What Comes Next for Small Business?

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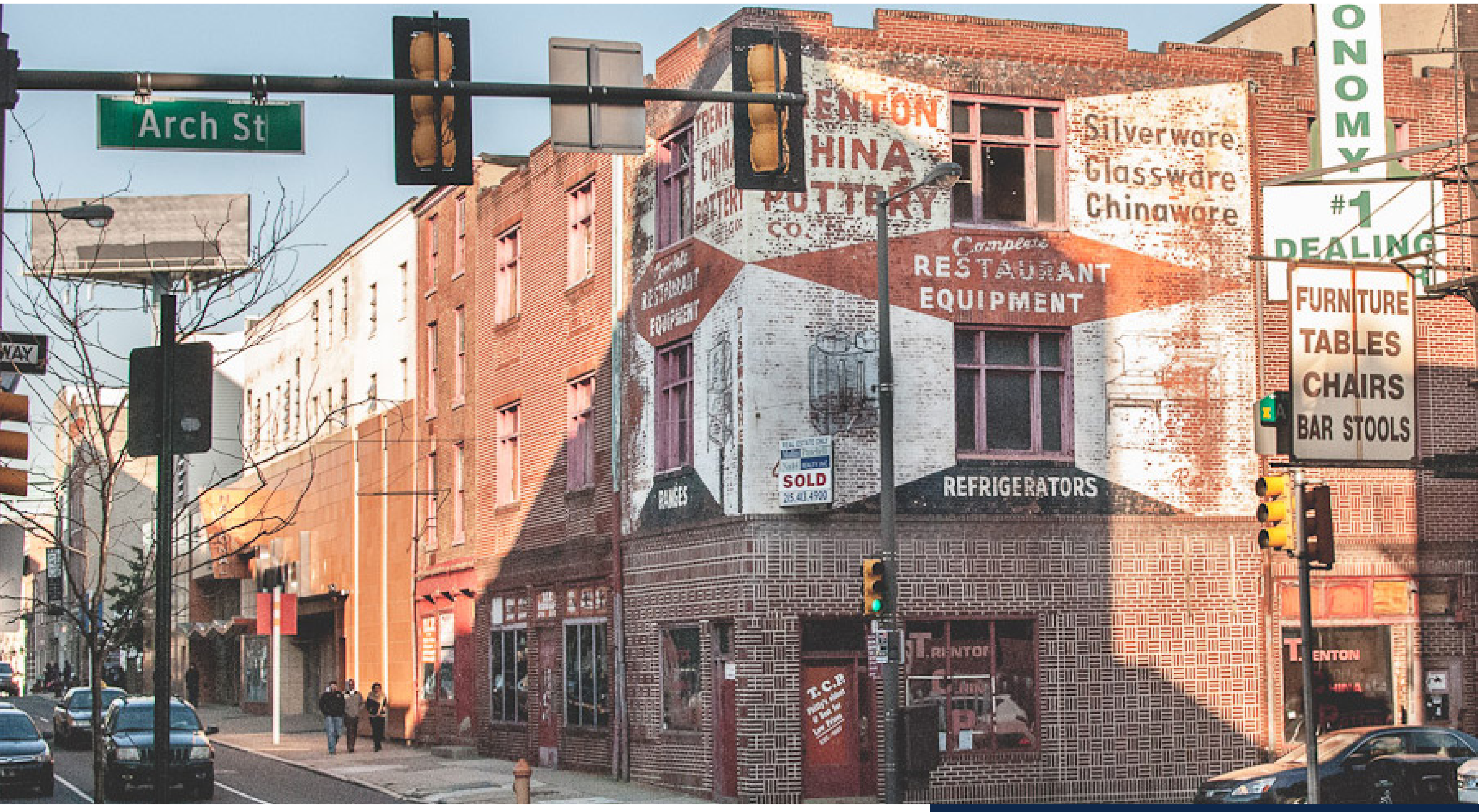

DREXEL UNIVERSITY
Nowak Metro Finance Lab
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ACKNOWLEDGEMENTS

DREXEL UNIVERSITY NOWAK METRO FINANCE LAB

The Nowak Metro Finance Lab was formed by Drexel University in July 2018. It is focused on helping cities find new ways to "finance the inclusive city" by making sustained investments in innovation, infrastructure, affordable housing, quality places, and the schooling and skilling of children and young adults. It is an initiative of Drexel University's Lindy Institute for Urban Innovation.

ACCELERATOR FOR AMERICA

Accelerator for America is a non-profit organization created by Los Angeles Mayor Eric Garcetti in November 2017. It seeks to provide strategic support to the best local initiatives to strengthen people's economic security, specifically those initiatives that connect people with existing jobs, create new opportunities and foster infrastructure development.

Cover Photo: Arch Street in Philadelphia.
Credit: Valerie Hinojosa

INTRODUCTION

There's an old story about a federal DOT employee out inspecting a highway project in the middle of Arizona. When she goes up to a gas station attendant to fill up her gas tank, she says "This place is pretty dry, I hear you only get ten inches of rain a year."

To this the attendant replies, "yeah, but you should see this place on the day we get it."

There's an important gem of wisdom for policymakers in that Southwestern tale: in desert monsoons and economic recovery, it's not just the amount, but the sequencing and duration of resources that matter.

As Congress negotiates the next round of funding, we fear that without the right action America's micro businesses and Main Streets may be left out in a funding desert—facing periodic and unpredictable torrents, rather than the long-term stable support they need to recover stronger. Fortunately, a series of proposed bills, building from locally developed solutions, provide a solution. Now all Congress has to do is pass them.

THE STATE OF SMALL BUSINESS

Four months into the COVID-19 crisis, the outlook for the country's small businesses is as murky as ever. COVID-19 cases continue to rise across the country, slowing and halting many states' reopening plans. Even if we were as far along in combatting the virus in mid-July, small businesses' path to recovery would be extraordinarily challenging. The fact we're behind the ball makes the challenge even more pronounced. The civil unrest in response to the killings of George Floyd, Breonna Taylor, and Ahmaud Arbery, has increased the moral imperative to rebuild majority-black business districts, but has also increased the challenges they face.

The country's small business problems existed long before COVID hit. America has not been forming new business or increasing economic dynamism[i] at a sufficient rate since the Great Recession. The most recent set of SBA data revealed disturbing trends[ii] in Black-owned small business: their share of all employer firms underrepresents the size of the Black population, they are smaller and have lower revenues, and they are highly concentrated in a few sectors. These issues have only been pronounced by the coronavirus crisis.

Since passing the CARES Act in March, Congress has yet to pass a much-anticipated "phase four" of relief funding. For a time, the White House seemed inclined to believe that the recovery was in full swing and that further relief would be unnecessary. However, the spike in cases paired with a second downward turn of main street economies[iii] has hopefully disabused the notion that the CARES Act alone was enough to bridge the economic hardship brought on by COVID-19. With the Congressional August Recess weeks away, there's now hope that Congress will enact further relief measures in short order.

Mere action is not enough: the correct action is required. If the federal government responds inadequately, there will likely be devastating ripple effects across Main Streets and the broader economy—suppressing the engines of economic opportunity in distressed communities when they're needed most. If Washington allows entrepreneurship and small business to languish, the country will feel the impacts for generations.

The primary source of federal small business relief to date, the Paycheck Protection Program (PPP) was designed to cover short-term payroll expenses at a moment in time when most believed that the worst of COVID-19 would be over within a few months of its passage. Although it served much of its purpose and was, for the most part, efficiently distributed, the program was never intended to bridge a long, uneven recovery.

By itself, the PPP has become increasingly insufficient to the crisis that our country's smallest businesses and metropolitan economies are staring down. This is perhaps best evidenced by the fact that the PPP's top-up allocation was not even used by its initial deadline, as the market cooled on its product structure and realized that problems would outlast the PPP's duration.

In the meantime, the best designs for the next phase of recovery are being developed through local ingenuity. We previously highlighted[iv] local relief funds that were formed immediately in response to the economic crisis, and summarized[v] the key lessons learned from these first movers. On the heels of these municipal funds, states replicated and expanded the models, bringing increased financial sophistication to serve the most vulnerable of businesses. States and localities have leveraged the CARES Act's Coronavirus Relief Fund (CRF) to seed small business relief funds. CRF funds[vi] consisted of $150 billion which can be used on unanticipated and necessary expenditures resulting from the pandemic—and which must be used before December 30, 2020 (creating a massive time pressure). One outgrowth of this intense time-pressure, combined with the ongoing small business crisis, is that state uses of CRF capital have laid out a usable, bottom-up blueprint for the next phase of relief funding.

LEADING STATE FUNDS

We have collaborated with two states that have set up effective local recovery vehicles, highlighted below: New York and Rhode Island. Both funds aim to help businesses reopen stronger after the initial period of shutdown. Many other state and municipal units of government set up local relief vehicles, some of which are profiled here.[vii]

New York: Recovery targeted at underrepresented nonprofits & businesses

In May, Governor Cuomo announced a $100+ million New York Forward Loan Fund ("NY Fund"). Unlike the PPP, the NY Fund targets small businesses most in need and is delivered through trusted local non-profit community lenders. These lenders are structured to bring capital from major financial institutions to historically underserved businesses, urban neighborhoods, and rural counties, work they have been doing for decades. The NY Fund targets small businesses and nonprofits which employ 20 or fewer full-time employees and with gross revenues (or operating budgets, in the case of nonprofits) of less than $3 million per year.

The NY Fund aims to distribute 60 percent of its loans to small businesses owned by women entrepreneurs and/or entrepreneurs of color—groups not explicitly targeted (and therefore implicitly excluded[viii]) from the PPP, and which have faced longstanding barriers in accessing credit. The terms and conditions of the loans reflect the kind of flexible working capital that small businesses need to survive a crisis with no clear endpoint: Loans can be provided up to $100,000 at a rate of 3% for small businesses and 2% for nonprofits with no fees. They will be interest-only for the first 12 months to keep payments at a minimum and they'll then amortize over the remainder of the 60-month (5 year) term.

New York State seeded the NY Fund with $20 million in loan loss reserves, leveraged by senior and subordinate lenders to create a $100+ million credit facility. The facility is structured to purchase 95 percent of recovery loans made to small businesses and nonprofits across the State. The loans are being originated by five trusted CDFIs—Accion East, Community Preservation Corporation (CPC), National Development Council (NDC), Pursuit, and TruFund Financial Services—which each have a lending allocation to meet the needs of the communities they serve. The New York State Housing Finance Agency is also playing a role, recognizing that small landlords need help during a period when their tenants are unable to pay rent and were explicitly excluded from accessing PPP loans.

Rhode Island: relief and grants for reopening funding

Rhode Island has unveiled the Restore RI program, which would use an initial $50 million of CARES Act CRF funding for small business needs. Like many other local funds, eligibility will be restricted to businesses with 1-20 employees (with added flexibility for non-chain restaurants and caterers) to ensure that businesses whose needs were not fully met by PPP will be helped. COVID-affected businesses with at-least 30% revenue loss will be eligible, with the highest amounts reserved for those with at-least 50% revenue loss. Likewise, the program prioritizes minority-owned businesses with targeted outreach and a 20% set-aside.

This program will be primarily used to fund reopening & adaptation costs, as well as relieving fixed expenses. The state recognizes the significant costs associated with reopening in a COVID-safe way, including buying PPE, plexiglass, and cleaning supplies along with investing in physical alterations and technology upgrades. Restore RI will allocate grants up to $15,000, depending on the number of employees and percentage of revenue loss. Uses of the funds must be documented, but the eligible uses are much broader than the payroll restrictions of PPP.

KEY ATTRIBUTES OF THE FUNDS

Through the examples set by these and other funds, we have identified five key elements for a community-centered recovery package that grows out of a locally-driven blueprint:

Gain leverage through existing local assets: A package needs to recognize that some components of recovery efforts must be delegated and run locally while others benefit from national efficiencies of scale. Every organization that is well positioned to help is stretched beyond their capacity right now, so recovery models will need to bring centralized support that can be activated and tailored locally. Without additional direct and indirect resources, local organizations are not going to meet anywhere close to the need in their communities. For example, after PPP, most community lenders exhausted their available liquidity and are unable to raise additional capital for new lending. With a model like the NY Fund, for every $1M of available liquidity, there will be $20M lent to small businesses because of the combination of the centralized credit facility and decentralized distribution.

Activate, support and gain leverage from community-based organizations: There is a robust financial system of community development loan funds, community banks, community foundations, and other community-focused lenders and grant makers who are on the front lines of the economic crisis and have the networks, relationships, and trust required to tailor the response to local needs. The federal approach should augment and activate these organizations—rather than trying to duplicate or circumvent their efforts—so they are strong enough to support their communities now and in the future. Equity, operational support, and liquidity targeted towards certified community lenders should come as part of a federal package.

Leverage private and philanthropic capital: The NY Fund (and the $100 million Chicago Small Business Resiliency Fund launched in March) show that public resources can be smartly leveraged to garner bank debt and subordinate, catalytic, capital from philanthropic sources. Program and mission related investments from private foundations and donor advised funds can provide critical risk capital to scale some of these models.

Provide advisory services and increase transparency: The PPP experience was marked by confusion and lack of transparency. A new federal effort must engage a network of technical assistance providers with active, up-to-date information and reporting which can help businesses navigate this stressful period with pre- and post-loan advisory services. The use of mainstream, specialty, and social media should be employed at scale so that information can be disseminated broadly to multiple communities and constituencies.

Build back better: Relief and recovery efforts should be created with broader objectives in mind – expanded access to credit and capital for small businesses in communities that have been historically left out – so we create a path to a more equitable and resilient economy on the other side of this crisis. This is true in product design, eligibility requirements, use of technology and data analysis. PPP has made clear that small businesses need a loan product that provides flexible working capital rather than limited payroll support. The loan product must be easy to understand, underwrite and administer for lenders and borrowers. Standardization across eligibility criteria and product design and centralized technology platforms for distribution will enable data collection and reporting to support analytics and insight that will inform longer-term solutions to gaps in credit access.

MOVING FORWARD

As the federal government faces potentially the final chance before the November election to pass legislation to address the problems of a sputtering recovery, we see a distinct need to capitalize the types of state and local funds that have grown organically in response to the crisis. PPP reform[ix] has improved the product and made substantial strides in getting relief to the right hands on the right timeframe, but we believe that the PPP alone will be insufficient.

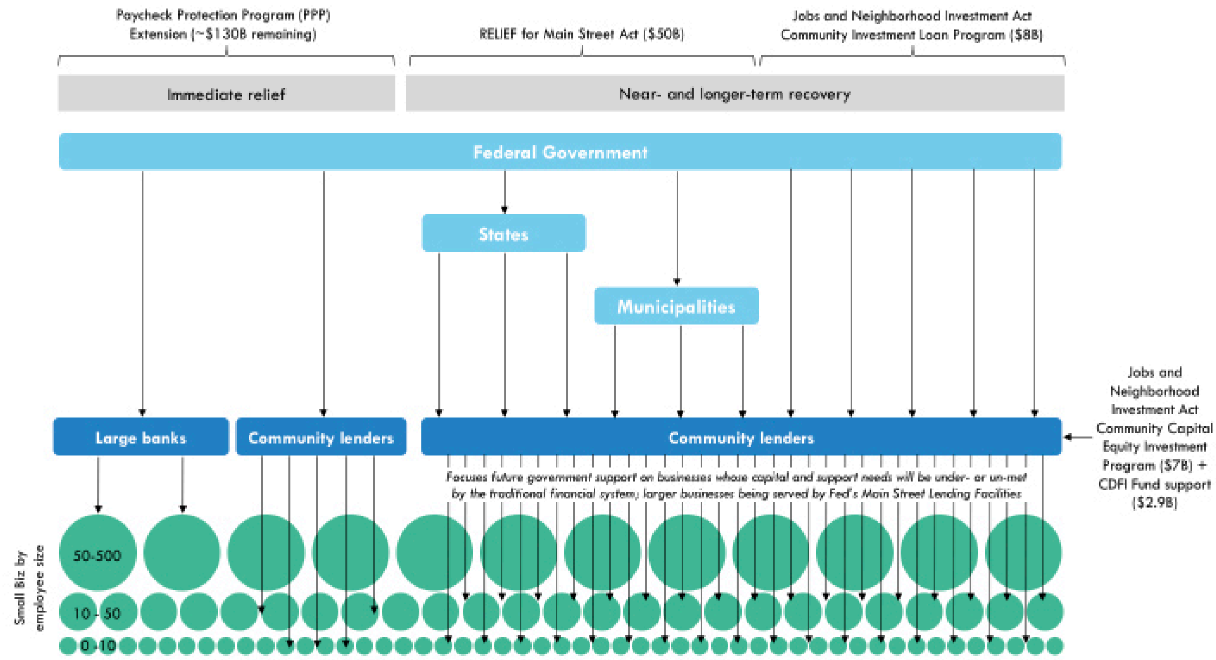
There is a need to think critically about a structurally different product to aid the smallest businesses for which PPP is not an ideal tool. As we outlined above, local actors are responding innovatively to the unique challenges facing their small businesses—they are setting up funds that supplement and reach where PPP does not. More states and municipalities can do so following the lessons we spell out.

But they need additional resources. The next legislative package should provide funds to top up, set up, and incent the types of state and local relief and recovery funds we've highlighted.

We previously advocated[x] for direct funding to state and local governments with the purpose of targeting the most vulnerable businesses, and have been working with Senators Booker and Daines as they advance the RELIEF for Main Street Act,[xi] which has continued to gain bipartisan, bicameral, momentum.[xii] We continue to believe that the proposed $50 billion to flow into local funds remains an essential component of any potential legislative package. The strongest proof of concept possible is the huge variety of states and municipalities[xiii] that have allocated CRF capital to respond to their small business crises.

A second proposed bicameral bill—the Jobs and Neighborhood Reinvestment Act, proposed by Senators Warner, Booker, and Harris, and in the House by Congressman Meeks—supplements efforts in the RELIEF for Main Street Act, by ensuring that if a state does not have capacity to set up a local fund by itself, federal capital can fill in the gaps. It does so by federally investing in CDFIs and Minority Depository Institutions.

Together, we see the RELIEF for Main Street Act and the Jobs and Neighborhood Reinvestment Act, in combination with a PPP reform, as key to a sound recovery. These bills enable approaches that, as we've stressed before, move from distinct financial products to a more holistic place-based approach that focuses on business districts and their neighborhoods, rather than businesses as stand-alone entities. We have proposed that Main Street Regenerators[xiv] serve as an organizing concept to provide the services needed to combat the problems that will be happening in business districts across the country. As we show below, together these funds can provide immediate relief and then build to a longer-term recovery that is more equitable and spurs a new cooperative federalism.



The desert story we opened with has a second moral familiar to readers of this newsletter: sometimes local players have a better idea of their environments than the statistics tell. Congress would be wise to listen to, and support, the blueprints they've laid out as they respond to their unique local economic crises.

At the time of press, Senator Rubio announced his intent to expand PPP and SBA 7(a) loan capacity. The expanded and extended PPP of $200 billion (including unused existing PPP funds) would come closer to targeting the most underserved small businesses, as it narrows the filter to businesses with 300 or less employees that have suffered at least 50% revenue loss. However, as of the initial announcement, these changes do not address the underlying issues, such as term and distribution capability, due to which the original PPP remains partially undistributed. Likewise, while expanding the 7(a) loan capacity is a good start towards getting the flexible capital that small businesses need, it falls short in providing the distribution channels and flexibility required to get the money to the businesses hardest hit. It is positive that the committee is adapting PPP and 7(a) based on some hard-learned lessons that local funds have already addressed, but we believe that the RELIEF for Main Street Act and the Jobs and Neighborhood Reinvestment Act should be part of a comprehensive legislative response.

The stakes are high. Large swaths of our small business ecosystem could continue to be wiped out. Black-owned businesses, already dealt a structurally unfair hand, will be hit harder than others. Vital Main Streets and business districts could see their vibrancy replaced by vacancy and blight. An essential component of any relief bill will be capital that, rather than attempting to be one-size-fits-all, increases the capability and capacity of local governments and local stakeholders to respond to their own distinct small business crises.

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