Innovations in Small Business Lending

Introductory Session

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Innovations in Small Business Lending

This series is designed to support business-oriented CDFIs that are experienced in providing loans and services to small and medium-sized enterprises.

Small business loans generally range from $50k to $1 million.

**Training themes:**

- **Finding innovations in the market:** Proactively monitor trends and the underlying small business opportunities

- **Finding capacity:** Understanding capacity requirements and building or finding substitutions for capacity

- **Considering mission impacts:** Foresee mission impact considerations – both intended and unintended
Innovations in Small Business Lending – CDFI Led Approach to Development

**Phase 1** – Data analysis and CDFI focused research
- Reviewed literature
- Conducted focused interviews with select CDFIs
- Conducted lending survey of CDFIs
- Performed market analysis and research of economic trends
- Interviewed subject matter advisors for select markets and industries

**Phase 2** – Development of training materials, included interviewing select CDFIs on their lending programs
Goals of the Training

• Focus on market “waves” that demonstrate potentially high profit and mission impact

• Analyze multiple national and local trends

• Discuss several “innovations” within these markets

Training was specifically developed for CDFIs who are already engaged in small business lending and are looking to grow their portfolios into new products or markets.
What challenges with Small Business Lending are you facing?
What challenges were most commonly cited by CDFIs in our Small Business Lending survey?

<table>
<thead>
<tr>
<th>Challenge</th>
<th>Description</th>
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<tbody>
<tr>
<td>Difficulty finding qualified borrowers</td>
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<tr>
<td>Technical and specialty knowledge needed</td>
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<tr>
<td>Operational infrastructure needed</td>
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<td>Access to funds (especially availability of capital at the right price)</td>
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Source: Small Business Lending survey of CDFIs
What challenges are small businesses in your community facing?
What challenges are small businesses across the country facing?

<table>
<thead>
<tr>
<th>Rank</th>
<th>Challenge</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Poor sales</td>
<td>23%</td>
</tr>
<tr>
<td>2</td>
<td>Taxes</td>
<td>23%</td>
</tr>
<tr>
<td>3</td>
<td>Government regulations</td>
<td>18%</td>
</tr>
<tr>
<td>4</td>
<td>Cost &amp; availability of insurance</td>
<td>7%</td>
</tr>
<tr>
<td>5</td>
<td>Quality of labor</td>
<td>6%</td>
</tr>
<tr>
<td>6</td>
<td>Inflation</td>
<td>6%</td>
</tr>
<tr>
<td>7</td>
<td>Competition from large business</td>
<td>5%</td>
</tr>
<tr>
<td>8</td>
<td>Other</td>
<td>5%</td>
</tr>
<tr>
<td>9</td>
<td>Cost of Labor</td>
<td>4%</td>
</tr>
<tr>
<td>10</td>
<td>Financing and interest rates</td>
<td>3%</td>
</tr>
</tbody>
</table>

What challenges are small businesses in low-income minority neighborhoods facing?

<table>
<thead>
<tr>
<th>Challenge</th>
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<tbody>
<tr>
<td><strong>Declining volume of small business lending</strong></td>
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<tr>
<td><strong>Challenges accessing mentoring, networking, and expert advice</strong></td>
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<tr>
<td>Changing consumer spending habits</td>
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<tr>
<td>Uncertain regulatory and tax environment</td>
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<tr>
<td>Lack of affordable infrastructure</td>
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<tr>
<td>Decreased skilled labor population for specialized staffing needs</td>
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</tbody>
</table>

Source: Goldman Sachs: 10,000 Small Businesses Report
Ninth District Insight Report – Quarter 4, 2011 Published by the Community Development Department of the Federal Reserve Bank of Minneapolis
Credit demand and success rates for small business

Demand for credit
- Only paid down debt: 8%
- Had sufficient financing: 17%
- Were discouraged: 29%
- Other: 5%
- Applied for new credit or to renew existing: 41%

Of those that applied, applicant success rates
- Full Amount Approved: 13%
- Partial Amount Approved: 36%
- Amount Not available: 14%
- Denied: 37%

Why are small businesses not getting loans?

- Banks just not lending to my type of business: 42%
- Insufficient collateral: 28%
- Low credit score: 25%
- Weak sales during the last few years: 23%
- Business is too young: 18%
- Uneven cash flow: 18%
- Level of outstanding debt: 16%
- Weak/missing financial statements: 15%
- Unwilling to provide personal guarantee: 15%

Finding Innovation in the Market
There are many types of "Innovation"

**Innovations That Grow Small Business**

- New Sources of Cash
- New Financial Models
- New Technology

- Industry Growth Initiative
- New Technology
- New Equity Models, Sources
- New Products

- CDFI

$ Services Partnership

Loan

Small Business
“If you’re not failing every now and again, it’s a sign you’re not doing anything very innovative.”

Woody Allen
Where will you find innovation?

Market Expansion

Time

GROWTH

Peak

Decline

1

2

3
Example: U.S. energy markets

Economic Changes Come in Waves
(Example: US Energy %, By Source)

Source: EIA website
### The Growth Period: **Good** for Distressed Areas, Small Businesses

**Pros:**
- Easier Entry
- Lower Competition
- Room For Inexperienced Workers
- Higher Profits
- Less Regulation
- Easier to Raise Equity

**Cons:**
- Riskier
- Dirtier

![Graph showing growth period from 1845 to 2005](chart.png)
The Decline Period: **Bad** for Distressed Areas, Small Businesses

**Pros:**
- More predictable cash flows
- More templates available
- Lower enterprise risk

**Cons:**
- Difficult entry for new business
- Higher regulations
- Higher competition
- High losses
- Consolidation drives out small business
- Impending death of industry
Process for innovating new business

Step 1: Identify Trends
- Monitor costs/prices/ROI
- Monitor economic/market activity

Step 2: Identify Small Business Opportunity
- Verify market/business needs
- Meet with vendors/applicants
- Meet with various stakeholders to identify risks to implementation

Step 3: Market Assessment
- Core CDFI capacity
- Deal capacity

Step 4: Assess Capacity
- Economic impact
- Social impact on community

Step 5: Mission & Profit Alignment
- Business sources and uses
- Discounted cash flows
- CDFI sources & uses

Step 6: Assessing the deal financials

Step 7: Make the deal happen
- Negotiate lending terms
- Enlist financial partners, if needed

Assessing the deal financials
- Business sources and uses
- Discounted cash flows
- CDFI sources & uses

Make the deal happen
- Negotiate lending terms
- Enlist financial partners, if needed
“Innovation – any new idea – by definition will not be accepted at first. It takes repeated attempts, endless demonstrations, monotonous rehearsals before innovation can be accepted and internalized by an organization. This requires courageous patience.”

Warren Bennis
Finding Capacity
## CDFI - Capacity Assessment Tool

### SECTION 2: Capacity Assessment Questionnaire

<table>
<thead>
<tr>
<th>Mission/Strategy</th>
<th>Baseline Expectations</th>
<th>Capacity to Provide Full Service Line</th>
<th>Capacity to Grow the Service Line</th>
<th>Capacity to Sell Services to Other CDFIs</th>
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</thead>
<tbody>
<tr>
<td><strong>1. Mission</strong></td>
<td><strong>N/A</strong></td>
<td><strong>Items to the left, plus</strong></td>
<td><strong>Items to the left, plus</strong></td>
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<td></td>
<td><strong>Yes</strong></td>
<td><strong>Items to the left, plus</strong></td>
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<tr>
<td></td>
<td><strong>No</strong></td>
<td><strong>Items to the left, plus</strong></td>
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<tr>
<td><strong>2. Overall Strategy</strong></td>
<td><strong>N/A</strong></td>
<td><strong>Items to the left, plus</strong></td>
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**Notes:**
- **N/A**: Not Applicable
- **Yes**: Yes
- **No**: No
Common Capacity Needs – By Strategic Pillar

OPERATIONS
- New Product Development
- Operational Planning
- Marketing
- Procurement
- New Business Vetting

HUMAN RESOURCES
- Human Resource Planning
- Staffing Levels
- Performance Management
- Compensation and Incentives
- Knowledge Management

LEGAL
- Legal Structure
- Legal Risk Management
- Legal / Regulatory Staffing
Ways to Find Capacity

- Partnerships
- Service Agreements with larger institutions
- Shared services
- Industry cooperatives
- Self-directed training for staff
- Volunteers (local institutions, colleges, business/law schools)
- Automated systems
- Streamlined transaction procedures
- Standardized documents and language
Considering Mission Impact
Considering mission impacts of loans

Lending has many mission impacts – some intended and some unintended.

Mission Considerations:
Job and Employment Impact
Economic Development
Quality of Life
Environmental Impacts
Training Agenda
Training Modules

Community Staples – building the core community businesses required to retain and attract residents

Growth Financing – utilize quasi-equity financing tools to provide funds to small businesses looking to enter the growth stage of business development

Real Estate Restructuring – non-traditional real estate restructuring opportunities such as business incubators and sale-leasebacks with purchase option
Training Modules

**Community Exporters** – financing local niche businesses that have the prospect of exporting their products or services regionally, nationally, or internationally

**Operational Infrastructure** – exploring operational infrastructure challenges and brainstorming solutions

**Energy** – financing energy efficiency improvements, renewable energy, and emerging green businesses
Takeaways

• Training will cover five market opportunities and several innovations in these markets

• Market opportunities are based on market “waves” and trends in the economy

• Not all opportunities will be applicable to all CDFIs
Creativity is thinking up new things. Innovation is doing new things.

Theodore Levitt