ED Now Feature: Three Best Practices for an Effective Small Business Loan Program

tags: access to capital, small business finance
Eli Dile on Monday, December 11, 2017 at 9:03:00 am

By Sheldon Bartel, CEcD, EDFP, National Development Council

Economic development finance exists due to market failures that limit capital access for small businesses. A lack of collateral, bank regulations limiting long-term lending, and rate risk can stymie much-needed private finance even to profitable businesses. As a result, small business owners often resort to poorly structured, expensive loans to meet their needs. A single bad loan can prove disastrous to a small enterprise and its owners.

The Grow Cuyahoga Fund (GCF) successfully fills this void in northeast Ohio, and offers some insights for other small business lending programs. (GCF is a program of the National Development Council's Grow America Fund, which provides small business lending in communities across the United States. The fund offers longer term loans requiring little or no equity contribution and are reasonably priced. This type of financing structure, when used with the Small Business Administration 7(a) guarantee loan program, reduces risk for both borrower and lender.)

Since 2008, the Grow America Fund (GAF) has worked with GCF to turn $3.8 million of community investment into more than $21 million in loans and $12 million in participation investment throughout Cleveland and Cuyahoga County. For every dollar provided by the community, it saw $8.75 in business investment. Twenty-five businesses have taken advantage of the program, creating 112 new jobs and retaining 742, coming to a cost of just $1,405 per job to the community.

We can attribute the success of GCF to three best practices that can inform small business lending networks in any community:

1. Establish and maintain relationships with a prospect referral network.
2. Educate that network about what you are looking for in a prospective borrower.
3. Get to a yes or no decision in a quickly, confidential manner.

Establish and maintain a prospect referral network

Think of yourself as a small business owner seeking assistance. Where would you go to buy real estate, apply for permits, or access training assistance? Or for that matter, to pursue government contracts, and get legal, accounting, or tax advice? There are many points of contact between business and government, each affording opportunities to establish relationships that delivers prospects for your loan program. Learn what that

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Quoted

"Most people think of church as a building people go to once a week to pray. But we don't believe Sunday is the only day that counts."

Pastor John Cummings of Detroit's Grace in Action church, which doubles as a business incubator

Did You Know?

About one-third of U.S. workers do not have permanent jobs with a traditional employer-employee relationship (Governing).

What's Hot at IEDC

The Role of Community Colleges in Economic Diversification

A trio of reports explores how community colleges support economic diversification through workforce development, supporting community initiatives, and partnerships with EDOs. This project was done in partnership with the American Association of professional contact has to offer businesses, and educate them on what you can do for their customers' capital needs. (I often share a few letters of recommendation from customers.)

After six years, my referral network in Cuyahoga County has grown to include accountants, lawyers, commercial real estate brokers, economic developers from Cuyahoga County and the City of Cleveland, the Cleveland Industrial Retention Initiative, SBA District Office staff, bankers and other non-bank business lenders, and existing borrowers. During this time, I learned that working with business retention and expansion personnel is essential, as they hear the needs of businesses firsthand. (The Cleveland Industrial Retention Initiative has provided more referrals than any other source from Cuyahoga County.)

Building a network of contacts can be difficult if your organization is not tied to a single geography. A personal rule is to ask if you can contact them via email once per month to notify them when you will be visiting their community. Don't spam them; this is a quick way to get your email blocked. The best marketing and education comes from face-to-face interaction. This means maintaining the network you already have established. Do this between prospect visits if you have time, or with a direct call.

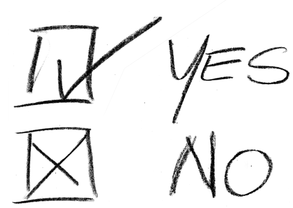
Educate your network

Your contacts must understand what you are looking for in a prospective borrower. This will save you from becoming a wastebasket where every lead is forwarded to you regardless of their creditworthiness. This results in few, if any, loans being closed, which can damage your own creditworthiness in the eyes of the community.

Therefore, your loan program guidelines must be established quickly and strictly. These guidelines will depend on the goals and objectives of your economic development finance program and the characteristics of your business base. GAF has a very specific method for adding borrowers to its existing portfolio. We rarely consider startups, do not bail out failing businesses, and do not incentivize movement from one community to another. Because our resources are scarce, we strive to leverage rather than replace private-sector money, and fill the finance gap when banks are unable to do so.

I frequently explain approvals and denials with the referrer to demonstrate what good and bad prospects look like. This helps them ask the questions you would ask up-front to vet a prospect. Referrals over the past six years from my Cuyahoga County network have decreased from 55 in 2012 to 37 in 2016 but lending activity has remained constant. I correlate this to a better-educated network. I quickly learned that your network will contact you when they have a good prospect. Don't pester them, or they may feel pressured to put forward weak prospects. Additionally, it's essential that your contacts have your most recent application package so they can share it with a prospect, which gets the process moving along quickly.

Get to a yes or no decision quickly



It is imperative you are able do this within a few days. A yes can come in the form of a loan offer with covenants requesting additional documentation and actions needed for a credit analysis and underwriting. (A loan offer is non-binding, but keeps the applicant focused on getting the deal completed.) A no must be given with a direct detailed explanation (specific trends, ratios, or statistics that explain why they were turned down), and when warranted, encouragement to reapply at a later date. My rule is a phone call followed by an email summarizing the former.

I keep a list of denials and follow up in nine to 12 months to see if anything has changed that might warrant a loan offer. GAF has approved some reapplications after a company has shown improvement in necessary areas. GAF also refers prospective borrowers to public and private resources for technical assistance.

The Grow America Fund's role goes beyond making loans. Armed with a loan offer from GAF, a prospective borrower is always encouraged to share it with their bank or other lending partners. If the alternative offer is competitive and the business owner chooses it, GAF considers that a success. Our actions resulted in job creation or retention and investment that may never have occurred otherwise, even when we are not the creditor.

Lessons learned working with prospects

Small business lending is as much an art as it is a science. The numbers must add up, but you also must remember that you're working first and foremost with people. Navigating the human element is invariably tricky

Community Colleges and with funding from the U.S. Economic Development Administration.

Resources

Community Investment Explorer

The Federal Reserve Bank of St. Louis has compiled more than 500,000 community development transactions dating back to 1987 to visualize investments made by Community Development Financial Institutions, New Market Tax Credits, and Low-Income Housing Tax Credits.

when money is exchanged. I try to abide by four key principles when working with prospective borrowers: managing expectations, preparation, vetting, and building relationships.

1. Manage expectations – yours, your prospects', and your referrers'. Demonstrate to all you are knowledgeable about the loan program's procedures and rules, credit analysis, loan structuring, and the business's needs at the outset. Communicate to all how the process works from initial contact to loan closing and beyond.

2. Preparation – ask the prospect to have their last three years of tax returns, compilations, or reviewed financials at the initial meeting. But don't forget to take advantage of online information too. Doing an internet search on the business and its owners, as well using the Secretary of State Uniform Commercial Code, tells a lot about a prospect. This is free information.

3. Vetting – experience has taught me to ask the hard questions first. In the past, I had invested valuable time and effort into a project only to discover a deal killer that should have been identified during preparation or in the initial interview. Do the math. Does the business have the ability to repay a loan of the requested size? Refer a company you turn down to resources that may be able to help them. You want people to recognize you as a friendly, knowledgeable resource. Handled correctly, both a borrower and a declined prospect are potential referrers of your services.

4. Relationships – when visiting a business or new member of your network, pay attention to pictures, décor, etc. Listen to them! Do you have any commonalities? If so, strike up a conversation to develop a stronger relationship. Strong relationships drive referrals whether you tell the prospect yes or no.

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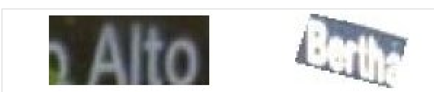

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