

TRANSMITTAL

To:

THE COUNCIL

Date: 1/19/2018

From:

THE MAYOR

TRANSMITTED FOR YOUR CONSIDERATION. PLEASE SEE ATTACHED.



(Ana Guerrero) for

ERIC GARCETTI
Mayor



ERIC GARCETTI
MAYOR

January 12, 2018

Council File No.:
Council District Nos.: All
Contact Persons and Phone No:
Miguel Acuña, (213) 595-7460
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The Honorable Eric Garcetti
Mayor, City of Los Angeles
Room 303, City Hall

Attention: Mandy Morales, Legislative Coordinator

**UPDATED COMMITTEE TRANSMITTAL: ECONOMIC AND WORKFORCE
DEVELOPMENT DEPARTMENT RECOMMENDATIONS TO ESTABLISH A
REVOLVING MICROLOAN FUND PROGRAM**

The General Manager of the Economic and Workforce Development Department, or designee, respectfully requests that your office review and approve this transmittal and forward to the City Council for further consideration.

RECOMMENDATIONS

The General Manager of EWDD requests that the Mayor and Council:

1. NOTE AND FILE the EWDD transmittal dated November 4, 2016, (Council File No. 15-1041-S3), relative to the same subject;
2. APPROVE the proposed Microloan Program as presented in this report;
3. AUTHORIZE the General Manager of the Economic and Workforce Development Department (EWDD), or designee, to implement the proposed Microloan Program with Community Development Block Grant (CDBG) funds allocated for this purpose and according to the attached Microloan Program Term Sheet and other recommendations in this report;
4. AUTHORIZE the City Controller to:
 - a) Establish a new account 43PXXX Microloan Program Repayments, Interest and Fees, within the Community Development Trust Fund No.

424, and appropriate as repayments of principal and interest and other fees related to the Microloan program are received.

- b) Deposit repayments of principal and interest and other fees related to the Microloan Revolving Loans into the Community Development Trust Fund No. 424.
 - c) Expend funds from Account No. 43P240-Micro Loan Program and 43PXXX-Microloan Program Repayments, Interest and Fees, upon proper request of the General Manager of EWDD, or designee.
5. AUTHORIZE the General Manager of EWDD, or designee, to prepare Controller instructions, with the concurrence of the CAO, including any future technical adjustments relative to the intent of this transmittal, and request the Controller to implement these instructions;
 6. AUTHORIZE the General Manager, EWDD or designee, to execute microloans in an amount from \$10,000, and not to exceed \$50,000;
 7. AUTHORIZE EWDD to open an interest-bearing account at Union Bank to be used exclusively for the Microloan Program to deposit Microloan Program principal and interest repayments and any fee income, in accordance with 24 CFR §570.500 and as required by HUD;
 - a) Authorize EWDD and the Los Angeles Housing and Community Investment Department (HCIDLA) to remit the interest earned on the funds in this bank account to the U.S. Treasury, in conformance with CDBG regulations.
 8. AUTHORIZE the General Manager, HCIDLA or designee, to prepare and process any amendments necessary for the Consolidated Annual Plan as a result of this action; and
 9. INSTRUCT the EWDD to report bi-annually to the City Council and the Mayor's Office on the status of the Microloan Program portfolio including, but not limited to:
 - a) description and status of loans funded and applications in the pipeline;
 - b) average processing and review time;
 - c) funds remaining;
 - d) repayment rate; and
 - e) estimated revolving rate of the Microloan Funds.

FISCAL IMPACT

There is no General Fund impact. All Microloan Fund activities will be funded entirely through the City's CDBG Program with funds allocated on an annual basis through the Consolidated Plan process.

BACKGROUND

On September 6, 2016, a EWDD transmittal dated August 19, 2016 (Council File No. 15-1041) relative to implementing a proposed Microloan Fund Program with Community Development Block Grant funds was referred to the Economic Development and Housing Committees. On November 4, 2016, an amended EWDD transmittal dated November 4, 2016 (Council File No. 15-1041-S3) relative to recommendations to establish a revolving microloan fund program was referred to the Economic Development Committee. On November 8, 2016, the Economic Development Committee approved the EWDD transmittal dated November 4, 2016 (Council File No. 15-1041-S3), to implement the Microloan Program with \$250,000 of Year 42 CDBG funds, Noted and Filed the EWDD transmittal dated August 19, 2016, and transmitted the Council File to the Housing Committee (unscheduled). However, the CDBG funds identified to be used in the November 4, 2016 transmittal were reprogrammed on November 16, 2017 to fund other City projects. This updated transmittal will replace the previous EWDD transmittal dated November 4, 2016 (Council File No. 15-1041-S3), approved by the Economic Development Committee, and with the recommendation to now use Year 43 CDBG funds for the Revolving Microloan Fund Program.

On March 1, 2017, the City Council adopted the 43rd Program Year Housing and Community Development Consolidated Plan (C.F. 16-1091). The Plan included CDBG funds in the amount of \$250,000 for a Microloan Program with instructions for EWDD to report back with guidelines and procedures to implement the program. As further discussed in this report, the Microloan Program will invest in Microenterprises and Small Businesses that may have difficulty obtaining financing through the private lending institutions. EWDD proposes to administer the Microloan Program as a revolving loan program, which is expected to be fully funded from loan repayments within five years. Assuming EWDD makes \$250,000 in loans per year, this program is expected to fund approximately 75 loans totaling \$1,250,000 over the next five years. It is estimated that every dollar loaned to a small business or microenterprise generates approximately two dollars of economic activity¹. As such, the Microloan Program could generate \$2,500,000 in stimulus to the Los Angeles economy over the next five years.

SUMMARY

The goal of the Microloan Program will be to support the economic growth and revitalization of Los Angeles by strengthening locally owned and operated microenterprises and small businesses that create and/or retain jobs for low- and moderate-income Los Angeles residents.

The Microloan Program will be available to microenterprises² and small businesses³ located or establishing a location in the City of Los Angeles. EWDD is using the SBA

¹ Boyer, Jenna. "Ripple Effect: The Macroeconomic Impact of Small Business Lending." Opportunity Fund, June 2016. Web. 22 July 2016.

² The Department of Housing and Urban Development (HUD) (13 CFR § 119.2 Definitions) defines Microenterprise as a sole proprietorship, partnership or corporation that— (a) Has 5 employees or less, including the owner; and (b) generally lacks access to conventional loans, equity, or other banking services.

³ The Small Business Administration (SBA) defines small business as having less than 500 employees for most manufacturing and mining industries and \$7.5 million in average annual receipts for many nonmanufacturing industries.

definition of small business in the absence of a HUD small business definition. CDBG regulations consider assistance to microenterprise to meet a national objective with no further public benefit requirements, as long as 100 percent of these businesses are owned by an eligible low- to moderate- income person. If the business owner is not an eligible low- to moderate-income person, then the business owner could qualify by meeting the job creation or retention requirement. Assistance to small businesses, however, requires the business to meet an additional public benefit test of one job created for each \$35,000 of assistance, or portion of \$35,000 of assistance. Additionally, 51 percent of the jobs created or retained as a result of this loan, must be made available to Low- to Moderate- income individuals. This means that a small business borrowing \$10,000 would be required to create one job, while a microenterprise borrowing the same amount would not have to meet this requirement. As a result, while the Microloan Program is available to both types of businesses (small and microenterprises), EWDD expects the program will be more attractive to microenterprises.

Gaps in Service and Opportunities to Improve Access to Capital

The attached proposed term sheet for the Microloan Program is designed to support, rather than replicate, financing available to small businesses and microenterprises from private lenders by applying more flexible underwriting criteria and loan terms. EWDD researched other lending programs and examined our own current program guidelines to identify gaps in services and opportunities to improve, and the Microloan Program recommendations in this transmittal incorporate our research findings.

We found that in general, private lenders and the SBA Loan programs have strict underwriting guidelines and a lower tolerance for risk, making it difficult for businesses to qualify for conventional low-cost loans. For example, many private lenders, SBA Loan programs and other second tier financial institutions do not accept borrowers with bankruptcies that are less than 2-7 years old. If they do make loans to these borrowers, their interest rates may be substantially higher to compensate for the higher perceived risk, making the payments unaffordable and causing excessive financial stress on the business. Furthermore, while start-up businesses may be technically eligible for many private loans, in practice, private lenders are very reluctant to make loans to these businesses.

The Microloan Program is designed to fill such gaps in access to capital and in many ways, the Microloan Program may be considered a loan of last resort given its accessibility and the target clientele we are seeking to serve. Continuing with the bankruptcy example, borrowers with a bankruptcy as recent as 12 months may be eligible for the Microloan Program, provided that other mitigating factors demonstrate that the business is viable and will be able to repay the loan. Additionally, EWDD will finance startups businesses or businesses with short operating histories, as long as they can provide sufficient security to support the loan.

EWDD Microloan Program Terms

The EWDD Microloan product will offer loan amounts ranging from \$10,000 up to \$50,000 with interest rates between 7 percent and 9 percent, depending on the

repayment period, term periods of 12 to 60 months, and other risk factors. Payment terms will be based on applicant and owner financial information, and on the purpose of the loan. For example, loans for short-term needs (such as operating expenses) will have shorter repayment periods while those for longer-term uses (such as equipment or other capital expenditures) will be financed over longer periods of time. Both Microenterprises and Small Businesses will be eligible for Microloans. As an added incentive to repay, EWDD may consider adjusting interest rates 1 percent lower upon a clear demonstration that the borrower has made 12 consecutive, on-time payments. Furthermore, borrowers that satisfactorily pay off their loans will be reported to the credit bureaus to help build their credit record.

It is important to note that because EWDD's proposed underwriting criteria are more flexible than other lenders', EWDD expects a slightly greater loss rate. While every effort will be made to ensure that microloans are structured to maximize repayment potential, EWDD anticipates a 7-8 percent loss rate for the Microloan Program fund. In comparison, the loss rate accepted by private banks is 1-3 percent. However, in the spirit of supporting microenterprises and small businesses to overcome any financial challenges that may push them to fall behind in their loan payments or default on their loan, the EWDD will employ every resource available to assist these borrowers, including in-house assistance through the EWDD Finance Officers or referrals to the BusinessSource Centers Network, SCORE and other financial assistance organizations in order to lessen the projected loss rate. Even though the anticipated loss rate for the Microloan Program is more than double the loss rate by private banks, EWDD considers the loss rate to be acceptable because of the benefits that the Microloan Program will help provide through the creation or expansion of these local businesses, newly created jobs being made available to local low- and moderate-income residents, and more goods and services being made available to the local low- and moderate-income community.

Revolving Loan Fund (RLF)

EWDD proposes that the Microloan Program be established as a RLF as provided for in HUD regulations, and as such, all loan repayments will be automatically deposited in the Microloan Program Repayments fund to be re-loaned to other eligible borrowers. Figure 1 on the next page demonstrates that the revolving rate for the Microloan Program, the time it will take for loan repayments to fully support approximately \$250,000 in loans annually, is anticipated to be five years. Using this estimate, we are hopeful that by year six, no additional CDBG funding allocations will be needed for EWDD to continue to loan \$250,000 annually under the Microloan Program.

Figure 1 – Estimated Microloan Program Revolving Rate (based on 12-month cycle)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Starting/New CDBG Request	250,000	250,000	250,000	250,000	250,000	0
Loan Repayments	0	54,978	174,930	269,892	379,842	469,812
Amount Disbursed	250,000	304,978	424,930	519,892	629,842	469,812
*Percent supported by loan repayments	0%	18%	41%	52%	60%	100%

*All percentages are rounded up.

Additionally, the department proposes to establish a separate bank account at Union Bank, as required by HUD regulations, to accept deposit of all microloan program transactions and loan application fees. The department will also regularly transfer and record funds from this account to the Microloan Program Repayment account in Fund 424 and disburse new loans from this account. EWDD and HCIDLA will also remit interest earned on all funds deposited into the Union Bank account to the U.S. Treasury, as required by HUD regulations.

Administrative Process

EWDD’s lending unit will accept applications directly, along with applications made through the LA BusinessSource Centers and other business development partners. EWDD staff will work with the LA BusinessSource Centers to ensure that they are able to accurately assess applications for eligibility and completeness before forwarding to EWDD for evaluation. Once a complete loan application is submitted, EWDD staff will evaluate the borrower’s financial information for ability to meet the national objective and public benefit requirements (if applicable) and ability to repay the loan. EWDD’s goal will be to provide a loan application determination within 10 business days. All responses will be explained thoroughly such that, if a loan application is denied, applicants will understand the reason and what they need to improve/change to successfully re-apply.

Implementation Timing and Performance Reporting

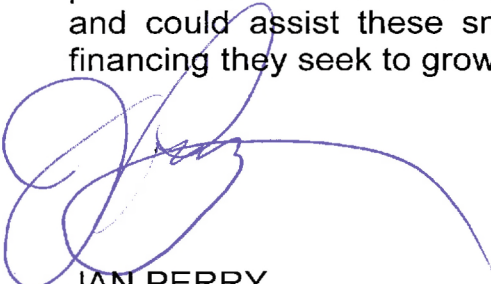
Upon Council and Mayoral approval, EWDD will immediately begin to market the Microloan Program to the microenterprise and small business community, private banks, community lenders and stakeholders as an alternative financing tool that offers terms that are more flexible, thereby making financing accessible to microenterprises and small businesses experiencing challenges in obtaining financing from private lending institutions. We estimate that the first year’s \$250,000 Microloan Program allocation will be fully loaned to eligible businesses within the first 12 months of Council and Mayoral approval.

EWDD will report bi-annually to the City Council and the Mayor's Office on the status of the Microloan Program portfolio including, but not limited to:

- a) description and status of loans funded and applications in the pipeline;
- b) average processing and review time;
- c) funds remaining;
- d) repayment rate; and
- e) estimated revolving rate of the Microloan Funds.

CONCLUSION

The EWDD Microloan Program's goal is to meet the needs of small business and microenterprise borrowers that have a difficult time qualifying for loans from private banks or community lenders. The EWDD Microloan program is flexible and could assist these small businesses and microenterprises to obtain the financing they seek to grow and expand in the City of Los Angeles.



JAN PERRY
General Manager

JP:SH:DH:MA

Attachment: Microloan Program Term Sheet

MICROLOAN PROGRAM TERM SHEET

<p>Program: Microloans will be made available to qualifying Microenterprises or Small Businesses from the Microloan Program Revolving Loan Funds. Funds must be used to provide for “Expanded economic opportunities including job creation and retention; establishment, stabilization and expansion of small businesses (including microbusinesses or microenterprises); and access to capital and credit for development activities that promote the long-term economic and social viability of the community.” (CFR Title 24 Part 91.1 and in accordance with applicable sections of Part 570.203).</p>	
<p>Borrower Eligibility and Types of Loans:</p>	<p>The Program offers loans to create, stabilize or to expand Microenterprises and make loans to Small Businesses operating within the City of Los Angeles whose needs are Financially Underserved by the private banking industry.</p> <p>Loans offered under the Program are generally unsecured term loans. Loans may be disbursed in one or multiple draws over a predefined time limit.</p>
<p>Loan Amounts:</p>	<p>The amount of business loans for each applicant may range from \$10,000 to \$50,000.</p>
<p>Eligibility: Use of Funds and National Objective Requirements</p>	<p>Eligible uses of funds include operations/start-up, working capital, lease subsidy, and equipment purchase.</p> <p>Ineligible uses include dividends, distributions, pirating jobs, funding of severance payments or any other ineligible uses in the HUD CDBG regulations.</p> <p>Loans must be made for CDBG eligible purposes and meet a National Objective Requirement.</p>
<p>Maximum Loan Term:</p>	<p>The maximum term allowed under this program will be 5 years.</p>
<p>Maximum Amortization:</p>	<p>The maximum amortization allowed under this program is 5 years.</p> <p>The outstanding principal amount of business loans amortize monthly with monthly principal and interest payments. Repayment schedules are based on Borrower’s cash flow projections.</p>

MICROLOAN PROGRAM TERM SHEET (Cont.)

<p>Interest Rate:</p>	<p>Interest rates for each business loan are fixed at a rate to be set from time to time by the General Manager of EWDD. Interest rates may be reduced up to 1% for on-time payments for 12 consecutive months. Current Rates are:</p> <table border="1" data-bbox="451 431 1429 553"> <thead> <tr> <th data-bbox="451 431 938 491">Term (Maturity)</th> <th data-bbox="938 431 1429 491">Current Interest Rate</th> </tr> </thead> <tbody> <tr> <td data-bbox="451 491 938 553">1 to 5 years</td> <td data-bbox="938 491 1429 553">7.00-9.00%</td> </tr> </tbody> </table> <p>Final Interest Rates will be determined based on the business's risk assessment.</p> <p>Subject to availability, Borrowers that agree to pay via ACH (Automated Clearing House, a.k.a. "Autopay") will receive a 0.50% interest rate reduction.</p> <p>In the event of a default of any terms of the Loan Agreement, the loan would accrue interest at a default rate of interest at a rate to be set from time to time by the General Manager of EWDD. Currently, this interest rate is 15%.</p>	Term (Maturity)	Current Interest Rate	1 to 5 years	7.00-9.00%
Term (Maturity)	Current Interest Rate				
1 to 5 years	7.00-9.00%				
<p>Application and other Fees:</p>	<p>\$250.00 non-refundable application fee (includes the cost of up to two credit reports).</p>				
<p>Loan Fee:</p>	<p>Up to 1%.</p>				
<p>Collateral:</p>	<p>On a best efforts basis, EWDD supports each loan it makes with collateral. Collateral may include business assets such as cash, accounts receivable, inventory, equipment, intellectual property and/or real property.</p> <p>Maximum advance rates on Collateral are established during underwriting of the loan.</p>				
<p>Subordination:</p>	<p>On a case-by-case basis the City's loan and collateral may be subordinated to other loans subject to approval conditions. Such conditions may include a maximum Combined Loan to Value Ratio of 90% and/or a minimum Global Debt Coverage Ratio of 1.10 or other applicable cash flow measure.</p>				
<p>Guaranty:</p>	<p>All loans are to be guaranteed by owners of 25% or more of the business (Guarantors). Each guarantor must provide a Guaranty.</p>				

MICROLOAN PROGRAM TERM SHEET (Cont.)

Source of Origination:	Loan applications will be made available to potential borrowers upon request from EWDD, at LA BusinessSource Centers and other business assistance/lender partners. Complete loan applications may be submitted to EWDD, to LA BusinessSource Centers and other business assistance partners. EWDD staff will work with LA BusinessSource Centers and other business assistance/lenders partners to ensure that they are able to accurately assess applications for completeness before forwarding to EWDD for evaluation.
Underwriting and Approval Process:	
Underwriting:	<p>Once an application is determined to be eligible and complete for the Microloan Program, either by EWDD or an LA Business Source Center, or other business assistance partners, EWDD staff will perform all underwriting functions and review, including:</p> <ul style="list-style-type: none"> a) evaluating financial statements, revenue projections, tax returns and applicant credit record; b) debt capacity analysis of borrower and/or guarantor(s); c) site visit and interview with borrower; and d) other documents required for underwriting a business plan. <p>EWDD staff will produce a Credit Approval Memorandum (CAM) for a recommended application or an Adverse Action Memorandum (AAM) for an application that is declined. The AAM will state the reason(s) that the application is recommended to be declined. Referral to a business assistance partners will also be offered.</p>
Key Cash Flow/Repayment Underwriting Requirements:	<ol style="list-style-type: none"> 1) Borrowers are required to exhibit sufficient supportable cash flow to achieve a Global Debt Coverage Ratio of 1.10. 2) Borrower's business and personal credit report should show that the Borrower and owner(s) are substantially current on accounts payable (money owed to business creditors) and personal loans including credit cards, installment debt and mortgages.

MICROLOAN PROGRAM TERM SHEET (Cont.)

Loan Committee Approval:	Each Credit Approval Memo and each Adverse Action Memo will be submitted for action to a Loan Committee consisting of the General Manager of EWDD, designated Assistant General Manager(s) of EWDD and the Chief Grants Administrator of the Market Investments and Innovation Division. The Loan Committee acts as the final approval authority and as a Best Practices Second Review panel for declined transactions.
Exceptions:	The above serves to indicate the terms and conditions applicable to most of the loans under this Program. Exceptions may be considered. Exceptions are to be clearly identified and justified to and approved by the Loan Committee.