Utilizing Revolving Loan Funds to Provide Working Capital and Promote Job Growth

Susan B. Wilson
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Mentor: Winston Brooks, TCEcD

TCED Staff Advisor: Dr. Dave Kolzow

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Introduction

Revolving Loan Funds are one of the capital tools most widely used nationally to provide gap financing for small business projects. They can be structured to support and promote different types of business development and used to encourage minority business ownership and improve underserved areas. Loans are often made in partnership with local banks or other governmental agencies. With lower interest rates and flexible terms, revolving loan funds reduce total expenses for the borrower while decreasing overall risk for the participating institutional lenders (Rittner). Loan payments are returned to the fund providing a self-sustaining, long-term program. These loans are an effective tool to grow the local economy. Tullahoma currently manages two revolving loan programs for businesses located within the city limits.

Background

Tullahoma has used many different advertising slogans over the years, but the one that seems to stick is “A city as unique as its name.” Although small in size, with approximately 20,000 residents, Tullahoma has a rich history in aerospace and aviation thanks to being home to Arnold Engineering Development Complex (AEDC) which is a U.S. Air Force research facility and to the University of Tennessee’s Space Institute. With a community composed of rock scientists and engineers, it is not surprising that in 2007, Tullahoma officials issued debt to invest in a high-speed fiber network and became one of the smallest communities in the nation to be considered a “Gigabit City.” For nature lovers, Tullahoma is centrally located near Tim’s Ford Lake and Normandy Lake as well as several state parks and hiking areas. Although there are many local shopping and cultural attractions, about an hour by car will provide access to Nashville, Huntsville or Chattanooga. Tullahoma is sited at the lower corner of Coffee County, Tennessee, and overflows into a portion of Franklin County. The city also provides borders to both Bedford County and Metro Moore County, which may have bragging rights as the home of the famous Jack Daniels Distillery, but Tullahoma also has its very own George Dickel Distillery, with whiskey tours to both facilities bringing about 250,000 tourists through the area.

Economic Development History and Small Business Recruitment

Due to its proximity to AEDC attracting aerospace engineering and manufacturing firms, economic development in Tullahoma was initially focused on related industrial jobs. One of the city's two current revolving loan funds was initiated through a federal grant in 1981 which was obtained to assist in the growth and expansion of a local aerospace business. For many years, Tullahoma's economy and workforce were heavily dependent on manufacturing companies located either in the city itself or at AEDC. In 2010, community leaders assessed Tullahoma's strengths and opportunities and how to best address growth across the different sectors of the economy. The Cities of Tullahoma and Manchester chose to combine resources with Coffee County for industrial recruitment. This alliance has been successful in creating a joint industrial park located in the county on U.S. Highway 41 between Tullahoma and Manchester and has enabled all three entities to work as a team with the State of Tennessee in recruiting prospects to the area.

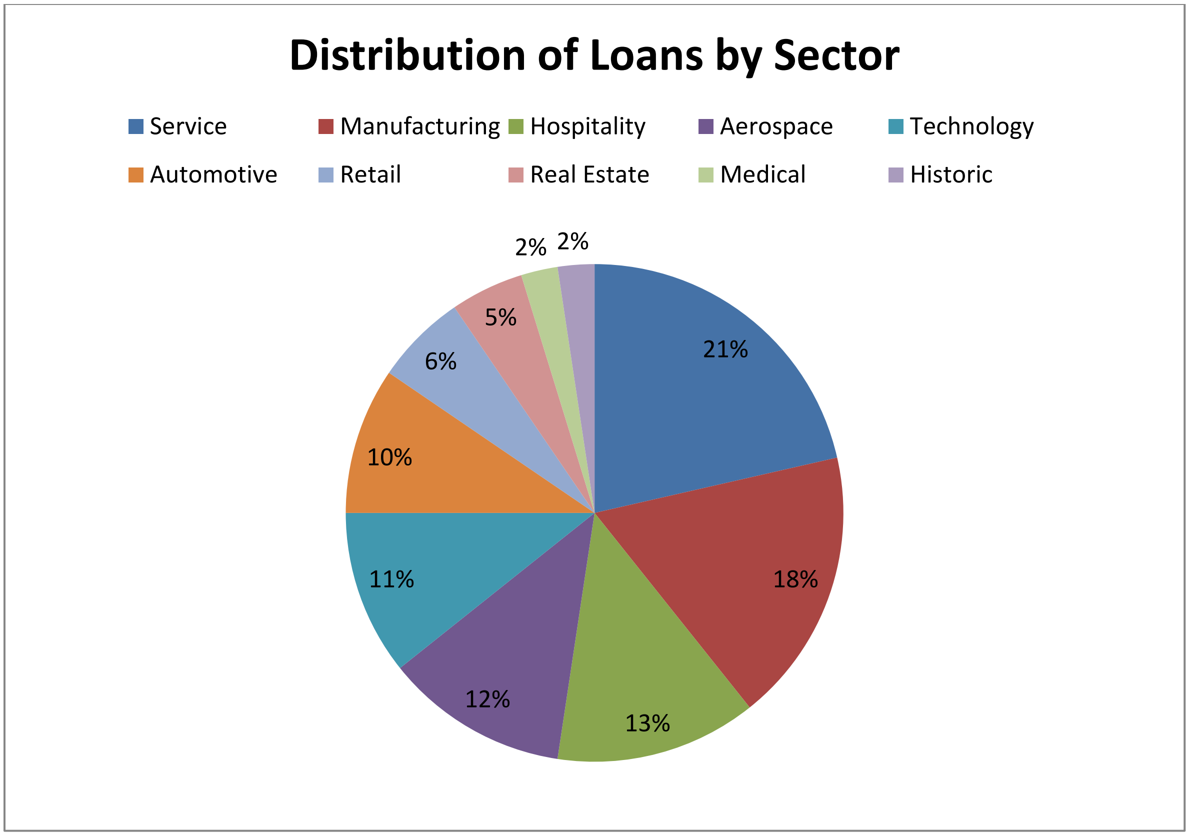
Tullahoma then created the Tullahoma Area Economic Development Corporation (TAEDC) in 2011 to focus on other economic sectors. Initially the TAEDC identified four main target areas: Aerospace and Aviation, Health Services and Biomedical, Retail, and Technology companies. Aerospace and Aviation was selected not only due to nearby AEDC, but also because of the Tullahoma Municipal Airport and its adjacent business park. In addition to retail, Tullahoma is medical services hub for a multi-county region with a 135 bed hospital which is now operated by Vanderbilt University Medical Center and several associated medical offices in town. Vanderbilt Life Flight is also based at the Tullahoma Airport. More recently, TAEDC has expanded the four target sectors to six by adding Entrepreneurialism and Hospitality and Tourism. Although always geared towards business friendly practices, the addition of the Entrepreneurial target sector increased TAEDC's focus on providing funding and support to local small business owners.

Tullahoma's Current Revolving Loan Programs

As part of the current offering of economic development incentives, the City of Tullahoma operates two different revolving loan programs. The initial loan program was originally funded through a Department of Housing and Urban Development (HUD) grant in 1981 that provided a loan to a local business for expansion and job creation in the amount of $850,000 with loan payments returned to the city to create a revolving loan program. HUD regulations restrict the use of loan funds to purposes enumerated under section 5305 of the Act that originated the program. In addition to commercial loans for economic development, job creation & retention, loans may be made to non-profit entities for acquisition, reconstruction and rehabilitation of public facilities (except general government), for historic preservation and community use. Past loans have been approved for amounts ranging from $5,000 to $370,000 based on the scope of the project and the funds available, and may be repaid over a ten year period. Loans must be secured with real property. The city has made over 45 loans through this program since its inception. Funded projects have ranged from large industrial equipment purchases to construction of an airplane hangar and for renovation of historic buildings.

The city's second revolving loan program was funded through a United States Department of Agriculture (USDA) Rural Development Business Enterprise Grant in 2008 to assist in the recruitment, development, and promotion of local small businesses. In identifying sources of local job growth, a Forbes article notes that small businesses generate 3/5 of net new jobs and employ about 47.8% of all private sector employees (Biery). To provide assistance to local entrepreneurs and small business owners, city staff worked with USDA representatives to submit the application, write an operating plan and set up loan parameters. The program retained some of the successful characteristics of the UDAG loan program, but was targeted specifically to the needs of small business owners. To be eligible, a business must be located in the City of Tullahoma, have less than 50 employees, and annual revenues under $1 million. Low interest rate loans are available primarily for capital improvements and equipment purchases. Loan amounts can be in amounts of $5,000 to $15,000 and may be repaid over a three to five year period. Loans must be secured with either equipment or real property as collateral. Loans have been made for many different types of business equipment such as purchases of large copiers and printers, restaurant ovens and coolers, delivery trucks, and computer systems, as well as for building renovations and modifications. Since 2008, the city has made 39 loans through this program.

The following chart indicates the number of loans made through both programs by sector type. The greatest concentration of small business loans was in the service sector, with18 loans made over the course of both programs. This is followed by manufacturing with 15, then Hospitality and Aerospace and Aviation heading up the loan portfolio.



The goal of the USDA small business program is to provide gap financing for business expansions, replace or modernize aging equipment, and provide entrepreneurs with an easy access to start up funds. The UDAG loan program has a broader scope and, while primarily geared towards job creation, can also support other economic development purposes. For larger projects, the UDAG program funds are often used in partnership with local bank financing or in concert with a business loan through the local development district, with the city assuming a subordinate position on real property as collateral. Both programs require small application fees and are reviewed by a loan committee comprised of staff and appointed citizens. UDAG loans also require Board of Mayor and Aldermen approval after committee recommendation. All loans are subject to credit check, financial and legal review, and sufficient collateral. Interest rates for both programs are set at 4% below prime with a floor of 1%, adjusting annually. Loan payments are returned to the funds for re-lending.

Economic Impact: Program Successes and Failures

There are different measurements to consider in assessing the success of the programs. The City of Tullahoma judges success based on two criteria: economic development and fund sustainability. In considering the economic development impact of the loans, city staff looks at the program goals. Were jobs created or retained? Was an older or vacant property renovated and returned to the property tax rolls? Did it provide a needed community service or provide economic impetus to upgrade an at risk area or bring in spin off businesses? How much sales tax was generated? From a sustainability standpoint, success is measured when loans are paid back into the pool by the borrower, preferably with minimal collection efforts. While sometimes necessary to preserve the continued payment stream into the revolving loan fund, collection efforts detract from the program's effectiveness both in terms of costs incurred and additional labor time.

Since the purpose of Tullahoma's programs is to support local businesses, the financial goal is not to generate profit, but to ensure that payments are returned to the pool for program sustainability. At times, the program has had to defer or decline sound projects due to lack of available revolving loan funds, which is why the timeliness of payments is important. A 30 day grace period is allowed before a payment is considered late and incurs a late fee of .25% of the outstanding balance or up to a maximum of $12.50 per occurrence. A payment schedule is provided, but no coupon book. At 60 days, staff begins emailing or calling the borrower to remind them of the payment status. If the borrower is nonresponsive after 90 days, the program attorney will then send the borrower correspondence and begin foreclosure procedures if necessary. Periodically, borrowers have had interim cash flow problems. This is more likely in the case of start-ups who have not yet developed the revenue base to cover all of their costs, or when the economy has slowed in various sectors and constricted normal business operations. In these cases, staff will work with the borrower to restructure or defer loan payments to bring the account current and keep the payments manageable. Maintaining contact with the borrowers improves the likelihood that they will reach out to us to work out payment options prior to the need for legal intervention. Currently, Tullahoma does not have adequate staffing to provide the level of business interaction and coaching that the program often requires.

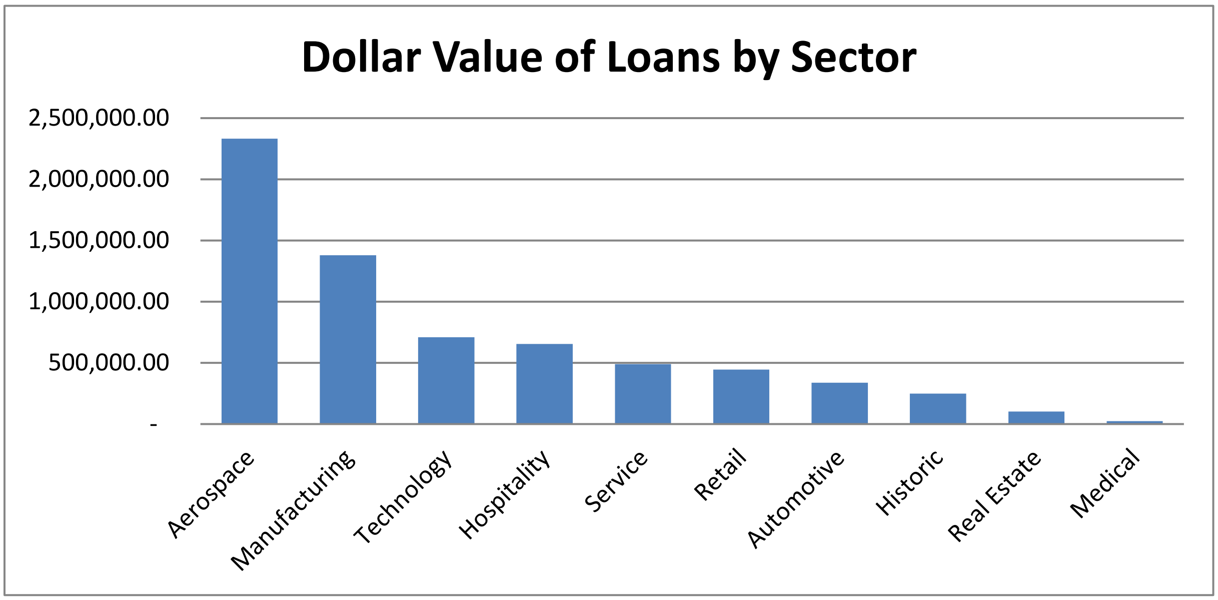
Under the UDAG program, only two businesses have closed prior to loan repayment. On the first business which was a machine shop, city staff foreclosed and sold the secured equipment and then wrote off the balance of the loan. On the second, the business and the loan were purchased by another company who then continue to operate the facility and repaid the loan. One company also relocated their business to another community, but then continued to repay their loan. There have been many instances of late payments requiring staff prompting, but usually with the same borrowers. There have also been a few occasions where the borrowers have been nonresponsive and have required legal intervention to bring the account current. From an overall financial standpoint, the UDAG loan program has been quite successful.

In assessing the economic impact of this 40 year program, all but 7 of the 35 businesses assisted are still operating in Tullahoma. Some of the others provided employment for over ten years and paid off their loans, so they also provided real benefit to the Tullahoma economy. Tullahoma's two main business sectors are still technology and aerospace. The UDAG loan program assisted in attracting a software company from out of state, and provided funds to develop space exploration tools. Retailers renovated their buildings and a developer constructed a connector road to link two shopping plazas. A local church renovated an adjacent historic building that had once been the city's post office and opened it for community activities. A dilapidated building was removed from a commercial property for safety code compliance, which enabled it to be sold for development. These are the various success stories of the UDAG loan program.

The USDA loan program is much more labor intensive to operate. Applicants are often sole proprietors needing assistance with business plans for their first start-up experience. They have vision, technical expertise in a particular field, but often no actual experience in operating a business. Some of the small businesses may have 20 to 30 employees. Others may only employ themselves and a few family members. The businesses have not yet developed a credit history, and are reliant on personal track record of the owner. Loans are capped at $15,000 and used primarily for equipment purchases, which also serve as the loans' collateral. Of the 39 loans made through this program, 3 have defaulted and 8 are no longer open. Some of these are also repeat borrowers who paid of their initial loans and then used the opportunity to borrow again for equipment replacements or upgrades. Data provided by the U.S. Bureau of Labor Statistics indicates about 20% of U.S. small businesses fail within the first year, with 50% failing by the fifth year, and only a third remaining open by year 10. Although it is normally thought that restaurants have a higher than normal failure rate, a recent study shows that restaurants established after 2010 tended to have the same failure rate as other businesses, up until the recent COVID-19 pandemic, where restaurant sales fell to their lowest level in 35 years (Gustafson).

Tullahoma's USDA revolving loan program saw successes in accounting and medical firms, automotive and printing businesses, dry cleaning and laundries as well as restaurants. Three retail shops went out of business as did three restaurants. City of Tullahoma staff had to work with many of the owners on modifying payment arrangements to meet interim cash flow problems. In a few cases, legal pressure was required. On two, the city repossessed and resold equipment, with funds returned to the loan program. However, the best outcome is to negotiate with the borrowers on loan terms prior to default. In most instances, small business owners not only took pride in their business operations but they also displayed personal responsibility and commitment to ensuring their loans were paid timely and in full.

The chart below shows the cumulative loan amounts invested by sector. The largest investment sector is Aerospace and Aviation with $2.3 million in total loans made, then Manufacturing with $1.4 million.



Lessons Learned

The City of Tullahoma ventured into revolving loan administration back in the 1980's without any dedicated staff or management plan. At that time, businesses found out about the program through word of mouth and then approached the Mayor or City Administrator with a project need. If there were sufficient funds available at the time and the City Attorney was able to negotiate collateral to guarantee the loan, then the Board of Mayor and Aldermen would approve it. Since funds to develop the program were generated solely by repayments from the initial business who participated in the HUD grant, there was a very small pool of capital. As more borrower requests were received and more collection efforts were required, it became obvious that more cohesive loan guidelines were needed. Staff established credit background thresholds and created an application form. The city then looked at a means of standardizing loan amounts per business. Since the primary purpose of the HUD grant was to generate jobs, the city tied in a job creation base line of $5,000 funded per new job and $2,500 per job retained, with other applicable economic factors to be considered on a case by case basis.

When the USDA program was added in 2008, a formal operating and managing plan was required as well as a loan committee. The loan committee also began reviewing UDAG loan applications at that time. Two of the staff members associated with the loan committee had previous banking experience which was useful in both applying for the grant and writing the administrative plan, as well as reviewing loan applications. At the committee's recommendation, collateral requirements for the UDAG program were strengthened to accept real property only, instead of allowing equipment or inventory. Considering that the program was lending as much as $250,000 to a borrower over a ten year repayment term, both equipment and inventory depreciated too quickly during this time period. After one borrower relocated prior to finishing repayment, a clause requiring the company to remain in the city limits was added to the application. The city also retained an attorney who was familiar with the paperwork required both for loan closings and for collections and foreclosures.

Partnerships

Considering the limited pool of funds available in both programs as well as the lack of dedicated staff, it became evident early on that the city needed to establish a number of private/public partnerships to be successful. On larger development projects that Tullahoma's pools could not finance, the city made referrals or collaborated with local banks to raise the necessary funding. In the case of new business start-ups, staff worked most successfully with South Central Tennessee Development District (SCTDD). SCTDD offers three different lending programs and is able to tailor the funding source and requirements to work with each individual business owner's specific project constraints. SCTDD indicates that their commercial loan programs are designed to encourage business growth and private investment while stimulating job creation and furthering several other economic and community development goals. SCTDD's mission is that they are focused on improving access to capital in rural areas of Tennessee, and supporting continued growth by enhancing competition in the urban areas of the State (SCTD Loans). SCTDD personnel are also instrumental in assisting new entrepreneurs with developing their business plans and identifying start-up issues. TAEDC staff also work with the Coffee County and Franklin County Industrial Boards, as well as State of Tennessee Economic and Community Development on industrial recruitment prospects, and are familiar with any state incentives that may assist with business growth. Tullahoma also partnered with the Chamber of Commerce to market the small business loan program to its members. Staff spoke at periodic chamber meetings and received additional exposure through chamber newsletters. The local Rotary Clubs have also given out information to their members on both programs.

State and National Small Business Trends

The U.S. Small Business Administration (SBA) issued a brief in March, 2021, on the effects of the COVID-19 pandemic on small businesses. The article focuses on employment data for small businesses. One of the measurements they provided showed that the number of people who were self-employed and working was 20% lower in April 2020 than in April 2019. They also grouped data by industry super sectors to show that leisure and hospitality businesses experienced the largest decline of 48% employment. SBA summarized their report by cautioning that the effects of the COVID-19 are ongoing, and that while some businesses have largely recovered, others continue to lag, and some recovered only to experience a subsequent decline (Wilmoth).

Locally, many Tullahoma small businesses closed initially then adapted to provide on-line ordering, take-out, curbside pick-up or delivery services and outdoor dining. Understanding that some local businesses were severely impacted by the pandemic, an email notification was sent in March, 2020 waiving late fees and informing borrowers that staff would work them on reducing payments if their businesses were either closed or restricted at that time. Several borrowers took advantage of these terms, and surprisingly a couple of others approached the city about borrowing funds since the shut-down was a good time to do building renovations and prepare for expansion. Many local businesses were also able to use some of the federal assistance programs.

Most recently, the federal government has enacted the American Rescue Plan which provides funding allocations to government entities to support COVID-19 response effort in containing the virus, and also to address the negative economic impacts of the pandemic specifically on small businesses. According to the Department of the Treasury, in April 2021, approximately 70% of small businesses reported that the pandemic has had a moderate or large negative impact on their business, and over a third expect that it will take over 6 months for their business to return to a normal level of operations (Interim Final Rule).

Future Plans for Tullahoma's Revolving Loan Programs

In assessing the business needs of the community, and the economic development tools that are available to government agencies, it is clear that while effective, Tullahoma's revolving loan programs could have a much greater impact both if they were better funded, better staffed and if they had clear program goals and measurements established.

While both of the city's current programs have been successful within their current capacities and operating constraints, the first issue to address is access to additional capital. The American Rescue Plan indicates that state and local government may provide small business assistance in the form of loans or grants both to mitigate financial hardships and to implement COVID-19 prevention tactics, as well as to provide technical assistance, counseling or other services to assist with business planning needs (Interim Final Rule). Adding a third revolving loan fund specifically for small businesses in this category would expand the city's ability to support struggling businesses to both recover from the 2020 effects of the pandemic, but also to prepare them to deal with the current resurgence of the virus. The American Rescue Plan also provides that payroll and overhead charges for program administrative staff may be charged to the Plan. This will provide interim funding to sufficiently staff the loan program, both from the initial marketing and assisting with the loan application process, through the due diligence, review, closing and loan administration process.

Additionally, the mission of each revolving fund needs to be refined and tailored it to the needs of the community. The Council of Development Finance Agencies (CDFA) recently presented an Introduction to Revolving Loans class. Various presenters spoke about the value of having a successful revolving loan fund, types of revolving loan funds, and how to establish and operate the fund. Revolving Loan Funds should have a clearly defined mission and vision. According to Joe Huber, the president of the Cincinnati Development Fund, their mission is “To provide innovative real estate financing for projects that strengthen low-income neighborhoods and improve lives.”(CinDev Fund) The Urban Development Authority of Pittsburgh’s mission states “We exist to support the City of Pittsburgh’s economic development goals, which are designed to create a city of inclusive opportunity for residents, stakeholders, and communities” (URA.org). Closer to home, the Economic Development Growth Engine (EDGE) in Memphis provides forgivable loans “designed to spark revitalization of Memphis inner city neighborhood business districts” (EDGE). Having a strategic mission and vision, and well defined policies will help identify the need and the target audience, making the program more efficient and successful.

In addition to opportunities created by the American Rescue Plan to provide either small business loans or grants, there are also other funding sources, both public and private to be considered. The City’s second revolving loan program was obtained through a USDA grant. This program is still available should other government organizations wish to participate. The United States Economic Development Administration (EDA) also offers revolving loan funds. Funding may also be obtained through private foundations that support the goals of each program. Clearly defining the program’s mission will allow the City of Tullahoma and TAEDC to target partners who share those goals. Once the program is developed, it will then need to be communicated to all stakeholders so that those most in need of the funding are aware of the program’s existence. In establishing and maintaining relationships with the small business owners in the community, it would also be helpful to be able to either directly provide technical assistance such as business plan writing or access to co-working space or an incubator for start-ups.

Revolving Loan Program Resources

In submitting the application and writing the plan for the USDA program as well as administering both programs, it was initially helpful to have staff members with previous banking work experience as well as an employee who had managed the City of Norwich, New York's UDAG loan portfolio. More knowledge was obtained about the advantages of revolving loans as economic development tools through both the Tennessee Economic Development Finance class and the Tennessee Economic Development Advanced Finance class. Both of these classes provided an overview of economic development incentives and how to implement and administer them effectively. Additionally, the Introduction to Revolving Loan class offered through the Council of Development Finance Agencies (CDFA) provided even more specific knowledge in this area and would be valuable to economic development professionals interested in starting a loan program.

Conclusion

Revolving Loan Funds are an effective tool to promote economic growth, especially in the small business sector. Funds can be targeted towards a particular location in need of real property improvement or business development. They can be geared towards encouraging minority or low-income business ownership. They can be used towards brownfield clean ups or façade renovation programs. Once the program's mission is established, sources of capital can be identified, and a program developed that will serve the particular needs of that target group. Since small businesses account for between 60-80% of all U.S. jobs, and account for 44% of the U.S. private payroll, incentives and assistance to grow this sector is essential to any economic development plan. Small business start-ups with innovative owners can become the next

Microsoft, Apple, Amazon, Google, HP, or Disney (Kirby). Unlike many other incentive programs, revolving loan funds are sustainable. As Tullahoma's programs show, if well managed, loan payments can be returned to the fund for continual relending and long term community benefit.

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