High-Risk Loans--From a Nonprofit

Community funds are filling a gap.

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Things were not looking good for Leo White. A longtime manufacturing executive, White was eager to acquire a Keene, New Hampshire, company called Bortech, which had been making welders to repair heavy equipment since 1989. Revenue at the company had never topped $5 million, but White was convinced he could increase that number considerably. His local bank seemed to think so, too, and had promised him a $500,000 loan backed by the Small Business Administration. But at the last minute, the bank backed out, and it looked as if the deal would fall through.

Then a friend introduced White to John Hamilton, who runs Vested for Growth, a program of the New Hampshire Community Loan Fund. Vested for Growth, a Concord-based nonprofit, finances New Hampshire companies that cannot get funding from banks or private equity groups. Hamilton thought White had the management talent to lead Bortech. Using a combination of debt and royalty payments, he was able to arrange half a million dollars in financing. Not long after, White had his company. "If John's organization hadn't stepped in, I thought I was out of luck," White says.

White was just one innovative program away from falling into what is known as a capital gap: a shortage of money for people who need $150,000 to $500,000 or so. Despite recent efforts by banks to reach out to small businesses, many are still loath to lend less than $1 million because the costs of managing a loan are much the same regardless of its size. The SBA is more flexible, but still avoids certain types of high-risk loans. On the equity side, angels and venture funds aren't necessarily shy about smaller investments, but they have little interest in businesses with projected growth rates of less than 30 percent. And of course, borrowing is always more difficult for people and companies that have little collateral, are in the early stages of development, or have less than pristine credit.

Fortunately for people like White, a new breed of community development financial institutions, or CDFIs, has emerged to fill this need. These organizations--which include community development loan funds, banks, credit unions, and community development venture funds--have been around since 1994, when Congress created the Treasury Department's Community Development Financial Institutions Fund. About 1,000 CDFIs operate nationwide, and while most focus on promoting affordable housing and home ownership, a growing number have begun financing small businesses. In 2005, the latest year for which data are available, CDFIs funded more than 2,000 small and medium-size businesses and held $739 million in outstanding loans and investments, according to the CDFI Data Project, which gathers data on the industry. Another 5,800 companies received microloans of $35,000 or less.

Some CDFIs specialize in particular industries, others in lending to geographic regions, such as the inner city or rural areas. The funds come from a variety of sources, including the government, investors, and private donors. In New Hampshire, Vested for Growth, which has more than $3 million to invest, works in partnership with...
In Leo White and Bortech, Hamilton saw an ideal opportunity. Bortech had been profitable for nine of its 10 years, but because of financial problems in its one off year, and its meager collateral, it was unbankable. Bortech's founder was a machinist who preferred practicing his craft to managing a company, and both White and Hamilton believed that a more business-savvy owner could expand the company by 20 percent a year. For Hamilton, that wasn't the only issue. If the deal with White fell through, the owner intended to sell to another buyer who would move the company, and its eight jobs, to Oregon.

To balance the risk, Hamilton structured a deal that would give Vested for Growth a good return: He offered White a 10-year loan of $500,000 at 9 percent, plus royalty payments that could bring Vested for Growth's internal rate of return as high as 20 percent if Bortech did well. If the company didn't perform, the royalties would be forgiven. It wasn't exactly cheap money. But White had few reservations. "I knew I could afford the higher payment," he says. "Since there was no other way of doing the deal, it became that much more attractive."

Because CDFIs make risky loans, they often have higher interest rates than banks, and their scrutiny is at least as thorough. Companies that can withstand the grueling examination, however, can benefit from the management training that CDFIs typically provide. "Before making a loan, I might be in their faces every day," says Barbara Nagy, director of Enterprise Finance Funds with ShoreBank Enterprise Group, a community development bank that funds businesses in distressed parts of Cuyahoga County, Ohio. After granting a loan, "I have been out at a company every week for months until I'm comfortable that everything is running the way it should be," she says. "We are here to grow companies, not to sell loans, and we know without sound management companies won't be able to grow." Hamilton took the same approach with Leo White, consulting with him regularly and offering him a spot in monthly CEO peer group discussions led by Vested for Growth.

Hamilton's risk paid off: In White's second and third years of running Bortech, revenue grew 40 percent each year. At the end of the third year, White refinanced with an SBA-backed loan. Since the sale, revenue has tripled and Bortech has grown to 15 employees. After its initial surge, revenue is now growing about 20 percent a year, a pace White can fund through cash flow. And though his financial deal with Vested for Growth has ended, White still attends the CEO discussions. "The advice and guidance I'm getting from that group is just amazing," he says.

Hamilton, meanwhile, continues to search for solid companies that have slipped into the capital gap. His small portfolio now includes a high-tech start-up that has forged an international distribution arrangement with Intel (NASDAQ:INTC), and a chemical company that needed capital to enter a new market. "Good growth plans don't always fit with bankable debt or equity," he says. "We're keeping good growth plans from being shelved."