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Save-our Small (SOS) Business Loan Fund - A Proposal

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The shock of the coronavirus shutdown on local economies everywhere has left small businesses and their workforces in peril. Most local governments lack the resources necessary to fund sufficient programs to moderate the shutdown's impacts on small businesses. Many municipal programs are already helping small businesses to keep the lights on, but in the medium term, small business survival will require more capital. The Federal programs are helpful, but even the small business loan allocation in the $2 trillion stimulus bill simply is not enough funds to support medium-term small business survival. Nor is the Federal cash immediately ready for distribution.

What we are proposing is a product that the municipality could offer in tandem with any current grants or loan programs. The design of the loan product would not be a replacement to any federal or SBA lending, but rather a supplemental source of capital for small business. Where appropriate, state small business loan guarantee programs would greatly de-risk the product and enable the raising of capital and greater participation of constrained cities.

Municipalities face two major constraints: (i) a funding constraint as a result of a lack of funds for a far-reaching small business loan program, and (ii) a design constraint on their ability to implement such a program with repayment terms that are not so onerous that they do not cause borrowers to become insolvent as a result. With these two constraints in mind, we propose a structured financial recovery product for small businesses <u>funded in part by private capital.</u>

We further offer the Berkeley-Haas Sustainable Finance ecosystem to help municipalities design the terms of their Save-our-Small Business Loan Funds and to build the viability assessment model on which loan decisions would depend.

Save-our-Small Business (SOS) Loan Fund

Items in blue are suggested items for tailoring by municipality.

SOS Loan Fund Structure:

- The municipality, acting as a sponsor, establishes the SOS special purpose vehicle.
- The SOS fund is an asset-backed security, backed by the small business loans provided.
- All loans are pooled into the SOS fund, and investors participate pro rata in individual loans.
- The SOS fund issues two types of securities:
    - Preferred security claims to private capital investors.
    - Sponsor security claims to the municipality.

  The flows to these claims are described below.

Applications & Sorting:

- Small businesses would apply with the municipality to participate in the SOS.
    - The municipality would determine the small business qualifying thresholds based on a rubric such as:

      Maximum annual revenues <= [some number]
      And/or
      Number of employees <= [some number]
- These applicants would be evaluated using a *viability assessment tool to judge* their expected ability to survive 2 years ahead, conditional receiving SOS loan funding during the interim time period.
    - Viability assessment would be based on ability-to-pay calculations.
- Sorting
    - Small businesses which are not able to pass the assessment would fall into a different pool that could be supported by municipal loans that do not involve private capital participation.

      NOTE: The objective of the SOS Loan Fund is to make the opportunity appealing to investors to attract private capital to expand the reach of the municipality's own funds. Rather, the SOS offering would expand the reach of the limited capital of local governments, as an addition or tiered offering with the existing programs.

Loan Terms

- The loan would be administered by and collected by the sponsor, in coordination with municipal tax offices.
- Interest rate: to be determined by municipality (suggested: 2%) per annum[1]
- Maturity: 5 years

[1] Alternatively, the municipality sponsor might consider a structure whereby the municipality expects 0% interest and the private investors 2%, resulting in a rate to the small businesses that would be the blended average.

- Amortization: Payments will be an annuity starting in month 6 after closing, offering recovery time for the small businesses.
- The borrower will be accountable for the use of the loan as described in the *Loan Protections* section.

Loan Size:

- The loan size: Up to 3-month revenues that the business might have expected had the coronavirus shutdowns not occurred.
- Note: the municipality might also choose to vary the loan size by:
  - Whether or not the business is the owner of the property in which it operates.
  - The number/fraction of employees supported per $500,000 of revenue.
  - The extent of other debt obligations.
- Loans would fall in the range of $50,000 to $500,000

Preferred securities

The SOS program would offer fixed-income-like returns with de-risking protections to mobilize impact investor interest.

- Preferred security holders would receive:
  i. A claim on debt repayments senior to that of the municipality.
     The exact extent of this seniority can be adjusted in accordance with preferences of the municipality but would follow the European version of the standard Distribution Waterfall Method (below) used in private equity. The idea is that the municipality holds the first loss position on the loans to ensure the product is a low-risk, fixed income product. The municipality should be willing to be the first loss investor because of its role as a safety net and because of its exposure to the upside – successful businesses generate positive tax revenues and other benefits to the local economy.

     Distribution Waterfall Method:
     - The determination of the loan repayment flows is made by the following sequencing, noting that if a State Small Business Loan Guarantee is available, the state contribution to covering losses becomes a part of this calculation:
       1. <u>Preferred return of capital</u> - 100 percent of payments made by borrowers go to the preferred security holders until they recover all of their initial capital contributions made into the ABS
          - (i.e., total capital invested, not loan-by-loan capital)

2. Sponsor catch-up tranche - 100 percent of the next payments made by borrowers go to the sponsor (the municipality) until it recovers its capital.
3. Preferred return - 100 percent of further distributions go to investors until they receive the [2%] rate of return on the entire pool of invested capital.
4. Sponsor return – The residual payments go to the sponsor.

ii. Potentially the possibility of opportunity zone tax benefits [to be discussed with the municipality].

Sponsor securities:

- The sponsoring municipality would receive proceeds from loan repayments after satisfying the preferred portion paid to the preferred security holder, as described in the Distribution Waterfall Method.

Loan Protections

- The Viability Assessment and necessary documentation for closing a loan would include necessary provisions for the accountability of small business lenders, ensuring that the loan funds serve to enable the small business borrowers to weather the coronavirus-caused downturn through support of certain fixed costs (rent and leases) or variable costs (payroll) that become insurmountable during the low-revenue recovery months.