resource for Inner City Entrepreneurs

The Initiative for a Competitive Inner City's mission is to drive economic prosperity in America's inner cities through private sector investment to create jobs, income and wealth for local residents.

Staples Foundation's mission is to support educational and job skills programs that provide people from all walks of life with the resources needed to achieve success.

This paper is a joint research effort between the Initiative for a Competitive Inner City (ICIC) and Staples Foundation. ICIC and Staples Foundation have a long-standing dedication to fighting urban poverty through inner city economic development. Together, we have developed a primer to help inner city businesses take advantage of federally funded programs designed to increase capital access for entrepreneurs.

Overview

Despite the poor economy, sales at Milwaukee-based Gestra Engineering are growing. Masud Alam, Gestra's founder and principal engineer, says that – thanks to large highway projects and some new partnerships – Gestra should bring in about \$3 million in sales in 2011, up about 20% over the previous few years.

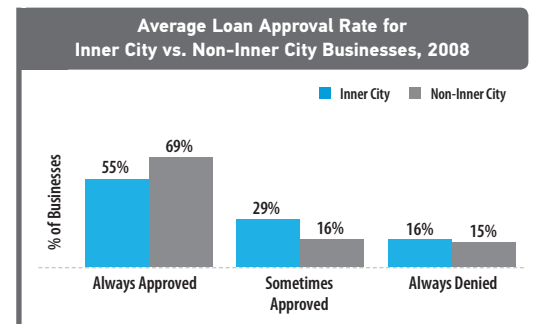
Neither Alam nor his bankers expected such success. With 30 employees, Alam says his company is “bigger than I ever thought it would get.” And like many entrepreneurs, Alam had a tough time getting the capital to launch his company. “I needed a substantial amount to buy equipment and lab tools,” says Alam, who has a Ph.D. in engineering. Eventually, he found a bank that would a \$250,000 loan, provided it came with a guarantee from the Small Business Administration (SBA). The SBA guarantee made the loan more expensive, but Alam says there was no other way. “Without that loan,” he says, “I would probably still be working for someone else.”

The Small Business Administration's guarantee program is just one federal initiative that makes it easier for entrepreneurs – especially those from distressed economic areas – to raise the capital they need to start and grow their businesses. Together, the SBA's 7(a) and 504 loan programs, the New Markets Tax Credit (NMTC) program and Community Development Financial Institutions (CDFIs) helped direct more than \$10.6 billion to inner city business owners in 2008. The SBA, NMTC program and CDFIs can often provide access to financing and opportunities that would otherwise be missed, even by the most aggressive entrepreneurs.

Capital Access and Inner City Entrepreneurs

Capital access is a hurdle even for elite inner city entrepreneurs. The ICIC compiles an annual ranking – the Inner City 100 – of the fastest-growing inner city companies; of these companies, more than one in five, or 21%, say that access to capital is the largest impediment to growth. Some 71% of inner city companies are dramatically undercapitalized, having on average just one-quarter of the capital needed to compete in their industries.

The lowest income census tracts get only 79% of the loans that would be expected given the number of firms based there, even though inner city entrepreneurs are more likely to apply for loans than entrepreneurs located elsewhere. In 2007, 16% of inner city business owners applied for a loan, compared to 13% of non-inner city business owners. Yet inner city businesses are less likely to be approved for loans: Only 55% of inner city businesses say they are “always approved” for loans, compared to 69% of businesses outside the inner city, according to an ICIC analysis of 2008 Kauffman Firm Survey data.



Source: Kauffman Firm Survey, 2008

Even successful inner city firms are often launched with surprisingly low amounts of capital, and inner city companies are nearly five times more likely than others to finance growth through personal assets, friends and family. Inner City 100 companies launch with an average of \$60,000 in startup capital, nearly two-thirds of which comes from the founders' personal assets. Almost one-third of Inner City 100 companies launch with \$10,000 or less.

"While the Inner City 100 companies show outstanding growth, improved access to capital would enable them to create even more jobs and have an even bigger impact on their communities," says John Mahoney, vice-chairman and chief financial officer of Staples, Inc. "Small businesses across the country have felt the pinch from the recent economy, particularly as the equity in homes has not been a source of capital for start-ups as it has been in past years."

A lack of capital can dampen the growth of even the most successful companies. "I've got some nice jobs in now, almost a whole year's worth of work in-house," says Luc Brami, the owner of Washington, DC custom sign maker Gelberg Signs. Gelberg Signs brings in about \$7 to \$8 million in sales annually and employs about 55 people, "but I have to buy raw materials, pay people and pay for fabrication, so now I have a cash flow situation. I can't qualify for cash discounts or for prompt-pay discounts. It's preventing me from growing the company at the pace I could because it's stopping me from going after other business."

SBA Loan Programs

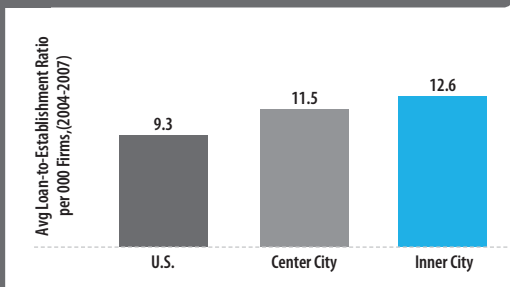
Fortunately, thanks to the SBA's loan guarantee programs, Brami's cash flow situation is much better than it might be. With help from the agency, Gelberg Signs has secured both a \$750,000 line of credit and a \$750,000 loan.

The SBA's 7(a) loan program is the largest government-backed loan program for entrepreneurs. Like the agency's 504 loan program, 7(a) is designed to encourage lenders to work with companies they might otherwise consider too risky. Depending on the size of the loan, the SBA generally guarantees from 75% to 85% of the total loan amount. From 2006 to 2008, the SBA's 7(a) and 504 loan programs guaranteed a total of \$26 billion in loans to entrepreneurs.

The 7(a) loan program can help finance up to \$5 million, which can be used to buy a business, for long-term working capital or to purchase equipment. The 504 loan program is designed to help finance long-term assets such as buildings and real estate and provides up to \$5.5 million for manufacturers. The SBA also guarantees lines of credit. Borrowers from distressed communities are eligible for SBA Express, which promises a decision on all loan applications within 36 hours.

The SBA is particularly active in the inner city. It guarantees about 35% more loans in the inner city than the national average and about 10% more loans in the inner city than in center cities, which are more affluent urban areas.

Average SBA Loan-to-Establishment Ratios, 2004-2007



Source: Small Business Administration 7(a) and 504 Loan data, 2004-2007; SICE, 2004-2007; IICIC analysis

In 2008, SBA loans made up about 2.3% of all small business loans in the U.S. but about 2.6% of all inner city small business loans.

SBA Loans-to-Total Small Business Loans, 2006-2008

(U.S. Millions \$)	2006	2007	2008
Total Small Business Loans	305,590	329,220	295,560
Total SBA Loans	9,060	8,900	6,690
Percent of Total	3.0%	2.7%	2.3%
Estimated Total Small Business Loans in the Inner City	22,710	24,460	21,960
Total SBA Loans in the Inner City	800	800	560
Percent of Total	3.5%	3.3%	2.6%

Source: Small Business Administration 7(a) and 504 Loan data, 2004 - 2007; FFIEC CRA National Aggregate Reports, 2006 - 2008 ■ Notes: (1) Small business loans are defined as those whose original amounts are \$1 million or less and were reported as either loans secured by nonfarm or nonresidential real estate or commercial and industrial loans. (2) The total inner city small business loan amounts were estimated by taking the 2006 % of inner city employees/total U.S. employees, which is 7.4%, and applying it to the total U.S. small business loan amount. (3) All SBA small business loans in this table are loans of \$1 million or less.

The caveat is that SBA loans can come with hefty fees – in a sense, the business owner is buying insurance on the loan. For 7(a) loans, such fees start at 3.5% of the guaranteed amount of the loan. After \$1 million has been guaranteed, any additional amount carries a guarantee fee of 3.75%.

Devon Henry, CEO and president of Newport News, Va.-based environmental contractor Team Henry Enterprises, relied on SBA financing to start his company and has been able to secure additional SBA financing as his company's growth has accelerated. In 2006, Henry needed about \$250,000 to help purchase The Silty Lady, an environmental contracting company that had been in business since 1986. His bank wouldn't help him, so Henry turned to another bank, an SBA preferred lender. Through that bank, Henry was able to get an SBA-backed loan for \$250,000 and an additional \$100,000 line of credit.

Henry's company enjoyed annual sales of about \$700,000 when he bought the Silty Lady. Under Henry's ownership, the company (now called Team Henry Enterprises) brought in about \$1.2 million in sales the first year and \$1.7 million in the next. Henry was quickly outstripping his line of credit, which he needed to bring on key staff and buy materials for jobs that might take several months to pay. Last year, Henry started lobbying for an increase and managed to get his line of credit doubled to \$200,000. Now, with sales projected to reach \$10 million in 2011, he's pushing for a \$350,000 line of credit. Says Henry: "We have some really good contracts coming down, and I really need some good capital to start these projects up."

New Markets Tax Credits

The New Markets Tax Credit program is designed to encourage investment in low-income areas. Investments in qualifying projects can get a 39% tax credit taken over a seven-year period. Through the end of 2008, a total of \$25 billion in tax credits had been granted. Between 2004 and 2008, slightly over half of NMTC projects were in urban areas and, of those, about 80% were in inner cities. In dollar terms, about half of NMTC money goes to projects based in the inner city.

In the inner city, NMTC money is chiefly used for real estate projects, with about 82% being used this way. But entrepreneurs can also benefit from the program. NMTC helped Gestra Engineering's Alam buy a new headquarters building in downtown Milwaukee. Because his company rehabilitates many buildings in Milwaukee, Alam says, "I'm kind of entangled with the engineering department of the city." When he came across a run-down building he thought would make an ideal headquarters, one of the city's engineers told

him about the NMTC program and suggested Alam approach the Milwaukee Economic Development Council. The city was able to get about half of Alam's \$450,000 loan financed through NMTC. The interest on that half of the loan is only 3.25%. As the company expands, Alam says, "It's definitely helping us big-time to own the building on our own."

Community Development Financial Institutions

CDFIs are financial institutions that support the economic revitalization of low-income communities, including the businesses located there. Banks, credit unions, venture funds and loan funds may all be certified as CDFIs and use federal funds to invest in businesses or real estate to make consumer loans or to provide other financial services in communities that lack them.

While the SBA relies on banks to make loans to entrepreneurs, CDFIs are often able to provide capital even when traditional lenders are reluctant to get involved. Entrepreneurs who have worked with CDFIs describe the due diligence process as being more intensive than that used by most banks, but often say they get a valuable mentoring relationship – in addition to cash – in return.

In 2008, Sai Barade, the founder of IAQ Systems, a \$1.5 million company that consults on construction projects, had just signed a big contract with the New York City school system. That was the good news. "But a lot of clients who owed us money were going bust," says Barade. "We had a real cash crunch." He went to his banks to see if they could increase his lines of credit, which totaled \$100,000. One bank turned him down, and the other said it was becoming more cautious and might actually cut his credit line. Barade did all he could to trim expenses but knew that laying off his seven employees would be the next step.

Through some contacts in New York's city government, Barade learned about Seedco Financial, a CDFI based in New York. After Barade made an inquiry, a Seedco staffer came to IAQ's offices, reviewed all of the company's financials and contracts and spoke with many of its clients. Barade ended up with a \$200,000 loan, allowing him to hire two more people to work on his biggest contracts. "Seedco has been great to me," says Barade.

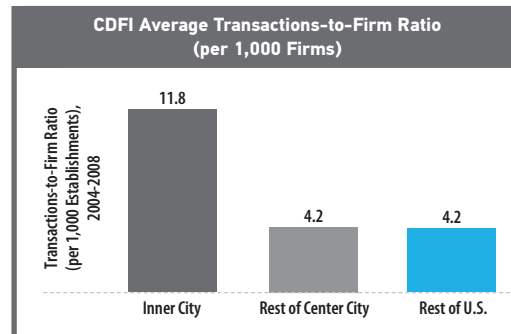
ADDITIONAL RESOURCES

Small Business Administration
www.sba.gov

**Small Business Administration
Office of Advocacy**
www.sba.gov/advo

**New Markets Tax
Credits, U.S. Department
of the Treasury**
[www.cdfifund.gov/
what_we_do/programs_id.
asp?programID=5](http://www.cdfifund.gov/what_we_do/programs_id.asp?programID=5)

**Community Development
Financial Institutions**
www.cdfifund.gov/



Source: U.S. Department of Treasury CUIS Database 2006-2008

CDFIs are a modest source of small business lending, but they are extremely active in the inner city. From 2006 to 2008, CDFIs provided a total of \$6.5 billion to businesses and individuals, but business transactions (as opposed to those for real estate or other uses) totaled only \$1.2 billion. That's about 5% of the Small Business Administration's 7(a) loan program activity for that same time period. In those three years, inner city businesses received an average of \$113 million in CDFI loans annually. The average size of a CDFI business-purpose investment, excluding micro-loans, is about \$142,000.

The availability of CDFI financing depends greatly on the city in which a business is located. Loans are concentrated in a handful of inner cities. Milwaukee and New Orleans appear to have the most CDFI activity – perhaps due to the sophistication and experience of the financial institutions located there – and are followed by Richmond, Manhattan/Bronx, Durham, Memphis, Austin, Modesto, Nashville and Spokane.

Prisca Weems, the managing partner of FutureProof, a New Orleans-based green building consulting company, says her company's business got completely sidetracked after Hurricane Katrina – and got back on the road to growth thanks to a CDFI loan. After Katrina, two of FutureProof's big projects got canceled, and the company – eager to contribute to the rebuilding of the city – started taking on a variety of pro bono projects. "We got involved in any effort to bring sustainability to the rebuilding," she says. That clouded the identity of the company among potential clients. "If you asked five people what we did, you'd get five different answers," says Weems. Meanwhile, business development efforts had been haphazard,

and expenses had been charged to five different credit cards. With the 2008 financial crisis, the interest rates on those cards hit 30%, Weems says. FutureProof wanted to return to its original business plan – to be a regional green building consulting firm with experience in hot humid climates, and to eventually bring that expertise worldwide – but it didn't have the money to do it.

Weems knew about Seedco through various conferences she'd attended and turned to them for help. Before making the loan, says Weems, Seedco helped her "get all her ducks in a row," reconfiguring QuickBooks so it gave her the reporting she needed, reviewing her business certifications and talking over business development opportunities. FutureProof got a \$103,000 loan, which it used to pay off the credit card debt and establish an office in Washington, DC. "It's a total difference," says Weems. "Before, we waited for work to come to us. Now we have identified ideal clients and we go after that work." Thanks to her CDFI financing, Weems knows that when such work comes, she'll have the financial flexibility to take it on.

NEXT STEPS

- Become familiar with the full spectrum of capital programs and resources, along with associated eligibility requirements, available for growing small businesses
- Gain a clear understanding of how your business' use of the funds (R&D, real estate investments, new staff) impacts which program to use
- Research the fees and restrictions associated with programs you may want to use
- Quantify the impact additional financing has on your company's activity in job creation or exports, which can be important criteria for some programs.
- Find out which Community Development Financial Institutions are active in your area, and what types of businesses they have funded
- Determine which institutions in your area have qualified as Community Development Entities (CDEs) and are able to provide New Markets Tax Credits
- Determine whether or not your bank is an SBA preferred lender and, if not, the possibility of working instead with an SBA preferred lender



ICIC

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