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Save-our-Small (SOS) Business Loan Fund - A Proposal
Sustainable and Impact Finance Initiative, Haas School, University of California, Berkeley

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 programs to moderate the shutdown's impacts on small businesses, but they are under enormous pressure to do so.

Proposals are circulating in the US and Europe that argue for a wide-reaching 0% interest "bridge loan program" for small businesses funded by the federal or national government, with loans repayable in 5 to 8 year annual payments. Such business loans could be senior in status to other debt and repayable as an add-on tax obligation on their recipients to reduce administrative costs.[1] Congress is currently considering a broad federal loan program to provide assistance to businesses, both large and small, but it is highly uncertain whether such a program will be enacted, whether it will be adequately funded, and whether it could reach local small enterprises quickly enough and with enough support to help them survive. In the meantime, many municipal governments are seeking to create new loan and other funding programs to help their small businesses.[2] But these governments face two major constraints: a constraint with respect to a lack of funds for such a far-reaching small business loan program and a design constraint of being able to implement a loan program with repayment terms that are not so onerous that they do not cause businesses to become insolvent as a result.

With these two constraints in mind, we propose a structured financial recovery product for small businesses funded in part by private capital.

We further offer the Berkeley-Haas Sustainable Finance ecosystem to help municipalities design the terms of the Save-our-Small Business Loans and build the viability assessment model. We believe that our faculty, students, staff and broader Haas community could be mobilized to help bring the Save-our-Small Business Loans vehicles to fruition at this critical moment.

[1] https://scholar.princeton.edu/sites/default/files/markus/files/covid_liquiditylifeline.pdf
[2] The City of Berkeley, for example, has announced such a fund.

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, set ups 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 go through *viability assessment to judge* their expected ability to survive 2 years ahead, conditional on 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. Nowhere should this proposal be construed as a negative view of the idea of *genera*l government support for all small businesses. Rather, the SOS offering would expand the reach of the limited capital of local governments.

Loan Terms

- The loan would be administered by and collected by the sponsor, in coordination with municipal tax offices.
- Interest rate: 2% per annum[3]
- Maturity: 5 years

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[3] 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 property owner.
  - The number/fraction of employees supported per $500,000 of revenue.
  - The extent of other debt obligations.
- Loans will 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 are made by the following sequencing:
    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. <u>Sponsor catch-up tranche</u> - 100 percent of the next payments made by borrowers go to the sponsor 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. [Optional for the municipality - may be necessary to make the deal more attractive to private investors] Warrants that convert to company equity with a lag.[4] The warrants entitle the warrant holder to a portion of the firm's equity ownership after a maturity date. Again, the objective is to mobilize private capital by offsetting some loan losses with some equity on successes. A second objective of issuing warrants is to align incentives, whereby the private capital investors may have an incentive to support businesses of our communities in other ways.

iii. 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 documentation closing the loan will include necessary provisions for the accountability of small business lenders, ensuring that the loan funds serve the enable the small business 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.
- The viability assessment will also serve as a filter on ensuring directed use of the funds toward these goals.

[4] This equity term might include a buy-back provision for the owners. The German innovations on small business loans include private ownership commitments: https://www.ft.com/content/e85f35e0-6c30-11ea-89df-41bea055720b?desktop=true&segmentId=d8d3e364-5197-20eb-17cf-2437841d178a#myft:notification:instant-email:content