

# TRANSMITTAL

To:

**THE COUNCIL**

Date: 09/02/2016

From:

**THE MAYOR**

**TRANSMITTED FOR YOUR CONSIDERATION. PLEASE SEE ATTACHED.**



(Ana Guerrero)

**ERIC GARCETTI**  
Mayor



ERIC GARCETTI  
MAYOR

August 19, 2016

Council File: 15-1041  
Council District Nos.: All  
Contact Persons and Phone No:  
Meg Barclay 213-744-9340  
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The Honorable Eric Garcetti  
Mayor, City of Los Angeles  
Room 303, City Hall

Attention: Mandy Morales, Legislative Coordinator

**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 (EWDD), 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. 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;
2. AUTHORIZE the City Controller to:
  - a) Deposit repayments of principal and interests and other fees related to the Microloan Revolving Loans into the Community Development Trust Fund No. 424.
  - b) Establish a new account 43NXXX Microloan Program Repayments, Interests and Fees, within the Community Development Trust Fund No.

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

- c) Expend funds from Account Nos. 43N240-Microloan Program and 43NXXX-Microloan Program Repayments, Interests and Fees, upon proper request of the General Manager of EWDD, or designee.
3. 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;
  4. AUTHORIZE EWDD to open an interest-bearing account at Wells Fargo 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; and
    - 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;
  5. 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
  6. 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.

#### **SUMMARY**

On April 28, 2016, the City Council adopted the 42<sup>nd</sup> Program Year Housing and Community Development Consolidated Plan (C.F.15-1041). 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 activity<sup>1</sup>. As such, the Microloan Program could generate \$2,500,000 in stimulus to the Los Angeles economy over the next five years.

## **BACKGROUND**

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 microenterprises<sup>2</sup> and small businesses<sup>3</sup> located or establishing a location in the City of Los Angeles. CDBG regulations consider assistance to microenterprise to meet a national objective with no further public benefit requirements, as long as 51% of these businesses are owned by a low- to moderate-income person. 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. 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 term sheet for the Microloan Program (attached for reference) 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. To accomplish this goal, EWDD researched other lending programs and examined its current program guidelines to identify gaps in services and opportunities to

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

<sup>2</sup> 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.

<sup>3</sup> 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.

improve. The Microloan Program recommendations in this transmittal take our findings from this research into account.

We found that in general, private lenders and the SBA Loans 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. 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 6% and 8% depending on the repayment period, 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.

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% loss rate for the Microloan Program fund. This compares to 1-3% loss rate accepted by private banks. Even though the anticipated loss rate for the Microloan Program is double the loss rate by private banks, EWDD considers the loss rate to be acceptable because of the benefits of the newly created jobs being made available to local residents, and more goods and services being made available to the local community, that the Microloan Program will help provide through the expansion of these local businesses.

### Revolving Loan Fund

EWDD proposes that the Microloan Program be established as Revolving Loan Fund (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 below 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 – will be five years. We therefore estimate 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*	197,500	145,000	92,500	42,500	0
Loan Repayments	0	52,500	105,000	157,500	207,500	250,000
Amount Disbursed	250,000	250,000	250,000	250,000	250,000	250,000
% supported by loan repayments	0	21	42	63	83	100

Additionally, the department proposes to establish a separate bank account at Wells Fargo Bank, as required for 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 HCID will also remit interest earned on all funds deposited into the Wells Fargo Bank account to the U.S. Treasury, as required by HUD regulations.

### Administrative Process

EWDD's lending unit will accept applications directly and through the LA BusinessSource Centers. 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. 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 to successfully reapply.

#### 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:MB:MA

Attachment: Microloan Program Term Sheet

## ATTACHMENT: MICROLOAN PROGRAM TERM SHEET

<p><b>Program:</b> 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><b>Borrower Eligibility and Types of Loans:</b></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 secured term loans. Loans may be disbursed in one or multiple draws over a predefined time limit.</p>
<p><b>Loan Amounts:</b></p>	<p>The amount of business loans for each applicant may range from \$10,000 to \$50,000.</p>
<p><b>Eligibility:</b>  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><b>Maximum Loan Term:</b></p>	<p>The maximum term allowed under this program will be 5 years.</p>
<p><b>Maximum Amortization:</b></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>



**ATTACHMENT: MICROLOAN PROGRAM TERM SHEET (Cont.)**

<p><b>Interest Rate:</b></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. Current Rates are:</p> <table border="1" data-bbox="451 317 1419 537"> <thead> <tr> <th data-bbox="451 317 935 373">Term (Maturity)</th> <th data-bbox="935 317 1419 373">Current Interest Rate</th> </tr> </thead> <tbody> <tr> <td data-bbox="451 373 935 432">1 to 3 years</td> <td data-bbox="935 373 1419 432">7.00%</td> </tr> <tr> <td data-bbox="451 432 935 537">Greater than 3 years up to 5 years</td> <td data-bbox="935 432 1419 537">8.00%</td> </tr> </tbody> </table> <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 would be 10%.</p>	Term (Maturity)	Current Interest Rate	1 to 3 years	7.00%	Greater than 3 years up to 5 years	8.00%
Term (Maturity)	Current Interest Rate						
1 to 3 years	7.00%						
Greater than 3 years up to 5 years	8.00%						
<p><b>Application and other Fees:</b></p>	<p>\$250.00 non-refundable application fee (includes the cost of up to two credit reports)</p>						
<p><b>Loan Fee:</b></p>	<p>None.</p>						
<p><b>Collateral:</b></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><b>Subordination:</b></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><b>Guaranty:</b></p>	<p>All loans are to be guaranteed by owners of 25% or more of the business (Guarantors). Each guarantor provides a Guaranty.</p>						

**ATTACHMENT: MICROLOAN PROGRAM TERM SHEET (Cont.)**

<p><b>Source of Origination:</b></p>	<p>Loan applications will be made available to potential borrowers upon request from EWDD or at LA BusinessSource Centers. Complete loan applications may be submitted to EWDD or through LA BusinessSource Centers. EWDD staff will work with LA BusinessSource Centers to ensure that they are able to accurately assess applications for completeness before forwarding to EWDD for evaluation.</p>
<p><b>Underwriting and Approval Process:</b></p>	
<p><b>Underwriting</b></p>	<p>Once an application is determined to be eligible and complete for the Microloan Program, either by an LA Business Source Center or EWDD then EWDD staff will perform all underwriting functions and review, including</p> <ul style="list-style-type: none"> <li>a) evaluating financial statements, revenue projections, tax returns and applicant credit record;</li> <li>b) debt capacity analysis (borrower and/or guarantor(s)),</li> <li>c) site visit and interview with borrower; and</li> <li>d) other documents required for underwriting a business plan.</li> </ul> <p>EWDD staff will produce a Credit Approval Memorandum (CAM) for a recommended transaction or produces an Adverse Action Memorandum (AAM). The AAM states reasons that the application is recommended to be declined.</p>
<p><b>Key Cash Flow/Repayment Underwriting Requirements:</b></p>	<ul style="list-style-type: none"> <li>1) Borrowers are required to exhibit sufficient supportable cash flow to achieve a Global Debt Coverage Ratio of 1.10.</li> <li>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.</li> </ul>
<p><b>Loan Committee Approval:</b></p>	<p>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 Market Investments and Innovation Division Director. The Loan Committee acts as the final approval authority and as a Best Practices Second Review panel for declined transactions.</p>

**ATTACHMENT: MICROLOAN PROGRAM TERM SHEET (Cont.)**

<b>Exceptions:</b>	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.
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