Early Learnings

JUNE 2023

Entrepreneurs of Color Fund

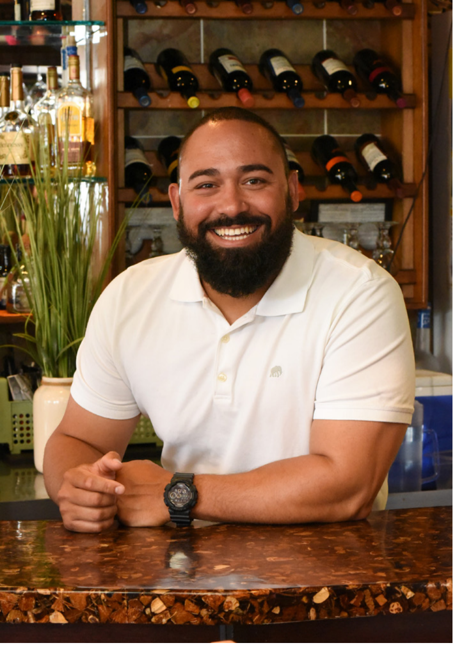
Early Learnings: Introduction

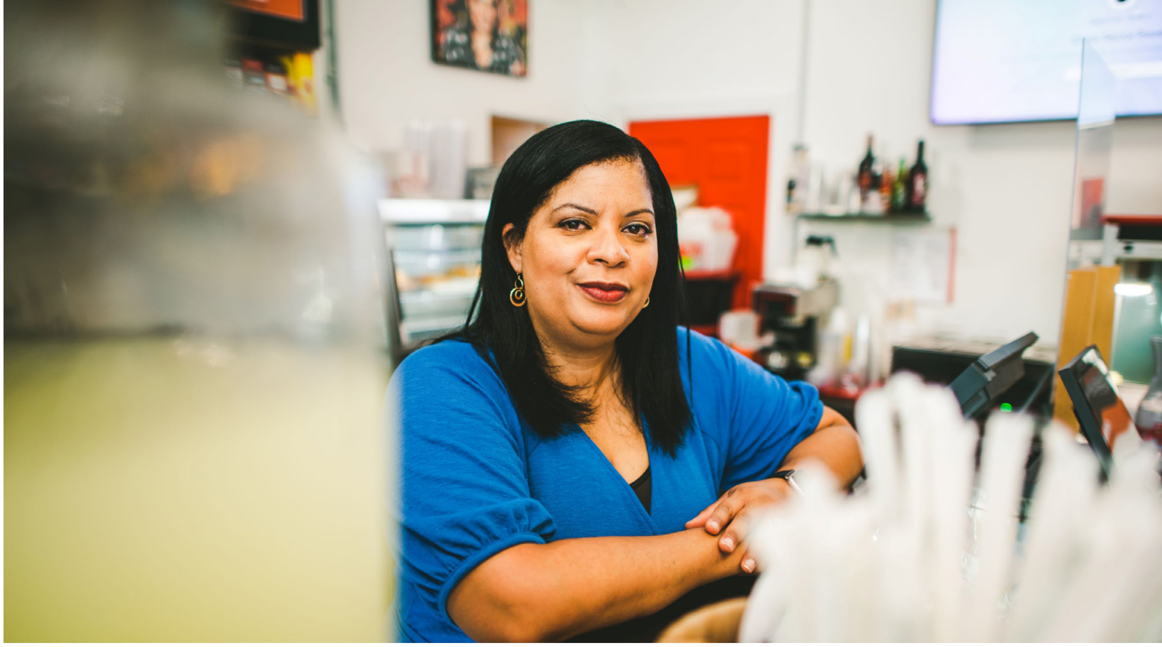
THE ENTREPRENEURS OF COLOR FUND (EOCF) was launched in Detroit in 2015 as a pilot program to test and implement strategies that bridge persistent capital gaps for Black and Latinx businessowners. Since then, the program has expanded to 10 cities and fueled more than $197.5 million in affordable financing for diverse businesses.

EOCF has two primary goals—to finance growth for entrepreneurs of color and to help community development financial institutions (CDFIs) build their capacity to invest in underserved businesses and communities. Toward that end, EOCF partners with 24 CDFIs and five technical assistance providers, providing grants to help them identify opportunities and deploy capital. EOCF also works with foundations, municipal agencies, and business support organizations to package funding and technical assistance that supports equitable small business growth, including:

- Helping owners expand their access to markets and their customer reach
- Helping firms build their assets, workforce and financial track records to support growth
- Activating commercial corridors to expand economic opportunity, especially in low- and moderate-income (LMI) communities

All of those require not just an increase in the number of loans to Black and Latinx owners but, critically, an increase in the size of the loans deployed. Larger loans support larger scale enterprises and help build wealth in communities of color. They also respond directly to long-standing capital constraints for minority borrowers. Federal Reserve data indicates that entrepreneurs of color are half as likely as white owners to have their loans fully funded. Even owners with strong credit face racial barriers when it comes to accessing appropriate capital.





Snapshot of EOCF Borrowers

Over the past eight years, EOCF and its CDFI partners have made loans to more than 4,000 small businesses supporting nearly 6,600 jobs. A third-party evaluation of EOCF's 2022 activity (2,700 loans totaling $118 million) finds 50 percent of loans were made to women businessowners of color and 37 percent to owners with FICO scores that are too low to qualify for conventional loans or financing from the U.S. Small Business Administration (SBA).

Those indicators are important because they tackle significant market gaps. For instance, while the SBA's traditional small business lending programs deployed 61,000 loans worth $44.8 billion in 2021, less than $1.1 billion of that went to Black-owned businesses, with another $2.7 billion supporting Hispanic-owned firms and $5.7 billion fueling businesses owned by women.

EOCF is helping fill that gap with products that fall into three categories:

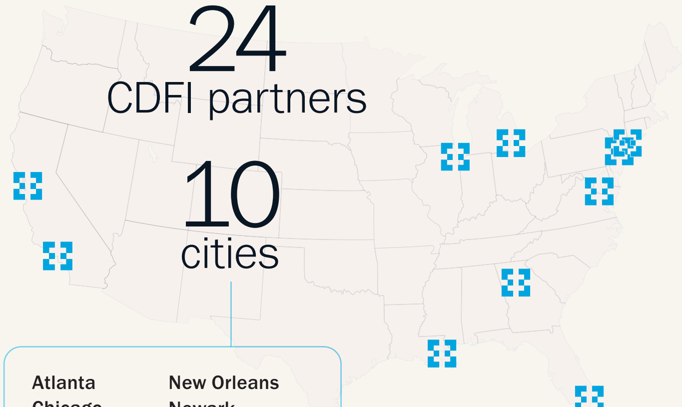
- Microloans from $500 to $50,000
- Working capital, lines of credit, and term loans from $50,000 to $500,000
- Commercial real estate acquisition loans of $500,000 to $5 million

The EOCF portfolio of borrowers reflects some similarities to the national small business landscape, which includes 33.2 million enterprises and 61.7 million employees, as well as some clear distinctions. For instance, on average, EOCF borrowers have 3.5 employees and been in business six years—outpacing the 50 percent of start-ups that fail within five years and falling squarely in the 51 percent of existing small businesses that are less than 10 years old.

In 2022, EOCF borrowers generated average revenue of just over $280,000, though the median business was smaller, at $120,000 in revenue with two employees. The average EOCF loan to them was $90,000.

All EOCF borrowers are entrepreneurs of color, compared to approximately 20 percent of small business owners nationally. Moreover, in 2022, nearly half of EOCF-supported businesses were operating in low-to-moderate-income (LMI) communities.

EOCF ACTIVITY: 2022



24
CDFI partners

10
cities

- Atlanta
- Chicago
- Detroit
- Los Angeles
- Miami
- New Orleans
- Newark
- New York
- Oakland
- Washington, D.C.

2,700
loans

$118M
in lending

50%
of loans were made to women businessowners of color

37%
of loans were made to owners with FICO scores too low to qualify for conventional loans or financing from the U.S. Small Business Administration (SBA).

Nearly
50%
of EOCF-supported businesses were operating in low-to-moderate-income communities.

100%
of loans were made to entrepreneurs of color

The average EOCF borrower:

3.5 employees

6 years in business

$280,000 in annual revenue

Overall, the 2022 evaluation found EOCF is serving entrepreneurs that typically have the most difficult time accessing capital. Without these types of lending programs, underserved entrepreneurs of color may struggle to move beyond “friends and family” funding and to reach the scale needed for long-term sustainability and growth.

Snapshot of CDFI Activity

CDFIs are the foundation of EOCF’s delivery system. These community-focused financial organizations already have clear missions to fuel positive social impact by investing in communities—from affordable housing and economic development to health, education and financial inclusion. But, though many serve small businesses, their capacity is often limited. EOCF provides grants and program support that helps them expand their ability to support entrepreneurs of color and fuel economic opportunity, especially in LMI communities.

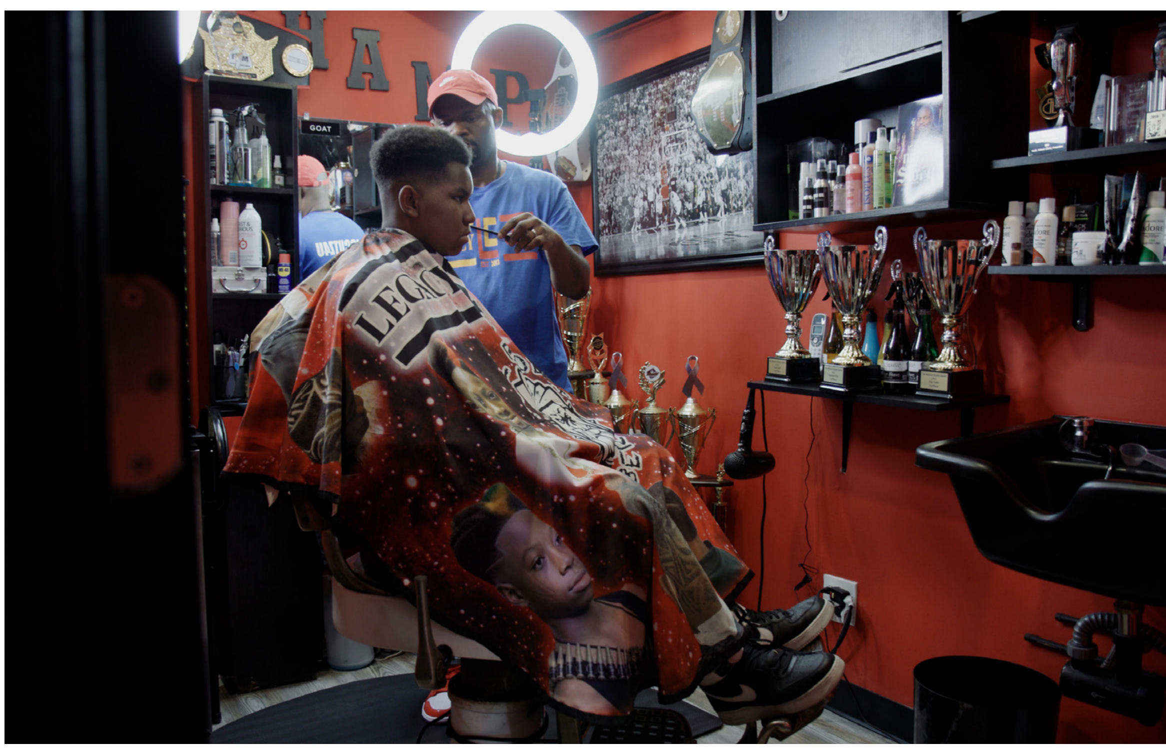
EOCF works with its CDFI partners to support deployment of capital as well as technical assistance to small businessowners, including individual coaching, general business education, credit repair, and help preparing financial statements. In addition, a new EOCF conduit loan fund is helping free up capital, purchasing existing small business loans from CDFIs so they can lend more to entrepreneurs of color.

Some CDFIs report that EOCF has helped them build on work they were already doing, essentially scaling their programs and investments to reach more entrepreneurs of color. Others are using EOCF support to reach LMI communities that they had not previously served, while still others are creating new products and services to better support target markets.

Key Learnings

EOCF was developed, seeded, and continues to be supported by JPMorgan Chase as part of its commitment to increasing access to capital for underserved communities. It is managed by the Local Initiatives Support Corporation (LISC), a national CDFI with a 40-year track record of successful community development investments, aligning with LISC's Project 10X initiative to close racial gaps in health, wealth and opportunity. LISC also makes loans as part of EOCF.

What follows are some key reflections on the EOCF initiative to date. The examples and recommendations are meant to spark engagement among funders, investors, lenders and others working in the small business space, identifying sound opportunities to narrow racial capital gaps and promote economic opportunity.



Credit policies and risk models may fuel racial bias

Underwriting Standards and Equitable Small Business Growth

Even when public, private and nonprofit lenders expressly seek to upend systemic bias, inequities persist—often because the metrics of traditional lending models, including those related to capitalization, length of experience, business location, and personal history of the owner, can end up excluding underserved borrowers and geographies.

This is particularly challenging when certain underwriting standards permeate the financial system. For instance, many models include a “51 percent” provision for commercial real estate (CRE) loans, adopted from the SBA’s CRE approach. It requires a borrower to occupy more than half of the property being financed which, when automatically applied across the board, knocks down promising opportunities for economic development, particularly in LMI communities.

An example in New Orleans illustrates the impact. When trying to evaluate its own credit policies, one of EOCF’s CDFI partners described a $475,000 deal it had previously rejected—one that would have financed a multi-use, multi-tenant property in an underinvested community. The proposed borrower was a Black-owned business that had sufficient financial capacity to assume the debt. But the business would only occupy 20 percent of the space, leasing the remainder to other local entrepreneurs and thereby promoting economic opportunity more broadly in the area.

The lender could not provide financing, even though it otherwise might have, because of the 51 percent requirement, and the project stalled. (The lender did provide the borrower with working capital to reassess how to move forward.)

To head off similar denials in the future, the EOCF team suggested alternatives. For instance, projects like these could be completed in phases to better manage risk. Developers could leverage advances in heating and lighting technology to separate the building into individual units. Lenders could gain comfort by securing a plan and cost review of potential uses for the site. And early buy-in from local CRE brokers could help line up potential tenants and assuage concerns about occupancy.

These strategies have proven effective in helping housing and economic development projects succeed, both in terms of financial performance and community impact.

Predatory Financing and Communities of Color

Debt is predatory when it imposes unfair and/or abusive terms on borrowers, and it is an all-too-common risk for minority-owned businesses that do not have equal access to more traditional borrowing opportunities. Predatory loans tend to move quickly to approval, and so may seem to be an attractive option for much-needed capital. But they can create debilitating debt cycles, as unclear or misleading terms hide higher-than-expected interest rates, fees, and/or balloon payments.

Two approaches—seller financing and merchant cash advances—have been particularly prevalent in communities of color. Neither is predatory by definition, but both are often deployed in ways that negatively impact the financial outlook for owners.

Seller financing is, essentially, what it sounds like. Without access to appropriate capital, Black and Latinx borrowers may have to rely on a property owner to directly finance a CRE purchase. It is an often-expensive approach that can put the new owners at much higher risk for eviction and/or seizure of the property. EOCF has seen difficult scenarios play out in Atlanta, Chicago, Detroit, and Miami, among other markets, most often in low-wealth communities where entrepreneurs are looking to create jobs and grow.

CDFIs can sometimes step in to mitigate the damage. For example, in Atlanta, an EOCF partner refinanced a costly owner-seller carryback loan at a lower interest rate. The loan is supporting a Black-woman-owned business that is developing co-creation space for photographers, videographers, business owners, and community members, adding jobs and vibrancy to the surrounding area. The high cost of the original loan was a threat to the long-term sustainability of the project.

A **merchant cash advance (MCA)**, like seller financing, is also a risk. These loans connect repayment streams to a borrower's sales receipts, and often carry sky-high fees that put owners at a higher risk of default. In fact, the track record of MCAs has been so negative in some communities that it has poisoned the overall view of the financial system, leaving some entrepreneurs skeptical of mainstream banks and CDFIs that offer responsible lending and investment products.

‘Low and Grow’ Models and Nontraditional Borrowers

Standardized, online underwriting strategies can put nontraditional borrowers at a significant disadvantage. Designed to streamline the small business loan application process, these “low and grow” models use what is essentially a one-size-fits-all digital approach that eliminates the human element from the process—and, thereby, eliminates the chance for loan officers to make qualitative assessments about risk and opportunity.

As a result, borrowers with a profile that doesn’t quite fit the model, whether because of where they operate or length of time in business or the owner’s personal history, are often rejected for loans altogether or are approved for less financing than they need and can support.

It is part of a broader challenge related to loan size for entrepreneurs of color. According to the Federal Reserve, Black and Latinx applicants are about half as likely to be approved for full financing when compared to white applicants. The gap is even reflected in pandemic relief efforts: the Paycheck Protection Program, for instance, supported loans that were 50 percent less, on average, for Black business owners than white owners.

EOCF borrowers have also expressed their frustration at the disparities. Sixty percent of EOCF-supported businesses eventually sought additional capital following their successful EOCF loans. But more than half of them reported that their bank loan application was denied. As we have seen through EOCF, as well as through the longer history of community development finance, CDFIs are well-positioned to fill this gap if they have sufficient capital and deliberate strategies that address racial bias.

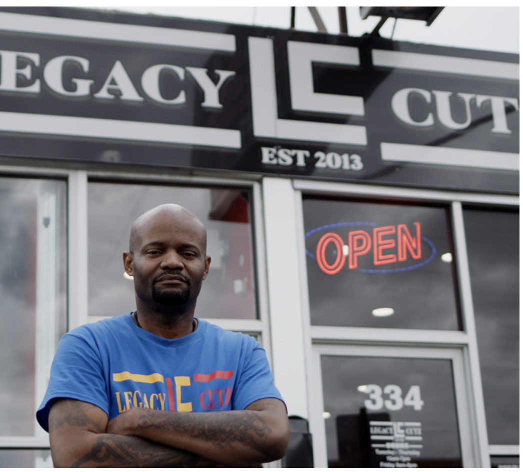
RECOMMENDATIONS

- Investors and funders should allow seasoned CDFIs to take on more risk. The credit policies at mission-driven, community-focused lenders should not be strict derivatives of SBA or commercial bank guidelines. Rather, CDFIs have the expertise and track records to identify credit-worthy small business borrowers and engage in high-touch underwriting and asset management, with direct involvement of loan officers that understand how to support owners and communities that have long been sidelined by the financial system without compromising financial performance.

- “Mission ceilings” can help lenders better differentiate risk, return and impact so that underwriting guidelines do not disadvantage entrepreneurs of color. For loan requests of less than $250,000, for example, CDFIs and other lenders might decide to lead with mission, largely erasing the impact of so-called lifestyle concerns. Transactions between $250,000 and $500,000 might be considered “mission-light,” while those over $500,000, would be less accepting of underwriting differences.

There are untapped opportunities for CDFIs and financial institutions to help entrepreneurs of color build assets

Commercial Real Estate: Activating Commercial Corridors, Fueling Growth



For small business owners, there is no substitute for property ownership. If a business can secure a real estate asset for its operations, it is more likely to be able to access debt in the future to fuel growth.

With this in mind, EOCF and its lending partners have made more than 200 real estate acquisition loans, in addition to providing a range of other types of financing. For example, an EOCF partner supported a Chicago-based, Latina business owner when she had the chance to purchase a commercial space for her salon in a prominent Latinx neighborhood, Belmont Cragin. It not only moved her from a renter to an owner, but it also positioned her salon on a busy thoroughfare that increased her long-term business potential. The purchase means she can avoid the risk of displacement, which is always present when renting a commercial space, while also acquiring a lasting asset that can be leased or sold in the future. EOCF funding mitigated two key risks: low borrower equity of 5 percent and a high loan-to-value ratio of 102 percent.

In other words, a flexible approach to underwriting can fuel small business success. When addressing the needs of underserved owners and communities, loans can be designed to overcome persistent barriers, such as high hurdles for down payments and reserves, which are unrealistic for firms that have not typically had access to capital to build wealth and grow. Lenders should also recognize that conventional CRE underwriting tends to flag businesses in low-income communities as higher risk and unlikely to appreciate quickly. As a result, valuations often don't reflect the business opportunity at hand or line up with the actual cost to purchase property.

The question, then, for lenders is how to realistically evaluate credit/collateral for owners and communities that have not had the chance to build a track record of loan repayment and growth. Traditional metrics, on their own, aren't designed to respond to the on-the-ground realities in many communities.

RECOMMENDATION

- Small business and commercial real estate lending teams often operate in silos, with their own management, underwriting models and goals. As a result, nontraditional borrowers are bounced from one team to the other, not quite fitting with the priorities of either. With an intentional approach to bridging disparities, CDFIs have demonstrated the value of looking at these loans more holistically so they can successfully lend to entrepreneurs of color, especially in LMI communities.

Mergers and Acquisitions: Reimaging the American Dream

For many small business owners, the concept of entrepreneurship means going it alone. But the reality is that to grow, microbusinesses need to build a workforce and expand their market reach. If they merge with or acquire similarly situated firms, they have an opportunity to win contracts that would not otherwise be available and borrow at a scale that supports long-term growth.

This growth strategy is particularly important given the “silver tsunami” that is coming. There are 11 million businesses whose owners are age 55 or older—representing more than half of all employers—and an increasing number of retiring owners may find there is no “next generation” to take over. They are looking for exit options that protect their employees as well as the communities in which they operate.

CDFIs are a natural fit for these transactions because they generally prioritize community-based ownership. For example, in Kalamazoo, Mich., a business owner is working with EOCF and its partners to acquire a printing business in an LMI community. The current owner is retiring and wants to preserve the company as a local resource, having operated in the same neighborhood for more than 25 years. The loan helps achieve that by financing a buyer who has deep experience in the printing industry and who will maintain the firm’s long history as a diverse, locally owned enterprise.

Importantly, when looking at these opportunities, there is a difference between buying assets and buying contracts. It rarely makes sense to buy a firm just to gain a big contract, though some owners may see it as an opportunity for quick growth. The risk is significant, however, as contracts can be fleeting in competitive fields or may be a product of the previous owner’s relationships. Lenders and business development organizations can provide invaluable technical assistance to help owners assess the real value of a potential merger or acquisition and its impact on sustainable growth.

RECOMMENDATION

- Lenders should be open to financing mergers and acquisitions for entrepreneurs looking to build resilience and scale in LMI communities.
- The U.S. Treasury Department has certified more than 1,200 organizations as CDFIs, but most have fairly limited scopes and lending profiles. On their own, they may not be in a position to drive significant gains in the communities they serve. Part of EOCF’s work is to help more CDFIs build their capacity to support community-based business ownership through training, peer learning and one-on-one coaching.

Improve community trust to support small business growth

For Owners, Debt is a Powerful Teacher… If They Are Open To It

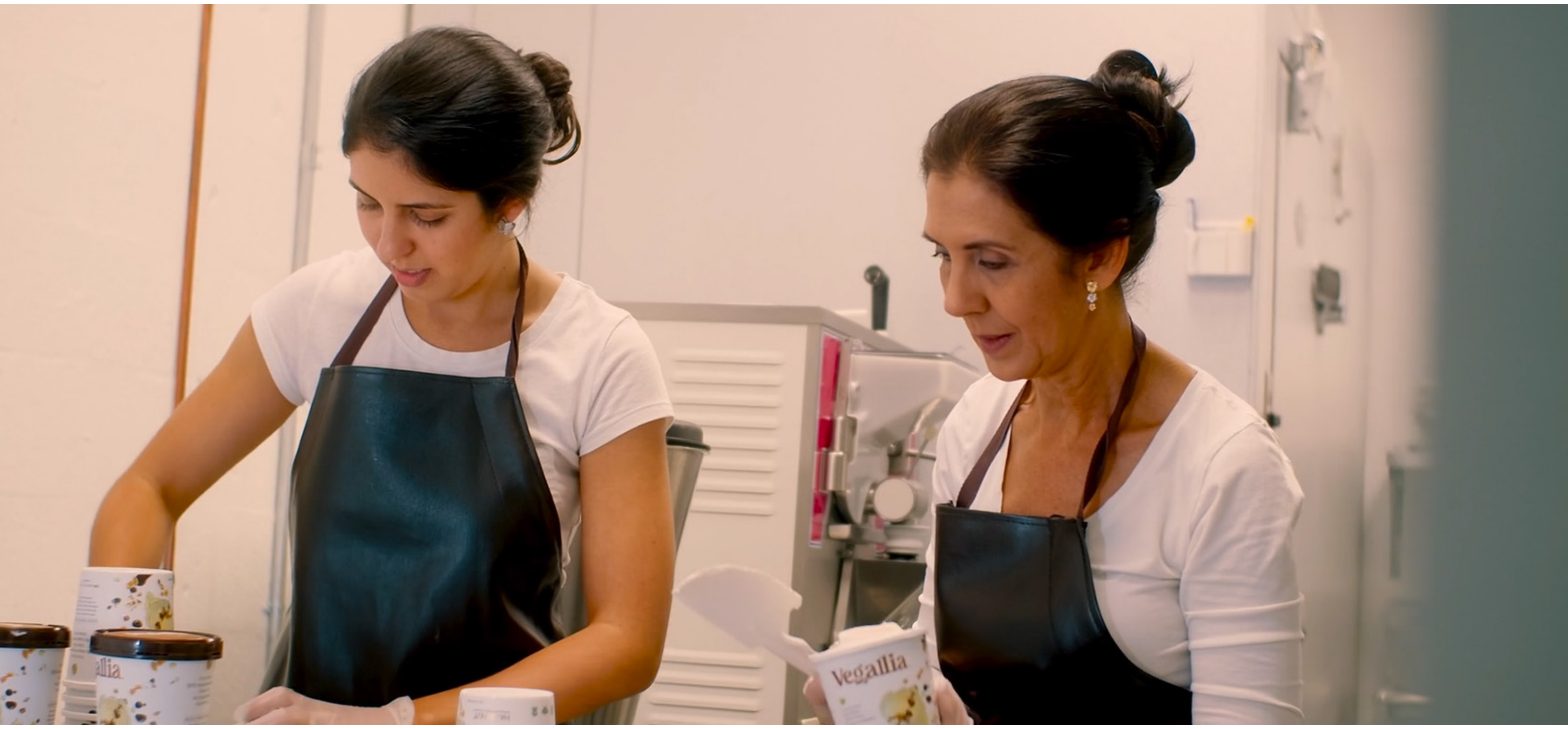
There are valuable lessons to be learned for owners when in a relationship with a lender—experience that can't be gained through informal funding options or even equity investments. Nonetheless, there is often skepticism about conventional borrowing in communities of color, based on long histories of damaging predatory lending.

In EOCF's 2022 survey of its borrowers, owners expressed feelings of unease in using traditional banks for capital, even among the larger businesses (revenue greater than $2 million). Though 35 percent of EOCF borrowers applied for subsequent loans following their EOCF financing, none sought loans from their primary business bank, saying they "did not believe it would be approved."

Sometimes, this mistrust extends to programs specifically designed to lend and invest in underserved communities. For example, mission-driven loan funds like the New York Forward Fund and the Southern Opportunity and Resilience Fund, and public programs like the Paycheck Protection Program and Economic Injury Disaster Loans, were launched to help businesses navigate COVID-19, recover from pandemic losses, and grow. When they all saw slow initial adoption rates in communities of color, they designed various strategies for outreach and education, working to alleviate anxiety and demonstrate that legitimate forms of borrowing can offer substantial benefits for small businesses.

RECOMMENDATION

- When it comes to building trust, technical assistance programs are vital. Business owners tell EOCF that technical assistance is often as important as the capital they receive to their long-term success. Similarly, loan officers point to the value of high-touch support—as one-on-one connections to financial advisors help owners strengthen their management and help assess opportunities and risks. They say it is a critical component of bankability, and without it, entrepreneurs may not be "loan ready" or know how to effectively use the capital they receive.



Conclusion: Design strategies that meet entrepreneurs of color where they are

Black- and Latinx-owned small businesses are well-represented among firms that grow organically but underrepresented among firms with external financing. To change that outlook so that more owners can borrow, hire, expand and build wealth, lenders need to rethink their approach to small business underwriting and marketing as well as community relations—developing strategies and partnerships that directly respond to systemic bias.

Toward that end, EOCF is continuing to grow. JPMorgan Chase and LISC are expanding the number of CDFIs and other partners participating in the program as well as the range of communities that the program serves. The goal is to deploy $500 million to entrepreneurs of color by 2027.

Entrepreneurs of Color Fund

ATLANTA

Access to Capital for Entrepreneurs

LISC Atlanta

Invest Atlanta

Village Micro Fund

CHICAGO

Allies for Community Business

LISC Chicago

DETROIT

Detroit Development Fund

LOS ANGELES

LISC LA

Inclusive Action for the City

Accion Opportunity Fund

Pacific Asian Consortium in Employment

Vermont Slauson Economic Development Corporation

MIAMI

Ascendus

Miami Bayside Foundation

Community Fund of North Miami Dade

Prospera

NEW ORLEANS

New Orleans Business Alliance (NOLABA)

NewCorp

TruFund

NEW YORK

Pursuit

TruFund

BOC Capital

La Fuerza CDC

Ascendus

NEWARK

Greater Newark Enterprises Corporation

Greater Newark LISC

Rising Tide Capital

OAKLAND

ICA Fund

Community Vision

Pacific Community Ventures

ESO Ventures

WASHINGTON, DC

Capital Impact Partners *(part of Momentus Capital)*

City First Enterprises

Latino Economic Development Center

Washington Area Community Investment Fund

Learn more about our work at

www.lisc.org/EOCF