House Committee on Financial Services

"Initiatives to Promote Small Business Lending, Jobs and Economic Growth"

Tuesday, May 18, 2010 1:00pm

Testimony of Paul Brown of the Michigan Economic Development Corporation

The efforts of this administration and this congress over the last year can only be described as having saved our economy. The bill you are considering today is not designed to save our economy, but to save our economy as we know it. This country's true economic strength has always been in its small businesses, especially small manufacturers. The vast majority of workers are employed by small and medium size firms. We have to rely on small businesses for job growth if we hope to quickly recover the millions of jobs lost during the Great Recession. This administration and Congress had to save Wall Street. Now we should save Main Street.

Small businesses, particularly manufacturers, have faced a perfect storm in the Great Recession decreasing their revenue, collapse in the real-estate market decreasing the appraised value of their property, plant and equipment (PP&E), and frozen credit markets decreasing their ability to borrow the capital they need to hire and expand. The effects of these challenges continue to pose a serious threat to our small businesses, our country's industrial capacity, employment and GDP. The effects of these threats could be long lasting, even permanent, if you don't act soon to make capital available to our small businesses.

Michigan and the upper Midwest have been particularly hard hit by these factors because of our high manufacturing concentration and real-estate value. Unemployment in the state is still over 14%[1]. A recent University of Michigan report projected the state will continue to shed jobs in 2010, before a gradual recovery in 2011[2]. Many of those losses will likely come from small manufacturers, which is troubling given the large economic multiplier of the sector[3].

Michigan entered a recession earlier than most states therefore we have been grappling with these challenges longer than most. Governor Granholm, working with the Michigan Economic Development Corporation, has put in place programs to diversify our economy. These programs coordinated the state's colleges and universities, local economic development organizations, the business community and local governments to leverage our strengths to diversify and create jobs. A year and a half ago at the depth of the recession Governor Granholm had the foresight to recognize that once these seeds for growth had been planted our businesses would need capital to take advantage of the inevitable upturn in the economy. The Governor charged the MEDC with coming up with a program that would help businesses get the capital they need to survive and grow. We subsequently created and funded the Michigan Supplier Diversification Fund, with the leadership of our CEO Greg Main. This two part program supports banks in financing the strongest small businesses.

We spoke with hundreds of banks and manufacturers in order to understand the problem and design a solution. We recognized that businesses would need increased capital in order to compete for new business. Unfortunately, what we were seeing were firms failing, not for a lack of customers, but for a lack of capital. Companies were "browning out" for lack of financing. The small businesses were closing and holding asset sales on their doorsteps. Many of our manufacturers are being forced to sell their equipment at cents on the dollar. The resellers of this

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[1] "Labor Market Information". Michigan Department of Labor, Energy, and Economic Growth. March, 2010.
[2] George A. Fulton. "RSQE Forecasts". University of Michigan Seminar in Quantitative Economics. April 6, 2010.
[3] David Cole. "The Impact on the U.S. Economy of a Major Contraction of the Detroit Three Automakers". Center for Automotive Research. November 4, 2008.

equipment are reporting that the best of this equipment is not being reused by domestic manufacturers but carted of to countries like China and India.

Our solution recognizes that small businesses finance their operation with bank financing. Their ability to obtain financing is determined by their available free cash flow and value of their collateral. Banks are under increasing pressure from regulators to require a historic three year average of free cash flow levels over 1.25 times loan service and collateral values of at least 120% of loan value. Healthy firms are finding it impossible to get the capital they need to grow or even survive because of the temporary drop in revenue and asset values.

Focusing on these factors, the MEDC launched the Michigan Supplier Diversification Fund ("MSDF" or the "Fund"), which has been highly successful at inducing new loans that were otherwise disqualified from the bank's perspective. Many of the projects induced by the Fund have garnered financing for diversification into emerging industries like alternative energy.

The Fund accomplishes this via two mechanisms designed to address the financial impediments of the borrower given current market conditions. One: Companies' three-year average of free cash flow is artificially low because of the devastating hole in revenue created by the recession. Small businesses with strong free cash flow today are penalized by the use of this three-year average. To alleviate this problem MEDC purchases the portion of the loan not justified by the three-year average, but which the borrower can pay using the more relevant current free cash flow data. The banks work us out of the loan once the three year average improves. Two: Small businesses, especially manufacturers, rely on being able to borrow up to 80% of the value of their PP&E. Even healthy companies' PP&E has dropped as much at 80% in 18 months, decreasing the amount they can borrow. MEDC assists banks and borrowers by supplementing the collateral value on loan requests by depositing cash pledged to the bank. MEDC gets interest and fees on both of these programs making it profitable for the state.

Both of these mechanisms also improve the health of banks. The cash flow mechanism helps limit default risk exposure and supports debt service coverage. The collateral support mechanism, in addition to increasing collateral coverage for borrowers, also increases the banks' core deposit base improving its capitalization ratio.

Another positive of the Fund's design is that loans are made at the time public dollars are deployed. Loan closing is required for public funds transfer. In this way, the program self-regulates by ensuring that public dollars are contingent on each individual loan actually being made, in contrast to TARP, where follow-up lending has either severely lagged or failed to occur.

MSDF relies on the market expertise, prudent risk management, and financial capacity of private lenders, who source, underwrite, lead, and service the deals, while injecting targeted public dollars at the level of individual loan requests. So far, every $1 in public funds has leveraged $4 in private funds.

MSDF has been well received by the lending and manufacturing communities in Michigan. In less than six months from inception, the initial $13.3 million fund was fully committed. It resulted in twelve loans, leveraging a total of $41 million in private dollars.

Unfortunately the rest of the country is now experiencing the same effects as Michigan. Demand is increasing as economic activity increases, as evidenced by the Institute for Supply Management reported increases in the ISM Manufacturing Index.[4] Commercial real estate values continue to plummet, as indicated by the Moody's/REAL Commercial Property Price Index[5], without a recovery in sight. In addition, industrial machinery and equipment continues to sell at fire sale prices, reflecting the overall devaluation of hard assets. In other words, manufacturing production is outpacing the recovery of asset values, which significantly limits the borrowing base of manufacturers and their ability to sustain growth.

The constant demand from banks and borrowers for our loan enhancement programs at the Michigan Economic Development Corporation demonstrates the need for additional action to stimulate lending rapidly. While the recovery plan helped to capitalize the banks, it did little to stimulate new lending. In Michigan, commercial and industrial lending declined by over 10.5%[6] in 2009.

This moment is critical for small businesses especially manufacturers. In this tenuous environment, a failure to support new financing to allow businesses to accelerate production may actually cause them to suffocate on their own growth, a potentially insidious side effect of the recovery. Even stable companies that have 'right-sized' are finding it difficult to finance growth opportunities. In addition, businesses need capital to reorganize and consolidate efficiently and in an orderly manner to improve their financial health. Finally, those businesses seeking to utilize their core competencies in new economy sectors like wind and solar energy, medical device, and homeland defense are often unable to finance this transition.

We agree that the health of banks took precedence during the Great Recession, and access to cheaper capital was critical. But to grow our struggling small business sector, we must focus our attention to the health of borrowers. Lowering the cost of capital to small banks, increasing guarantees, and reducing fees and bureaucracy will save our critical small banking industry. But it does change the fundamental process of banks: making loans to borrowers with sufficient three-year cash flows and sufficient collateral values. We don't believe the banks should change their model. Their underwriting standards and expertise are essential to proper risk management and a healthy economy.

In our view, perhaps the only way to quickly stimulate new lending to small businesses and manufacturers in this environment, and without warping the banks' model, is to provide temporary support to borrowers such as those offered by Michigan and other states. These are the only mechanism to offset the effects of current market conditions, in order to make deals bankable from a commercial underwriter's point of view.

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[4] "Manufacturing ISM Report". Institute for Supply Management. April, 2010.
[5] "Moody's/REAL CPPI". REAL Capital Analytics. April, 2010.
[6] Michigan Bankers Association.

Unfortunately the resources available are insufficient. There is an estimated need of at least $1 billion in Michigan, and approximately $8-10 billion nationally[7]. This gap represents untapped growth potential that threatens to disappear should the necessary financing fail to materialize. A chain of bankruptcies remains a real possibility. The beneficiaries of such an outcome would be China and India, who would exploit our best machinery and equipment, which they will have purchased at cents on the dollar.

The economy has begun to improve, due in large part to your and the administration's efforts. Our small businesses, especially manufacturers, are the key ingredient for sustained growth, and they are falling behind. As we speak, China, Germany, and other nations are seizing the opportunity by supporting programs that assist their businesses' ability to get capital, and will take the lead in economic strength unless we act soon.

The Obama administration's proposed Small Business Lending Fund, which is being introduced and supported by many in our Michigan delegation, including Congressman Sandy Levin and Gary Peters, is a bold and necessary step to support our small businesses, save our manufacturers and create jobs quickly. Allowing states to use a portion of these monies to support targeted loan enhancement programs will leverage dollars ten to one and have the potential to create millions of jobs. I believe loan enhancement programs like these will be the spark to our economic recovery and the cornerstone of a successful national manufacturing policy.

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[7] Robert E. McKenna. "Emergency Financial Assistance Request". Motor & Equipment Manufacturers Association. June, 2009.