Financing the Everyday Entrepreneur

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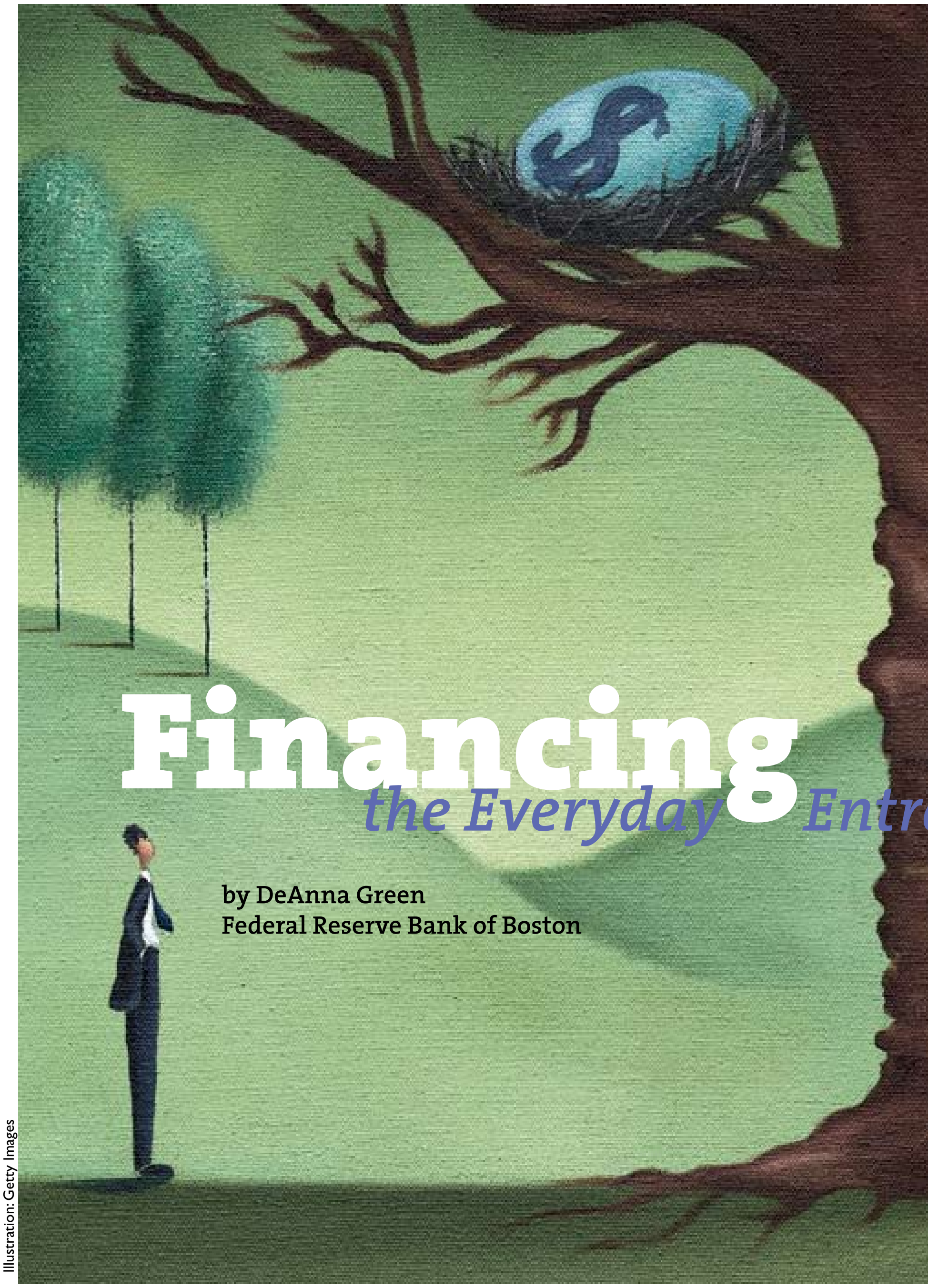

Illustration: Getty Images

It is not news that some small businesses face struggles when seeking financing. Small business lending can be a risky venture for several reasons, including the fact that every business is unique and each case different. This is especially true for what might be called the *everyday* small business.

The everyday sector is a small business subsector that has often fallen into a crack. It is composed of people who may lack the skills and knowledge needed to own and operate a business. They may be immigrants or families with low incomes without the resources to let them take a chance and not look back. But they all share a goal of turning an idea into an income and improving their lives. Every day, several everyday entrepreneurs are likely to seek help from one of the many programs offered across New England.

Trying to Go It Alone

Few everyday entrepreneurs know how the financing system works, and many start out by going it alone. The first step is usually to approach a bank. However, access to bank financing can be difficult for everyday entrepreneurs. Bank criteria are sometimes hard to meet, especially for very small businesses, businesses in early stages, and businesses owned by entrepreneurs without an established credit history or a poor one.

That is not to say banks are not willing, but an everyday entrepreneur may need to take several steps before qualifying for a bank loan. Sometimes that means establishing a credit history and gaining experience for the business, two things that are hard to do without financing.

Many types of loan funds have been created to address the needs of this subsector. Although they may not use the term everyday entrepreneur, municipalities, state agencies, and especially community-based organizations now operate loan funds specifically to create the bridge to help these small businesses eventually access mainstream capital. They share the goal of supporting entrepreneurship in communities and have realized the need for new tools and resources.

Traditional Loan Funds

New England is home to many nonbank lenders that support entrepreneurship at various stages and scales. The Massachusetts Association of Community Development Corporations reports, for example, that in 2005 Massachusetts CDCs lent more than $1.17 million to small businesses, with an average loan size running around $40,000.

Since certain funders (Franklin County CDC in Greenfield, Massachusetts, for example) require that business owners first be turned down by a bank before being eligible to receive financing through their programs, it is safe to say that those community-based lenders are financing businesses that otherwise would have had nowhere to turn.

Over time, some community-based lenders have become more sophisticated both through expanding the geography they cover and by collaborating with one another and with traditional financial institutions such as banks. Some nonprofits, including Community Capital of Vermont and MicroCredit in New Hampshire, cover a whole state.

An Imported Tool

In addition to providing financing through traditional loans, lenders are always thinking about ways to offer other products. An example is a product meant specifically for growth-oriented businesses—a subset of the everyday subset.

These are existing businesses that have acquired enough experience and credit history to access financing but need to augment their cash flow in order to allow for a planned growth. They may want to add a product to the business, expand into a new market, or shift the business focus as a result of changing markets. What this specific niche of everyday small businesses needs most is *patient capital*—inexpensive capital that gives a growth-seeking business the time needed for sales to take off. Instead of requiring specified monthly amounts, patient capital ties repayments to a percentage of sales, allowing the business to operate without being bogged down in too much debt too soon.

The Western Massachusetts Enterprise Fund has done several patient-capital loans. As executive director Chris Sikes explains, patient capital acts as both debt and equity. Frequently, the businesses receiving these loans, he says, have experienced a change in the market and need capital in order to redevelop the line of business. Their financial projections show potential for growth, but only over time. If sales don't meet projections, the lender doesn't get the anticipated payment, and the risk is no less than one associated with a traditional loan.

Sikes explains that patient capital is not a new concept. Often referred to as *mezzanine financing*, it is familiar in the business-lending world. State agencies and quasipublic groups such as the Massachusetts Community Development Finance Corporation also do some patient-capital lending. "The implementation of this product is similar to venture capital in that both are patient, i.e., the business is not immediately paying back the principal," says Sikes. He adds that the approach has been a welcome innovation across the Western part of Massachusetts.

Collaborations are equally important. As Sikes points out, they allow banks to get involved in deals they might not otherwise have been able to touch. Other business assistance organizations are critical, too—both for the capital they provide through their loan programs and for technical assistance such as helping entrepreneurs develop financial statements, marketing plans, and business plans.

Ideas for Future Innovation

In looking ahead, some lenders with experience and strong portfolios are thinking about how they can do more with their resources. They realize that the everyday entrepreneur represents a demand that is not being entirely met, and they feel a need to develop greater lending capacity.

Photograph by Don Treeger, Springfield Union News

Gary Weiss, owner of The Smokin' Hippo, is grateful for a business loan from the Franklin County Community Development Corporation in Greenfield, Massachusetts.

Will Armitage, executive director of the Biddeford Saco Area Economic Development Corporation, is interested in seeing a secondary market for small business loans similar to that for residence-secured credit products. The idea would be for nonprofits to sell off their business loans and recycle the proceeds back into the community.

However, there are hurdles to overcome in creating a secondary market. First, on a practical level, there are challenges related to loan documentation. Different organizations use different documents for their lending agreements, which means that bundling the loans to make them large enough for resale on the secondary market is complicated. An interested buyer would have to sift through different documents from each organization in order to ensure it had the necessary collateral and the security clauses generally required by an investor. That would take time.

Second, it is not clear that investors would receive the returns they require to foster sufficient demand. That is partly because community development lending is not yet well understood in other markets.

Until such issues are addressed, Armitage says, "Many organizations are facing limited resources, and we are asking ourselves, "How do we as an industry use our resources to the best of our ability and then turn them around rapidly enough so that we can continue to finance the businesses and communities we serve?"

As the industry moves forward and tries to reach out to more of the everyday entrepreneurs, additional solutions will be needed. But judging from New England's history of collaboration and innovation in this arena, the solutions will be found.

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