Mt. Auburn Associates

Capital and Credit Needs in the Appalachian Region

FINAL REPORT

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Table of Contents

Chapter One: Introduction

1.1 Purpose of the Study

Rural businesses, like businesses everywhere, need capital to fuel their development. Businesses need particular types of capital at each stage of their development: equity capital for startup, product development, major expansion, and buyouts; long-term debt for the purchase of durable assets -- land, plant, and equipment; intermediate-term debt for permanent working capital and equipment purchases; and short-term debt to finance inventory and accounts receivable. Each of these types of capital must be available in adequate amounts and at reasonable costs for a business to perform at its full capacity.

The market and regulatory changes that have transformed the financial service industry during the past two decades have been strongly felt in rural communities. First, the scale and locus of control of rural depository institutions have altered as the advent of interstate banking has produced greater concentration of the banking and thrift industries at the national level and reduced local control over credit decisions. Second, the number of depository institutions operating in rural markets has declined, lessening competition. Finally, consumer savings have increasingly shifted from local depository institutions to national non-depository intermediaries such as mutual funds, putting smaller borrowers at a disadvantage.

As market innovation, new technology, and regulatory reforms have made traditional savings and credit arrangements obsolete, policymakers and economic development practitioners at the federal, state, and local levels have sought to implement regulatory and programmatic responses to maintain and enhance credit availability for rural businesses and other affected groups. This has included developing programs that establish new public and quasi-public financial institutions to fill market gaps. One such program is the Appalachian Regional Commission's Revolving Loan Fund Program. Since 1977, the Appalachian Regional Commission (ARC) has provided \$20.6 million to capitalize 29 loan funds in 10 states. These funds have made a significant contribution to business credit availability in ARC communities, making about 1,000 loans totaling over \$50 million through August 1997.

As changes in the private financial market have spurred the establishment of RLFs and other development finance programs during the past 20 years, so too have recent developments in the financial markets and the field of development finance required a reexamination of traditional development finance tools. With the development of new credit products and lending procedures by private financial institutions and the proliferation of public, quasi-public, and private nonprofit development finance institutions, administrators of programs such as ARC's RLF Program, must revisit such issues as their programs' market niches, business targets, financing tools, and investment partners.

The purpose of this study is to:

1. help ARC and other economic development policymakers in the Appalachian region to better understand how conditions in the Appalachian economy and the functioning of the region's capital markets interact to affect the availability of capital and credit for the region's businesses and;
2. identify ways that the Appalachian Regional Commission can more effectively address unmet business credit and capital needs in the region. This includes helping ARC to assess the capacity of its RLF Program to address the region's business financing needs and to provide practical guidance in the refinement of the program or the development of additional tools to more effectively address such needs.

The approach to the study has involved the following:

- identifying and measuring the ***demand*** for financing among important business segments of the ARC regional economy, with a focus on small- and medium-sized enterprises;
- identifying major current business financing sources active in the ARC region and measuring the adequacy of the ***supply*** of important types of financing to the region's businesses;
- assessing the effectiveness and efficiency of current ***institutional structures*** for delivering business credit to the region's businesses; and
- identifying current gaps, weaknesses, and/or resource shortages in the current business finance system, and recommending programmatic and institutional changes for ARC to undertake or support in order to address business financing issues.

The study has included the following research:

1. analysis of county economic and banking market data;
2. a survey of over 200 businesses throughout the region with five or more employees;
3. interviews with 22 development finance professionals;
4. an inventory of almost 400 state, regional, and local development finance programs;
5. an assessment of recent financing activity by ARC RLFs;
6. case studies of business financing needs and gaps in three representative multi-county areas served by ARC RLFs; and
7. a literature review of business finance conditions and trends affecting small businesses and businesses in rural areas.

1.2 A Note on Capital Market Analysis

As we have noted, the purpose of this study is to assess the availability of capital and credit for businesses in the Appalachian region. This involves determining whether businesses in the region have sufficient access to capital in sufficient amounts, types, and at a reasonable risk-adjusted cost. While the question is straightforward, the ability to find an answer is seriously constrained by data collection and measurement problems.

In order to assess the performance of financial markets in the Appalachian region in meeting business financing needs and to quantify financing "gaps," it would be necessary to:

1. measure the demand for funds by examining the status and financing needs of firms in the region by characteristics such as size, stage of development, industry sector, and location; and
2. know precisely how capital and credit are being allocated to firms of these varying characteristics.

To date, no satisfactory empirical method has been developed to precisely measure supply of and demand for financing. To understand the true nature of capital and credit availability in the region would require methods that both quantify the demand for financing on a regional and sub-regional level, and precisely measure the supply and allocation of financing by all significant financing sources. There are serious limitations to accurate quantification of both demand and supply.

On the demand side, measuring a financing "gap" would require examining all users of financing to evaluate whether they are able to support the cost of financing at the current risk-adjusted market price. This involves making the difficult distinction between a business' or prospective business' desire for financing and its ability to pay for that financing. Even the most direct data collection methods, such as business surveys, only measure ***perceived*** need and do not arrive at ***real*** demand. At any given moment in time, the desire for capital is absolutely infinite, but the effective demand is relatively finite. The problem is that the measure of its relative finiteness is a human judgment call, not one that is mathematically measurable. Moreover, the ability to even identify all seekers of financing, particularly discouraged entrepreneurs and failed businesses, is problematic.

On the supply side, measuring the financing "gap" would involve not only quantifying the amounts and types of capital available but distinguishing the ***ability*** to provide financing from the ***willingness*** to provide financing. Many factors particular to given individuals, institutions, and industries can influence their risk preferences in a way that reduces their willingness to invest below a desired level from the standpoint of regional economic development. These can include institutional policies, the behavior of individual decision-makers, or the market, technological, and regulatory forces affecting an entire segment of the financial industry. Even if an outside analyst were able to study the financing decisions of a representative sampling of all important business financing sources, it is questionable whether a research methodology could be developed to accurately evaluate the efficiency of each individual lending or investment decision.

Consequently, our approach to the task of capital market analysis has been to use available and accessible information selectively to develop a profile of the regional business base and financial market that assesses capital needs, resources, and institutional structures from the perspectives that are most relevant to policymakers. We have synthesized our findings from several analytic methodologies that have proven to be reliable and valuable in many similar circumstances. These methodologies have been developed over time from in-depth strategic analyses in several states and regions.

1.3 Organization of the Report

In the following chapters, financing issues facing businesses and development finance professionals in the Appalachian region are assessed, and preliminary recommendations to the Appalachian Regional Commission for addressing these issues are presented. The report is organized as follows:

- *Chapter Two* presents a literature review of: 1) conditions and recent trends in rural financial markets and their impact on rural business financing; and 2) the impacts of recent trends in national financial markets on small business financing generally. The purpose of this chapter is to provide a context for the report's findings regarding issues more specific to the Appalachian region.
- *Chapter Three* summarizes findings regarding the demand for credit and capital among businesses in the Appalachian region.
- *Chapter Four* summarizes findings regarding the availability of capital and credit to businesses in the region.
- *Chapter Five* identifies current financing gaps resulting from imbalances in demand and supply for financing in the region and assesses the capacity of development finance organizations to fill these gaps.
- *Chapter Six* summarizes the overall findings from the study and presents recommendations for ARC initiatives to address financing gaps.

Chapter Two: Overview of Rural Financial Markets and the Availability of Small Business Capital and Credit

2.1 Introduction

Before examining the business financing environment in the ARC region specifically, it is useful to examine two broader issues that affect the availability of financing to small businesses in the region: 1) the recent performance of rural financial markets in meeting small business financing needs; and 2) and the impacts of regulatory and market changes in the financial services industry on the availability of small business financing. The following sections summarize the findings from a general literature review on these two topics, drawn mainly from Federal Reserve reports and working papers, and banking and business journals.

2.2 Trends in Rural Financial Markets

This section identifies rural financial institutions, and provides an overview of the performance of rural financial markets and the availability of capital and credit for rural business development. Access to financing in rural areas has generated particular concern among economic development policymakers and practitioners because these areas are smaller and more removed from major metropolitan centers of economic activity and investment necessary for business development. Moreover, rural areas may not have the kind of supportive economic infrastructure to facilitate business development because many of these areas are poorer, lack economic diversification, lack higher risk lending opportunities, and have relatively fewer financial institutions from which to obtain financing (Morentz Markley, 1990).

2.2.1 Rural Financing Sources

An assessment of rural capital and credit availability should emerge from an understanding of the financial institutions (both private and public) responsible for providing that financing. In this regard, the most traditional business financing sources are banks and they provide the majority of financing for rural business development. In addition to traditional banks, a wide range of institutions provides financing to rural areas. These institutions run the gamut from purely private sources of financing to publicly-owned and managed sources. Table 2.1 outlines the variety of financing sources for agriculture, housing, businesses, and community development by relative importance to rural communities.

Table 2.1
Sources of Credit for Agriculture and Rural Housing, Business, and Development

Credit sources vary depending on the nature of the loan.

	Type of Loan			
Type of Lender	Agriculture	Housing	Small Business	Community Development
Retail Lenders:				
Regulated financial institutions				
Commercial banks	Major	Major	Major	Major
Farm Credit System	Major	Minor	Minor	Minor
Thrift institutions	Minor	Major	Minor	Minor
Insurance and pension funds	Moderate	--	Moderate[1]	Minor
Unregulated Lenders				
Finance companies	Moderate	Minor	Moderate	--
Mortgage brokers	Minor	Major	--	--
Trade credit suppliers	Moderate	--	Moderate	--
Nonprofits (revolving loan funds, etc.)	--	Minor	Minor	Minor
Individuals	Moderate	Moderate	Moderate	Moderate
Government Direct Loan Programs				
U.S. Department of Agriculture	Moderate	Minor	--	Minor
Other Federal agencies	--	Minor	Minor	--
State and local agencies	Minor	Minor	Minor	Major
Secondary Markets and Credit Enhancements:				
Government-sponsored Enterprises				
Federal National Mortgage Assn.	--	Major	--	--
Federal Home Loan Mortgage Corp.	--	Major	--	--
Federal Home Loan Bank System	--	Major	--	Minor
Federal Agricultural Mortgage Corp.	Minor	Minor	Minor[2]	Minor[2]
Farm Credit System (OFI) Lending	Minor	--	--	--
Government Agencies				
U.S. Department of Agriculture	Moderate	Moderate	Minor	Moderate
Other Federal Agencies	Minor	Moderate	Moderate	Minor
State and Local Agencies	Minor	Minor	Minor	Minor
Private Sector				
Loan poolers	Minor[2]	Minor	Minor[2]	Minor[2]
Loan guarantors/insurers	Minor	Moderate	Minor	Minor

Note: Precise estimates of the relative importance of specific lenders within rural credit markets are generally unavailable. Categorizations are based on survey data, administrative records, and anecdotal evidence. A major participant provides or supports more than 20 percent of the market; moderate participants handle 5 to 20 percent of the market; minor participants handle less than 5 percent of the market.

[1] The insurance industry's assets include substantial commercial real estate holdings as well as corporate stocks and bonds and tax-exempt securities. While not considered major lenders to small independent rural business, insurance company investments may directly and indirectly finance the rural branch plants of large and medium-sized businesses.

[2] Support is provided primarily for federally-guaranteed loans.

-- Indicates no lending or an insignificant amount of lending.

Source: Credit in Rural America, 1997. Rural Economy Division, Economic Research Service, U.S. Department of Agriculture, Agricultural Economics Report No. 749.

As Table 2.1 attests, the most important sources of financing for rural business enterprises are commercial banks. And, rural businesses, not unlike their urban counterparts, rely heavily on these banks to supply them with credit and capital. While the role of commercial lenders in providing financing to rural businesses is clear, other financial institutions also provide significant forms of financing. Other sources of business financing considered at least moderately important to credit and capital availability for rural business enterprises include insurance and pension funds, finance companies, trade credit suppliers, individuals (angels), and federal agencies.

Other research has shown that rural businesses use a much narrower group of financial institutions than do urban businesses. This is primarily because of the less diverse group of financial institutions that compete in rural areas of the country. Nondepository institutions (such as finance companies, brokerage firms, and leasing companies) are also less likely to be used by rural businesses (Cole and Wolken, 1995; ERS, 1997).

Surveys conducted by the National Federation of Independent Businesses illustrate these differences. Tables 2.2 and 2.3 provide the 1995 results of that survey and delineate the sources of working and investment capital utilized by rural businesses.

Table 2.2: Sources of Business Working Capital During the Last Fiscal Year

Commercial banks are the most often used source of working capital for rural businesses and the most often used external source for urban businesses.

	Rural Firms		Urban Firms	
Source of Capital	Primary	Secondary	Primary	Secondary
	Percentage			
Bank loans (excluding credit cards)	40.7	13.2	30.7	12.3
Finance company loans	1.4	3.7	1.9	1.8
Other loans (family, investors, etc.)	8.5	10	11.8	11.8
Trade credit	7.4	7.4	9.6	8
Retained earnings	31.6	9.9	34.7	8.4
Credit cards	3.6	9.3	5.3	11.1
No secondary source	N/A	23.1	N/A	23.6

Source: Credit in Rural America, 1997. Rural Economy Division, Economic Research Service, U.S. Department of Agriculture, Agricultural Economics Report No. 749. Based on Economic Research Service's computations from the 1995 NFIB Credit, Banks, and Small Business survey.
Note: The columns do not sum to 100 percent because some firms did not answer the question.
N/A = not applicable.

Table 2.3: Sources of Business Investment Capital During the Last Fiscal Year

Commercial banks are also the most often used source of funds for capital outlays.

	Rural Firms		Urban Firms	
Source of Capital	Primary	Secondary	Primary	Secondary
	Percentage			
Bank loans (excluding credit cards)	39.2	8.5	29.7	8.4
Finance company loans	2.5	3.4	3.7	2.6
Other loans (family, investors, etc.)	6.7	7	9.6	8.3
Trade credit	3.9	3.6	3.9	4.2
Retained earnings	24.8	8.9	27.7	9.1
Credit cards	12.1	N/A	14.3	N/A
No secondary source	N/A	26	N/A	23.9

Source: Credit in Rural America, 1997. Rural Economy Division, Economic Research Service, U.S. Department of Agriculture, Agricultural Economics Report No. 749. Based on Economic Research Service's computations from the 1995 NFIB Credit, Banks, and Small Business survey.
Note: The columns do not sum to 100 percent because some firms did not answer the question.
N/A = not applicable.

From this data, it is clear that rural business rely more heavily on commercial banks as their primary source of both working capital and investment capital. It is also clear that they also rely less on non-institutional investors (family, friends, etc.) than do urban businesses (McGlone, 1991). Moreover, rural businesses rely less on credit cards for both working and investment capital than do urban businesses.

2.2.2 Performance of Rural Banking Markets

Overall, rural commercial banks are much smaller in terms of their asset size, but are well capitalized, profitable, and are characterized by a strong portfolio of financially sound loans (ERS, 1997). Moreover, in recent years, the performance of rural commercial banks has largely paralleled the performance of urban commercial banks around the country in most respects. Table 2.4 provides a comparison of U.S. and rural commercial banks from 1990 to 1995. Overall, this comparison indicates that rural commercial banks have performed at least as well as larger, urban commercial banks.

Table 2.4: Financial Trends of Rural and U.S. Commercial Banks, 1990-1995

While small by industry standards, rural-headquartered banks are well capitalized, profitable, and have relatively few problem loans

	1990		1991		1992		1993		1994		1995	
	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural	U.S.	Rural
Number of Banks	12,257	6,469	11,825	6,323	11,364	6,129	10,866	5,976	10,366	5,745	9,825	5,493
Million Dollars												
Average assets	274.6	57.2	288.1	61.1	306.3	64.7	337.4	67.6	383.1	71.5	434.7	73.9
Average deposits	214.6	50.6	225.7	53.8	235.7	56.6	250.8	58.5	274.4	61.1	305	63.4
Average loans	172.1	31	173.4	32.7	178.4	34.3	196.4	37.1	225.9	41.5	262.9	43.4
Percentage												
Composition of Loan Portfolio:												
Home mortgage	20.9	27.1	23.2	29.1	25.2	30.5	26.4	31	26.6	31.2	26.7	30.9
Other real estate	21.1	20.7	21.2	21.6	20.8	22.6	19.8	23.5	18.9	13.8	18.2	24
Consumer	20.1	20.9	20	20	19.8	19.1	20.6	18.6	21.7	18.7	21.5	18.9
Commercial	26.9	18.5	24.9	16.7	24.1	15.6	23	14.7	22.8	14.6	23	14.7
Other	9.3	2.9	8.8	2.6	8.2	2.3	8.4	2.1	8.2	2	9	1.8
Agricultural	1.7	9.9	1.9	10.1	1.9	10	1.9	10	1.8	9.7	1.7	9.7
Loans/Deposits	80.2	61.2	76.8	60.6	75.7	60.6	78.3	63.4	82.3	67.9	86.2	68.4
Net interest margin	3.4	3.8	3.6	3.9	3.8	4.2	3.8	4.2	3.7	4.2	3.6	4.1
Return on assets	0.5	0.9	0.5	1	0.9	1.2	1.2	1.3	1.1	1.2	1.1	1.2
Equity capital/assets	6.4	8.6	6.7	8.7	7.5	9.1	8	9.5	7.8	9.3	8.1	10
Problem loans/equity capital	35.7	10.6	32.9	10.1	23.7	7.6	14.4	6.1	9.8	5.3	8.6	5.2
Loan loss provision	1.5	0.7	1.6	0.7	1.3	0.6	0.8	0.4	0.5	0.3	0.5	0.3
Quarterly average holdings of tax-exempt/assets	2.5	5	2.2	4.8	2.1	4.9	2.1	5.5	2	5.5	1.7	5.3
Quarterly average federal funds sold, securities purchased/assets	4.8	5.4	4.8	4.8	4.5	4.2	4.3	3.6	3.9	2.5	4.2	3.9
Quarterly average federal funds purchased, securities sold/assets	8.4	1.4	7.2	1.6	7.5	2	8	2.2	7.8	2.8	7.9	1.9

Source: Credit in Rural America, 1997. Rural Economy Division, Economic Research Service, U.S. Department of Agriculture, Agricultural Economics Report No. 749. Calculated by ERS from the Federal Reserve Board's Report of Condition and Report of Income files, December 31, 1990-1995.

One notable difference between rural and urban commercial banks is in loan-to-deposit ratios. Lower loan-to-deposit ratios among banks based in rural areas indicates that these banks lend less aggressively than their urban counterparts. Further analysis, however, indicates that these differences are related to bank size, not bank location. Banks of similar size in both rural and urban areas have comparable loan-to-deposit ratios. In fact, among banks with assets of $500 million to $1 billion, rural banks outperform urban banks by about eight percentage points. (See Table 2.5.) It should also be noted that this data does not provide a complete picture of commercial bank lending in rural areas because many large banks that are headquartered in urban areas and thus classified as urban also have a large number of banking offices in rural areas.

Table 2.5:
Commercial Bank Loan-to-Deposit Ratios, by Bank Size and Location (12/31/96)

Bank Assets	Metro Counties	Non-Metro Counties	All Counties
Under $100 million	68.01%	65.01%	66.08%
$100-500 million	72.15%	72.34%	72.22%
$500 million to $1 billion	76.01%	84.18%	76.96%
$1-5 billion	85.96%	87.03%	86.02%
Over $5 billion	95.06%	94.19%	95.37%
Total	89.85%	72.62%	87.86%

Source: Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. Calculated by ERS from the Federal Reserve Board's Report of Condition and Report of Income files, December 31, 1996.

Table 2.4 also suggests that rural commercial banks have reflected larger market consolidation trends as the number of rural commercial banks declined from 6,459 in 1990 to 5,493 in 1995. As the number of banks has decreased, average assets, deposits, and loans have increased correspondingly.

Although Table 2.4 indicates that rural banks have performed as well as other U.S. banks, there are some trends that call into question the availability of debt financing for rural businesses and the capacity and willingness of rural banks to provide such financing. Since 1990, for example, rural commercial banks have decreased the percentage of their portfolios invested in commercial loans. Between 1990 and 1995, rural commercial banks and savings and loans financed fewer commercial loans in favor of increased home mortgage investments. In 1990, commercial loans reflected more than 18 percent of the total loan portfolio of these institutions. By 1995, these loans reflected only 14.7 percent of this portfolio. This slight shift can be partially explained as increased preference for investments in home mortgages and real estate development because of the greater stability and lower risk of these types of investments.

While the displacement of business lending in favor of other forms of local lending might be a cause for concern, this slight shift in rural commercial lending does not appear to have significantly harmed the availability of credit for rural business. Recent consolidation within the banking industry has not resulted in less financing availability for rural businesses (ERS, 1997; Rose, 1993; Calem, 1994; Nakamura, 1994). Rather, the upsurge of the nation's economy in recent years cushioned the impact of this displacement so that both rural and urban businesses have experienced significant increases in financing availability. Rural businesses, in particular, have been the beneficiaries of recent economic growth as they have actually experienced a greater increase in the proportion of debt financing than urban firms (ERS, 1997). In addition, rural businesses have seen their consumer base increase and broaden as rural population increased dramatically during the last decade. In fact, overall population growth in rural areas has outpaced population growth in metropolitan areas of the country.

Another important measure of the performance of rural financial markets is the distribution and accessibility of financial institutions in those markets. Table 2.6 provides a fairly concise assessment of bank market structure across rural counties. It indicates that as recently as 1994, almost 73 percent of rural counties were served by at least three banks (including the branches of banks headquartered elsewhere). This compares to 96 percent in urban counties. Only 25 percent of rural counties are served by six or more banking firms compared to 74 percent of urban counties. Although rural counties have, on average, substantially lower populations, the data indicate that businesses in rural counties have fewer banking choices than their urban counterparts. Nonetheless, most rural borrower do have some choice in their local banking relationships. Also, although relatively few rural counties are served by only local banking firms, about 30 percent of them are served by only small banking firms.

Table 2.6
Distribution of Urban and Rural Counties by Bank Market Structure, 1994

Rural bank markets have far fewer competing lenders.

	U.S.	Urban	Rural	Persistent Poverty
			Percentage	
Counties with an office of:				
No banking firms[1]	0.6	0	0.9	0.9
1-2 banking firms	20.6	4.2	26.4	43
3-5 banking firms	41.3	21.9	48.2	47.1
6-9 banking firms	24.5	34.4	21	8.4
10 or more banking firms	13	39.5	3.5	0.6
Counties served by:				
Only local banking firms[2]	6.9	1.1	8.9	16.1
Only "non-local" banking firms	29.2	21.3	32	31.4
Both local and non-local firms	63.9	77.6	59	52.5
Only small banking firms[3]	24.6	4.2	31.9	48.2
At least one large banking firm	67.4	93.6	58	41.7
Only small banks	37.3	8.1	47.7	60.4
At least one large bank	50.7	84.4	38.7	28.6
			Number	
Total number of counties	3,089	813	2,276	535

[1] A banking firm is an independent bank or a bank holding company. All of the bank offices and affiliates of a bank or holding company constitute one banking firm. Thus, a banking firm may own many banks in a county, but we treat those banks as a single competitor.

[2] A local banking firm has all of its offices and affiliates in one county; all others are considered non-local, even if the banking firm includes a locally-headquartered affiliate.

[3] A small bank or banking firm has assets of under $250 million; a large bank or banking firm has assets over $1 billion.

Source: Calculated by ERS from the June 30, 1994, Summary of Deposits file of the Federal Deposit Insurance Corporation, and from the June 30, 1994 Report of Condition and Report of Income of the Board of Governors of the Federal Reserve System.
Source: Credit in Rural America, 1997. Rural Economy Division, Economic Research Service, U.S. Department of Agriculture, Agricultural Economics Report No. 749.

Counties that experience persistent poverty are the most clearly disadvantaged and underserved areas in terms of bank presence. This dearth of bank presence has meant that almost half of persistent poverty counties have nearby access to less than three banking firms.

Rural financial markets have reasonably served the demand for business financing, and financial institutions appear to be widely distributed across rural counties (ERS, 1997). The fact that there are not only local and non-local banks in most rural areas, but also three to five different financial institutions in the majority of rural areas, is a positive indication of the vitality of rural financial markets.

In their use of commercial banks, rural businesses are more likely to use local institutions. In this regard, local commercial banks are better able than non-local commercial banks to identify and anticipate the financing needs of local businesses (Elliehausen and Wolken, 1990; Nakamura, 1994; Levonian and Soller, 1996). For rural businesses there are clear economic advantages in patronizing local lenders rather than non-local banks. Rural businesses face fewer collateral requirements than urban businesses and are more likely to have their loans approved when they approach locally-based banks (McGlone, 1991).

In the case of both rural and urban banks, multi-office banks make fewer loans to small businesses than do smaller, independent banks and, as a result of interstate branching, there has been a significant increase in the number of multi-office banks (Keeton, 1995). Although there has been much speculation, it is still unclear how the increase in multi-office banks will affect the availability of credit to small businesses in rural areas.

In general (with the exception of persistent poverty areas), rural financial institutions are well positioned to handle the credit and capital needs of rural residents and businesses. But if access to financial institutions is one measure of the stability and performance of rural financial markets, then the economic competitiveness of their services is another. It is in this area that differences in the performance of rural and urban financial markets are most visible. Rural financial institutions are not as diverse in terms of the types of financial services nor the combination of services they offer (ERS, 1997; McGlone, 1991). A more limited combination of financial services is offered more sporadically and less systematically in rural financial institutions. Less system-wide financial service offerings are not only a product of the attempt by rural banks to be more flexible in meeting the specialized needs of local businesses, but also a reflection of vast disparities in institutional capacity among rural financial institutions.

Excluding persistent poverty areas, much of the difference in the competitive environments of rural and urban financial markets can be explained by the smaller size of rural markets. Competition for loans in rural areas is not as intense as in urban areas, for example, and fewer borrowers in rural areas mean that lenders' ability to successfully and profitably compete for local loans is notably reduced. That is, the market is much smaller and larger lenders are not economically compelled to enter rural financial markets. As a result, rural financial markets have not been as competitive as urban markets. Persistent poverty counties have been particularly impaired by the lack of competition in the banking industry in these areas where financial institutions are fewer and less active. Generally then, although rural banks have adequate capitalization to meet the needs of rural businesses, rural banking markets are less competitive urban markets (ERS, 1997).

Finally, the performance of rural financial markets can be measured by the comparative cost of financing. Although the cost of financing is less important than the availability of financing, the price cannot be overlooked. Recent evaluations of the cost of financing in rural areas suggests that, overall, the costs of business credit in rural areas of the country are relatively comparable to those found in larger urban areas. Rural homebuyers, however, tend to pay more to mortgage homes than urban homebuyers (ERS, 1997). Additionally, Table 2.7 shows the characteristics of SBA guaranteed loans and the costs assumed by borrowers that are associated with those loans. Here the cost of the loans assumed by business borrowers is much less than if borrowed in urban areas of the country. Although SBA loans represent a small portion of the total loans made to businesses in the United States, the percentage of SBA loans made to rural businesses is actually higher. Thus, these findings have particular relevance to the cost of capital and credit to rural businesses.

Table 2.7
Characteristics of SBA-guaranteed Small Business Loans, 1995

Interest rates on rural small business loans are lower, on average, than urban rates.

		Average...				
Item	Number of Loans	Interest Rate	Loan Maturity	Gross Loan Amount	Proportion Guaranteed	Number of Employees
	Number	*Percent*	*Months*	*Dollars*	*Percent*	*Number*
All Firms:						
Rural	11,171	10.78*	118	126,824*	85.9*	11.4*
Urban	35,159	10.93*	118	154,464*	84.7*	9.0*
New Firms:						
Rural	3,979	10.84*	110*	113,455	87.1	5.1
Urban	11,268	11.00*	100*	116,623	87.1	6.4

* Indicates that the rural and urban means are significantly different at the 99 percent level of confidence.
Source: Credit in Rural America, 1977. Rural Economy Division, Economic Research Service, U.S. Department of Agriculture, Agricultural Economics Report No. 749. Calculated by ERS from data supplied by the U.S. Small Business Administration.

Although the cost of financing is generally analogous across rural and urban regions, there are some specialized circumstances that can fluctuate these financing costs for rural businesses. Generally, the price of credit is significantly lower when the lenders' clients are more diverse (McClone, 1991). Lenders with more diverse clientele are able to offer credit at slightly lower rates because they have a more diversified portfolio that helps to minimize the risk involved in business investment. That is, they invest in a variety of industries at different levels of the production cycle and, thus, are able to protect themselves against economic downturn in any one part of the local and national economies. Unfortunately, rural lenders tend to have a much more homogenous clientele that can result in higher financing costs in some rural areas. As a result, although financing costs are comparable to urban areas overall, credit costs differ across specific rural areas of the country.

It is interesting to note that rural business owners often rate the cost of credit as secondary to its availability. Table 2.8 lists, in order of importance, the institutional characteristics that attract rural businesses. Rural businesses indicate that the most important characteristic of their financial institutions is the existence of a personal relationship with their lenders. Rural businesses then, are clearly concerned that their lenders understand their priorities and constraints. Generally, rural businesses tend to be much more satisfied with their lenders and have much better personal relationships with their lenders than urban businesses (McGlone, 1991). Additionally, capital and extensions of credit are more likely to flow to businesses that have established personal relationships with their lenders and those that use other services of that financial institution to transact business (Peterson and Rajan, 1994).

Table 2.8
Importance of Financial Institution Characteristics to Business Firms and Financial Institution Performance

Credit availability is more often rated as important by rural businesses than is the cost of credit.

	Rural Firms		Urban Firms	
Source of Capital	Very Important	Good Performance	Very Important	Good Performance
	Percentage			
Knows you and your business	72.4	45.1	65.5	34.2
Reliable source of credit	60.6	46.7	55.8	34.6
Easy access to loan officer	56	52.8	49.8	40.1
Speed of decisions/services	55.1	39.1	50.7	28
Offers the cheapest money available	52.2	15	46.5	12.5
Knows the local market/community	40.7	34.6	29.9	24.6
Convenient location	37.2	51.1	39.7	46.4
Knows your industry	35.6	19.9	29.4	13.6
Offers a wide range of services	29.5	29.6	26	25.6
Provides helpful suggestions, advice, and/or seminars	24.9	16.5	22.9	11.1
Social contact with loan officer	17.4	20.3	11.9	13

Note: Firms were asked to indicate the importance of each characteristic on a scale of 1 to 5, where 1 is very important, 3 is important, and 5 is not important. Firms then rated their principal financial institutions on a scale of 1 to 5, where 1 is good, 3 is acceptable, and 5 is poor. Firms that did not answer a particular question (value 0) were included in calculating the percentages reported above.
Source: Credit in Rural America, 1997. Rural Economy Division, Economic Research Service, U.S. Department of Agriculture, Agricultural Economics Report No. 749. Based on Economic Research Service's computations from the 1995 NFIB Credit, Banks, and Small Business survey.

2.2.3 Capital and Credit Gaps in Rural Financial Markets

Most assessments of financing availability to rural businesses have concluded that these firms are not at a disadvantage in terms of acquiring necessary financing. Rather, these businesses have regular and significant opportunities to attract capital and credit from financial institutions. Recent business surveys by the National Federation of Independent Businesses and by the Federal Reserve, for example, indicate that financing availability for rural firms is similar to that of urban firms. Moreover, these surveys found that interest rates paid by rural businesses are similar to the terms found in urban areas and that rural business owners are relatively satisfied with the financial institutions that serve them (ERS, 1997).

Not all rural areas, however, have experienced the level of capitalization in their local financial markets and some rural areas have experienced diminished economic growth due to inadequate level of capital investment. Although in recent years economic growth in rural areas has been strong, there is a need to identify the characteristics of rural areas and rural businesses that are systematically underserved in terms of access to financing.

In terms of the characteristics of rural areas, underserved rural areas are more likely to exist in areas where: (1) larger banks dominate the financial services market in the area and small businesses characterize the business population overall; (2) small banks dominate the financial services market in the area and larger businesses characterize the business population overall; and (3) the businesses are either from nontraditional or overly-crowded industries (Shaffer and Pulver, 1990). Moreover, where financing inadequacies exist, they have been attributed to the lack of competitive pressure among financial institutions in the particular rural markets (ERS, 1997; Shaffer and Pulver, 1990).

As might be expected, the most underserved rural business enterprises in terms of financing needs are those that are marginally creditworthy or have some difficulty qualifying for traditional financing in both the primary and secondary markets. These businesses are more likely to rely on debt financing and smaller local lenders rather than larger financial institutions or venture capital investors. In addition to these rural businesses, other rural businesses have been traditionally underserved in rural financial markets such as: (1) small businesses (particularly new and young ones); (2) businesses in persistent poverty or economically depressed areas; (3) rural businesses in emerging sectors; (4) minority- and women-owned firms; and (5) businesses with nontraditional management structures such as cooperatives, worker-owned businesses, nonprofits, and some community development corporations.

A recent report by the Department of Agriculture suggests most rural businesses will face at least three major problems in identifying and acquiring financing in rural markets:

- ***risk financing (equity for new businesses, long-term operating loans for businesses and community organizations, etc.) is difficult to find;***
- ***transaction costs are often higher for rural borrowers whose financial needs are unusually large or complex (by local standards) as they have to shop over a wider geographic area and deal with a broader range of institutions than is typically true in urban settings;*** and
- ***access to credit and other financial services remains a problem for those who fail to qualify for commercial loans because of low incomes, low skills, and lack of collateral (ERS, 1997).***

The most significant gap in the availability of financing in rural areas is the availability of equity or risk capital. Rural businesses have had much difficulty in identifying potential sources of risk capital and even more difficulty in securing such forms of capital for their businesses. Rural businesses encounter more difficulties as they attempt to obtain risk or equity financing (Taff et al, 1984). These businesses are also less likely than urban businesses to be directed to alternative sources of financing when lenders are unable to provide startup capital

(Pulver and Hustedde, 1988). Overall, there is little information about the availability of venture capital in rural areas nor much comparative literature between traditional lenders and venture capital investors, but anecdotal evidence suggests that venture capital firms do not play a strong role in rural capital and credit markets (ERS, 1997).

2.3 Trends In Small Business Lending

2.3.1 Overview

The availability of credit to small businesses has gone from near drought in the early 1990s to a borrower's market during the last several years. Banks went from a "credit crunch" so tight that foreign banks were able to significantly expand their lending to U.S. small businesses to a lending binge made possible by industry-wide deterioration of lending standards, and, more recently, to a somewhat less aggressive push for small business lending with slightly more rigorous lending standards.

Much of this trend can be attributed to the strength of the economy in recent years and the subsequent strong position of banking institutions. That is, the rates of return on equity and on assets are high, delinquency rates for business loans have remained extremely low, and bank profits are strong leaving banks in a good position to make capital available to small businesses. Another important factor is federal regulatory reforms, which have significantly loosened restrictions on geographic market entry and lending products for banks and other depository institutions. In addition, product innovations and new technologies have increased the ability of nonbank financial institutions to offer a wider range of products to consumer and small business markets.

The financial services industry in the United States has undergone enormous structural change during the last two decades. The growth of nonbank lenders, for example, has signaled a considerable decline of traditional banks as the primary repositories for savings and as capital lenders and has forced many banks to redefine roles, products, and services in a variety of their lending markets. Concomitantly, the significant growth in capital market transactions largely based on the packaging, repackaging, and hedging of financial instruments has dramatically altered the content and character of capital markets in the United States (Arista and Schlesinger, 1996). Moreover, the failure of the savings and loan industry after industry-wide banking deregulation generated multiple repercussions and restructuring not only for banks and their customers but in the regulation of banks.

Notwithstanding these sweeping changes, commercial banks still dominate the market for small business lending. Commercial banks loaned more money to small business than any other time in the history of commercial banking, with $172 billion in bank credit to small businesses in 1996. Even so, nonbanks have been expanding into the small business market and nonbank small business lending also reached record proportions, with more than $96 billion allocated by finance companies in 1996. Government lending programs to small businesses also invested heavily in the small business market in 1996. SBA guaranteed loans totaled more than

$26 billion and SBA guaranteed loans in the secondary market allocated $12 billion (SBA, 1997).

Banks have been quite generous with loans to consumers and small businesses alike since 1994, and this has raised some questions concerning the lending practices that generated this lending (Hansell, 1995). While credit standards have not reverted to the level they were before the savings and loans debacle, many are concerned by the fact that credit both to small businesses and to consumers generally, has been expanding much faster than the overall economy. Even as the federal government has decreased its size, for example, government securitized lending is up at higher levels than ever before.

Yet, small business customers are not the only ones on the receiving end of more aggressive lending activity. As Tables 2.9 and 2.10 attest, loans to large and mid-sized companies have increased dramatically over the last two years as well.

Table 2.9
Characteristics of Loans to Small Businesses By Loan Size, 1994-1996

	1994		1995				1996			
Loan Size	Dollar Amount	# of Loans Made	Dollar Amount	% Change '94-95	# of Loans Made	% Change '94-95	Dollar Amount	% Change '95-96	# of Loans Made	% Change '95-96
< $100,000	97,675	4,496,327	100,374	2.8	4,885,066	8.6	105,187	4.8	5,313,182	8.8
$100,000 - $250,000	57,866	500,149	63,517	9.8	553,851	10.7	67,132	5.7	587,164	6.0
$250,000 - $1 million	138,876	413,556	152,022	9.5	461,454	11.6	160,723	5.7	496,131	7.5
> $1 million	434,299	NA	490,078	12.8	N/A	NA	515,060	5.1	N/A	NA
Total	728,716	NA	805,991	10.6	N/A	NA	848,102	5.2	N/A	NA

Source: Small Business Administration, Office of Advocacy

Table 2.10
Average Data on Small Business Lending in U.S. Banks for 1996

	Small Business Loans as a % of:		Small Business Loans	
Asset Size	Assets (a)	Total Business Loans (a)	Value (b)	Number
<$100 million	12.3	82.7	5.67	184
$100 - $500 million	10.7	52.8	19.74	556
$500 million - $1 billion	6.7	31.7	45.25	1,230
>$1 - $10 billion	4.4	22.3	118.17	5,137
Total>$10 billion	2.3	15.6	494.35	18,341
All Banks	11.4	70.9	17.82	610

(a) Ratio expressed as a percent.
(b) In millions of dollars.
Source: Small Business Administration, Office of Advocacy

Banks have not only been generous with credit but, because of intense competition in the small business lending market, have also been more liberal with the terms of their loans.

Many banks in the small business market are lending money to businesses with less collateral at narrower margins and less restrictions (Hansell, 1995). Overall, banks have been more willing to require less collateral, increase limits on lines of credit, and, generally, improve the terms of credit to large and middle market businesses as well. A smaller minority of banks have invested in long-term loans that were more risky, and others have set margins so low that, after accounting for future loan losses, the loans are unlikely to be profitable. Such losses are expected to be more than offset by profits from money transfers, management of corporate pension plans, and other banking services (Hansell, 1995).

Although the price of credit is being driven down by competition, the small business market is still considered highly profitable. A recent report by the Federal Reserve demonstrates that small-business-friendly banks were more profitable than banks that made few loans to small businesses (SBA, 1997).

Given the potential for additional profitability in the small business lending market, many larger banks have begun to focus on the smaller end of the small business market such as auto repair shops and other firms where the size of the loan often does not exceed $20,000 (Cline, 1995). In this economic climate, even the lower end of the small business market is considered too profitable to ignore. Even recently merged or acquired banks have continued to add significant levels of small business loans to their portfolios (Barry, 1996; Federal Reserve, 1997). In doing so, newly merged banks have increased the total value of loans to small businesses over the past two years by more than $439 billion or 10.3 percent (Federal Reserve, 1997). Private industry surveys of the largest banking institutions and holding companies have generally found increased small business lending as well. (Cline, 1995).

To be sure, even with this high level of competition in the small business market, marginally creditworthy small businesses continue to have considerable difficulty in obtaining credit from traditional lenders. The growth in nonbank lenders, however, has helped to somewhat mitigate these difficulties. A significant alternative market comprised mostly of nonbank entities has developed that caters to the less than creditworthy clientele. The price of credit in this alternative market has traditionally been higher than with traditional banking institutions, but the strong economy, coupled with significant competition even in this alternative market, has made the dichotomy in the price of credit between traditional banks and nonbanks less divergent.

In the following sections, some of the factors that have contributed to the current environment in the small business lending market will be examined in greater detail. These include: 1) federal financial regulatory reform; 2) banking industry consolidation; 3) the growing role of nonbank lenders in small business lending; 4) innovations in banking products and services; and 5) the adoption of new loan underwriting tools and practices.

2.3.2 Federal Financial Regulatory Reform: Catalyst for Changes in Financial Market Structure and Competition

A major catalyst for the enormous structural changes in U.S. financial markets is the regulatory reforms aimed at the banking industry. Since 1980, the banking industry has gone through many phases of regulatory reform. Although many of these regulatory changes have occurred at both state and federal levels, the most fundamental changes have occurred at the federal level. The most sweeping transformations have resulted from four legislative acts: 1) the Depository Institutions Deregulation and Monetary Control Act of 1980; 2) the Garn-St. Germain Depository Institutions Act of 1982; 3) the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA); and 4) the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

Over the years, concerns have been raised about the impact of these regulatory reforms on access to credit for small businesses. Some have argued that more stringent banking regulations following the savings and loans debacle actually led to reductions in credit availability to small businesses in the early 1990s (Cole et al, 1996). Recent analyses of this issue suggest that small business credit availability has not suffered at the hands of some of the most recent efforts to deregulate the banking industry, although this has not been the case through the entire 1990s period (Barry, 1996).

The most recent major regulatory reform affecting the banking industry, the Riegle-Neal Interstate Banking and Branching Act of 1994, has paved the way for full-scale interstate banking. This legislation is expected to substantially increase the number of multi-office banking institutions. Although states have the option to resist interstate banking by opting out of the legislation, thus far only a few states have opted out while many more of them have welcomed interstate banking.

One of the favorable outcomes expected from this legislation is that it will reduce banks' vulnerability to local economic downturns (Keeton, 1995). It is also expected to increase the potential to shift capital to regions of the country experiencing high capital demand. Beyond this, its likely outcomes are subject to considerable debate.

Many have expressed concerns about the short-term impact of this legislation on access to credit for small businesses. While changes in banking market structure may theoretically affect all consumers of banking services, particular concern has been expressed about its affect on small businesses. While larger firms may have access to other sources of credit and financial services, small firms are heavily dependent on local financial institutions. Changes in the way banks are regulated then, may have much larger repercussions for small businesses than for other banking customers.

One major concern about the impact of interstate banking is the potential reduction in the number of local, smaller banks that tend to lend more frequently to small businesses (Keeton, 1995). Another concern is that the decision-making process for credit approval will be removed from the locality and will not give small business customers the opportunity to develop lending relationships with local bankers. These relationships, it is argued, have been important in helping small businesses that, on the face of it, were not deemed creditworthy by credit scoring systems, obtain credit. Finally, major concerns have been expressed about changes in the variety and quality of banking services available to small businesses. Traditionally, local bankers have been able to tailor their services to the particular needs of the customers in their localities. The specific concern is that nonlocal banks may offer more standardized financial products and services that may not meet the particular needs of the local small business community.

Thus, overall concerns with this legislation from the small business perspective have focused on its impact on the reduction of community banks and the banking products and services that they provide, as well as the overall availability of credit to smaller, less creditworthy businesses. Although few major studies have tried specifically to assess the impact of this regulatory change on small businesses, other relevant studies have indicated that small business lending is not reduced when acquisitions by out-of-state banks occur (Berger et al, 1997). While this is only one kind of interstate banking, it may ease some concerns about the impact on small businesses.

Aside from these broader regulatory changes, a number of regulatory reforms designed specifically to increase small business access to credit and financial services have had a more clearly positive impact. Most important among these is the Community Reinvestment Act. To avoid challenges to merger applications, banks (particularly larger ones) have been willing to invest more heavily in the small business market particularly in urban areas. Chase Manhattan and Chemical Bank, like many other larger banks, have announced plans to invest billions of dollars in inner-city neighborhoods over the next several years (Drier, 1995). While these investments are being made in a variety of instruments, such as residential mortgages and nonprofit housing, a sizable portion of these kinds of investments is being targeted at small business customers, many of whom would not have received business loans due to their credit issues, redlining, and/or other industry-related issues.

Another significant regulatory reform was adopted in the latter part of 1993, when federal regulators increased the size of loans that banks could make to small businesses without requiring an appraisal. They also allowed banks to reduce the amount of capital they must hold against small business loans (Bacon, 1993). The purpose of these steps was to increase credit for small business development and to deal with credit shortages in the small business market. The impact of these actions was a significant increase in the amount of capital available to small business. Generally, business borrowing has risen steeply and small businesses have significantly increased their borrowing from both banks and nonbank institutions. Consistent with other assessments of credit availability, the results of the most recent survey by the National Federation of Independent Businesses indicated that small business owners believed that credit has been more accessible and easier to obtain than during previous periods (Allen, 1994; Federal Reserve, 1997).

2.3.3 Banking Industry Consolidation

One of the most explicit impacts of regulatory changes on the banking industry generally has been on the structure of the banking industry. In this context, structural changes refer to the number, kind, and character of banking institutions. Bank mergers and acquisitions that would have been challenged under old guidelines, were deregulated under the Garn-St. Germain Act of 1982. In this context, deregulation provided greater incentives for banks to consolidate and they have done so in large numbers.

From the period between 1987 to 1993, nearly 3,000 mergers in the United States banking industry took place. In 1995 and 1996, bank merger and acquisition activity remained at record levels (Spiegel and Gart, 1996). The 50 largest banks in the United States now account for over 75 percent of the total banking assets in the United States and continuing consolidation in the banking industry is expected to reduce the number of banks by at least 25 percent before the year 2000 (Spiegel and Gart, 1996). Table 2.11 provides a more detailed examination of merger and acquisition activity over the past two decades.

Table 2.11
Merger and Acquisition Activity 1979-1994

Year	Industry		All Mergers		Mergers of Equals		Family Mergers		All Acquisitions		Acquisitions of Equals		Out-of-State Acquisitions	
	Banks	GTA	Banks	GTA	Banks	GTA	Banks	GTA	Banks	GTA	Banks	GTA	Banks	GTA
1979	14,124	3,257	113	199	25	28	48	51	132	26	31	6	4	12
1980	14,404	3,267	104	206	21	6	24	28	206	31	26	11	6	1
1981	14,387	3,250	120	174	30	24	28	28	291	34	50	10	1	1
1982	14,402	3,310	189	237	36	18	54	59	385	64	64	18	17	10
1983	14,402	3,398	202	240	47	38	51	54	430	101	89	29	32	24
1984	14,375	3,482	212	299	57	55	65	87	560	105	176	36	60	24
1985	14,263	3,658	198	399	38	26	71	181	529	150	108	48	72	67
1986	14,041	3,838	215	386	50	92	89	115	588	121	96	9	134	60
1987	13,538	3,823	292	564	76	84	132	211	491	157	86	27	178	107
1988	12,965	3,833	311	547	84	57	168	229	518	224	141	120	202	105
1989	12,554	3,866	253	517	76	100	143	266	255	76	53	44	79	62
1990	12,194	3,801	235	527	63	100	131	240	228	103	49	38	82	74
1991	11,789	3,707	256	485	60	76	152	300	276	203	99	172	125	124
1992	11,347	3,681	274	680	84	393	124	337	295	91	71	10	130	66
1993	10,866	3,803	299	755	94	138	112	519	330	93	56	4	136	75
1994	10,359	4,024	323	720	88	88	99	192	326	99	67	43	122	81

Note: (1) GTA refers to the gross total assets; (2) all GTA's are shown in billions of dollars.
Source: Berger et al, 1997

While bank deregulation has been the primary catalyst for the intensified merger and acquisitions activity, the characteristics of these mergers have varied substantially. Table 2.12 provides a typology of the characteristics of mergers that occurred between 1990 and 1995, and provides specific examples of each type.

Table 2.12
Characteristics of Bank Mergers 1990-1995

Transaction Type	Examples
In Market Transactions	Fleet/Shawmut Bank America/Security Pacific Boatmen's/Worthen Chemical Banking/Manufacturers Hanover First Chicago/NBD Bancorp
Market Expansion	First Union/First Fidelity BankAmerica/Continental Banc Onc/Valley National Comerica/Plaza Commerce, Pacific Western, Metrobank Western, KeyCorp/Society
Mergers of Equals	Chemical Banking/Manufacturers Hanover KeyCorp/Society Dime/Anchor Bancorp First Chicago/NBD Bancorp
Business Lines Extension	Mellon/Dreyfus and The Boston Company Norwest/Island Finance NationsBank/US West BankAmerica/Arbor National
Source: Spiegel and Gart, 1996	

One overall effect of these mergers has been the reduction in the number of smaller banking institutions, most of which have historically been more aggressive small business lenders and have devoted a much larger portion of their assets to small business loans (Walraven, 1997). In 1995, for example, the smallest banks reported that approximately 97 percent of their total commercial and industrial loan portfolios were comprised of small business loans compared to 17 percent of the largest banks in the country (Barry, 1996). As a result, there has been some concern about the impact of banking industry consolidation on the availability and terms of small business loans. (Cole et al, 1996).

In recent years, however, fears that small businesses would not be served by newly merged banks, made much larger as a result of the mergers, have not been confirmed. Newly merged banks have continued to invest in the small business market at roughly the same rates as they did prior to the merger. (See Table 2.13.)

Table 2.13: Small Commercial and Industrial and Small Farm Loans at Banks Involved in Mergers, June 1993 to June 1996				
	Median Ratio of Small C&I Loan to Assets			
Size of Bank (Assets in millions of dollars)	Acquiring Banks		Acquired Banks	
	Bank Holding Company	Independent	Bank Holding Company	Independent
$250 or less	7.3	8.4	6.3	7.3
$251 - $5,000	5.5	9.3	2.0	5.0
More than $5,000	3.7	N/A	0.3	3.0

Notes: (1) Assets and loan volumes are from the most recent June Call Report at the time of the merger.
(2) Each member of a bank holding company is treated separately. The data include independent banks and individual members of a bank holding company.
(3) Data for members of each acquiring bank holding company are aggregated to the highest holding company. The data for acquired institutions include independent banks and holding companies.
Source: Walraven, 1997.

Moreover, although there has been an enormous growth in bank mergers and acquisitions in recent years, 60 percent of those mergers were between small banks that, even when merged, only created slightly larger, small banks. Most recent assessment of these "still small" merged banks indicates that they have been even more active in their efforts to attract and maintain small business customers after such mergers (Federal Reserve, 1997; Walraven, 1997).

In addition, recent mergers and acquisitions activity has led to the creation of a new wave of small banks. Bank charters increased by more than 300 percent in 1995 alone (Barry, 1996). Thus, while the banking industry may be in a state of dynamic transition, there is no reason to believe that banking options for small businesses are diminishing as a result of this transition. To the contrary, in recent years, lending opportunities for small businesses have dramatically increased leaving them in a rare position to take advantage of the volatility in the market.

Although newly merged banks have generally continued traditional lending patterns, there are some geographic markets where small businesses have had difficulty obtaining credit directly following major local industry consolidations. The most comprehensive examination of the impact of mergers and acquisitions on small business lending concluded that although there appears to be some negative impact on the availability of credit to small businesses directly following major consolidations, other banks in the local area tend to pick up additional loans in the small business market (Berger et al, 1997).

Overall then, while there has been concern that regulatory changes may have altered the structure of the banking industry in ways that had deleterious effects for small businesses, most recent analyses suggest that these concerns have not been confirmed.

2.3.4 The Emergence of Nonbanks as Significant Sources of Small Business Credit

The fluctuations and structural transitions within the financial marketplace have also opened up opportunities for nonbank finance institutions to service the small business lending market. For the most part, nonbanks "consist of finance companies, insurance companies, mortgage companies, leasing companies, brokerage firms, other business firms, families and individuals, and government sources of credit" (Cole et al, 1996). Nonbanking entities have continued to make inroads into the small business credit market and have been a major part of the growth in this market (Allen, 1994).

Over the last several years, the banking industry has consistently lost shares of the small business lending market to nonbank entities (Arista and Schlesinger, 1996). Evidence from the 1987 and 1993 National Surveys of Small Business Finances demonstrates that small businesses are relying much more heavily on nonbank institutions for small businesses loans and other small business services. Nonbanks like the Money Store and Merrill Lynch have become major competitors for small business customers. The Money Store, for example, loaned more than $457 million in 1995, becoming the largest Small Business Administration lender with more 1,502 loans to small businesses.

As the market grows and more institutions begin offering services to small businesses, the definition of "nonbanks" keeps expanding. For example, consumer credit card issuers are entering the small business finance market as nonbanking entities. American Express, Visa International, Diners Club, and Mastercard International have all launched small business corporate divisions whose purpose is to target small business customers. Saturation of the consumer credit card market has pushed many credit card issuers into the small business finance market. In response, more banks have begun offering credit card services to their small business customers and have enhanced them by co-branding with other companies like major airline companies and office supply companies. Overall, efforts to increase the credit card usage by small business has been extremely successful with the industry showing strong and steady growth. In the process, the availability of credit to small businesses has increased and the terms of credit have improved.

In their efforts to attract small business customers, most major credit card companies have enhanced the services they already provide rather than introducing completely new and innovative services and products to small business customers. For example, cards can be restricted to selected employees with customized spending limits per employee, transaction, and merchant. Improved services of this nature allow small businesses greater flexibility and control over their use of credit. The cards offer small businesses better control over minor purchases, inherent recordkeeping systems, electronic payment and reporting features, as well as time savings.

Overall, as the competition for small business customers intensifies, banks and nonbanks have had to define and exploit their strategic advantages. Nonbanks have a number of strategic advantages over banks that have enabled them to make inroads into the small business market fairly easily and quickly. ***First, they are not, on the whole, new to the financial services market.*** The most successful nonbanks have been institutions with prestigious and long-standing traditions in other areas of the financial markets that have introduced small business products and services, such as Merrill Lynch and American Express. Merrill Lynch, for example, now offers a small business product called Working Capital Management Account that includes business checking accounts, lines of credit, term loans, equipment financing, investment portfolio products, 401(k) planning, key person insurance, merchant card services, pension planning, stock option planning, employee stock purchase planning, executive financial management, and initial public offerings. American Express has recently announced its entrance into the small business credit market and is now offering credit, accounting, and tax services to small businesses.

Second, nonbanks have broad geographic scope and ability to concentrate on particular lines of business or products, and often on particular industries. Additionally, with less commitment to particular areas and less reliance on "brick and mortar distribution systems," these entities have been able to evoke greater efficiency and invest more in technological enhancements (Glassman, 1996).

Third, nonbanks have adopted aggressive measures to attract small business customers. Merrill Lynch and the Money Store have used radio, television, and other popular media fronts to attract small business customers and consumers generally (Morrall, 1997). Union Planters Corporation now offers pre-approved small business credit up to $25,000 in its direct mail campaigns. Nonbanks have been successful in their attempts to attract small business customers for many reasons, one of the most important reasons being that they have been more aggressive in using data and technology applications, such as credit scoring. Nonbanks typically approve loans with much less information about the applicant, which allows them a faster approval process, and they have been more flexible in structuring their loans (Glassman, 1996).

Fourth, nonbanks face less stringent regulatory restrictions on products and underwriting practices. Nonbanks, for example, do not have depository regulators monitoring their investments because they collect no depositor money. Regulatory agencies have been slow in responding to the diversity and variety of nonbanking institutions currently offering financial services to small businesses. As a result, banks have lobbied hard in recent years for further deregulation of commercial banking on the basis that their competitors operate under much less stringent federal regulations.

One indication of the success of nonbanks is that while approximately 55 percent of small businesses use some type of credit, about 37 percent use banks, 20 percent use nonbanks, while only about 10 percent use savings institutions. Moreover, while banks dominate business lines of credit, leasing is dominated by nonbanks (Glassman, 1996). Finally, recent surveys indicate that small businesses are increasingly reporting that they have some kind of credit relationship with a nonbank entity. More indication of their success is given by the fact that the top three SBA lenders are nonbanks as demonstrated by Table 2.14 which lists the top 10 SBA lenders as of September 30, 1996.

Table 2.14 Top 10 SBA Lenders	
Lender	Number of Loans
Money Store Investment Corporation	1,722
AT&T Small Business Lending Corporation	691
Heller First Capital Corporation	578
Bank of Commerce	346
BankAmerica FSB	320
Banco Popular de PR	318
Prestige State Bank	184
Bank of America	177
First National Bank, New England	138
Zions First National Bank	137
Source: Small Business Administration	

The Money Store found its niche in helping small businesses effectively package and obtain financing through the Small Business Administration. Many banks are now extending their services to compete with nonbanks in assisting small business in obtaining government-backed loans (Arndorfer, 1996).

Although banks have reason to be concerned about the growth of nonbank lending to small businesses, banks still have clear advantages over nonbank entities. These include:

- *branches that provide convenient physical access and a perceived local/community presence;*
- *deposits that provide a funding advantage and also help the bank understand the customer's circumstances;* and
- *a range of products and services that cement the bank-customer relationship -- for example, employee benefits and cash management services (Glassman, 1996).*

Most analysts agree that the extent to which banks can aggressively market their strengths will determine their share of the small business lending market. To capitalize on these advantages, banks are using a host of new and improved small business credit products as well as improving the quality and convenience of the services they offer. They are also beginning to target traditionally underserved business owners as a way to find a niche within the small business market. Wells Fargo, for example, has announced plans to lend more than $10 billion to women entrepreneurs over the next 10 years.

2.3.5 Innovations in Small Business Products and Services

Both banks and nonbanks report feeling increasingly pressured by intense competition to offer a wider variety of products and improved services. Even nonbanks, which have attracted many small business customers through aggressive marketing, products lines, and services, reported feeling "forced" to offer such services to compete in the small business lending market (Oppenheim, 1997).

As banks try to attract small business customers, they have actively promoted improved service and a wide array of new banking products targeted at small business owners. Many banks have initiated 24-hour, seven-day-a-week phone systems, bill-payer services, and automated teller machines. But banks are feeling pressure to go beyond these conveniences to attract small business customers. Comerica Bank in Detroit, Michigan, for example, offers free seminars to small business owners facilitated by company chief executives on topics that run the gamut from accounting and marketing to technology, succession planning, and exporting. Commercial lenders at Patriot National Bank in Reston, Virginia now carry pagers so that their small business customers have constant access to them as needed. Patriot also has couriers that collect deposits from business customers and bank branches are open until 8 p.m. every day of the week. Some banks now offer administrative and management services where they purchase the company's receivables and handle all of their accounting, billing, and collecting of the company's accounts. Other banks have added PC banking services where small business customers can conduct financial transactions from their own offices. And, still, others have placed loan applications on the internet, such as AT&T which now uses a standard "EZAPP." Using the EZAPP, business owners complete and send their loan applications via the internet and can receive loan approval the same day by e-mail or a phone call at their office.

Larger financial services firms, in particular, once chided for neglecting small business customers, are now developing a wide array of services and products that cater specifically to smaller customers (Allen, 1994). American Express, for example, which until recently offered very few services that catered to small business clients, has recently announced a new line of banking products and services specifically geared toward small businesses (Oppenheim, 1996). Wells Fargo, one of the nation's largest banks, has launched a new line of credit products nationwide through direct mail and telemarketing. And Bank of America, another well-known name in the banking industry, now solicits small business customers through loan production offices across the country.

In this increasingly competitive environment, small community banks have had to be creative in protecting their small business customer base. Some of these banks have reported running testimonial advertisements, giving substantial financial incentives for small business referrals, and cold calling small businesses in the local area (Arndorfer, 1996). The willingness of larger banking institutions to increase the variety of small business products and services they offer has threatened the service advantage typically assumed by smaller, community banks, raising concerns that they are ceding their niche in the small business lending market (Heady, 1994).

In addition to the introduction of new products, increased competition has affected features of small business loans such as pricing, structure, and turnaround time on loans (Allen, 1994). Banks have been working harder to sell business banking products to small business owners who may have relied on credit cards and personal credit lines to finance their businesses growth. Many larger banks have instituted fast-reply loan review procedures using credit scoring systems. Increased competition has also put small businesses in a better position to negotiate the terms of their loans and other banking products and services, and has driven down the prices of these products and services (Cline, 1995; Oppenheim, 1996). The Federal Reserve reported earlier this year that the disparity between loan rates and market rates has recently been relatively similar for businesses of all sizes with only slightly better rate spreads for larger loans (Federal Reserve, 1997).

2.3.6 Changes in Underwriting Tools and Practices

One of the criticisms of small business lending practices by larger banks has been the use of centralized loan decision-making systems that are too slow, require excessive documentation, and do not sufficiently incorporate the knowledge gained of the borrower and the local business environment through direct borrower/lender relationships. These criticisms have particularly come to the fore in instances where large banking organizations have acquired local, independent banks.

In response to these criticisms and in an attempt to improve profitability and gain market share in the small business lending market, some banks are returning to more decentralized lending processes where local bankers are given the authority to make final decisions about loans. Although the latter can be more expensive and substantially more risky, it has returned some larger banks to more customer-focused lending.

A much higher proportion of larger banks has responded to these criticisms by adopting credit scoring systems. Investment in these systems has allowed banks to expand small business lending volumes while managing associated risks. Credit scoring systems allow banks to statistically evaluate the creditworthiness of an applicant as well as to standardize the credit availability to those applicants. The emergence of credit scoring systems as a lending tool in the small business market has had industry-wide implications, the benefits of which are thought to be:

- *shorter cycle time and improved information quality resulting from fewer hand-offs;*
- *higher loan volume as work associated with shepherding a smaller number of bankable credit applications through the approval process increases;*
- *better elimination of subject inconsistencies in the approval process;*
- *more effective leveraging of a bank's skills -- more customer face-to-face time for relationship managers;*
- *more focused credit review that uses analyses to monitor the individual borrower's risk profile, to adjust aggregate loan loss reserves, and to feed directly back into the pricing process through some form of performance pricing;* and
- *greater opportunity to securitize loans because of standard analysis, to transfer risk portfolio risk, and to price loans according to their incremental risk in relation to the loan portfolio (Furash, 1997).*

In the consumer credit market, the increased use of credit scoring systems has made obtaining credit faster and easier for consumers with established credit. In the small business market, credit scoring has had much the same effect. Small businesses with established credit and strong financial performance have often received larger credit lines and much better credit terms from many banking institutions (Furash, 1997).

The decision to accept more risk when dealing with creditworthy small businesses has not been completely based on the use of credit scoring systems. Much of the decision to accept more risk has also been based on the expectation that resulting loans can be bundled, repackaged, and sold in the securities market rather than held on the balance sheet of the originating bank (Furash, 1997; Hansell, 1995). Many banks have also sought to manage risk by greatly diversifying their loan portfolios over many different kinds of companies and industries, and by reducing the size of loans made to smaller businesses (Hansell, 1995). This latter practice has, to some degree, benefited the smaller, creditworthy companies by enabling them to obtain financing from lenders who would have overlooked them in the past.

Credit scoring is not a panacea and there are some reasons to be concerned about the use of this tool in evaluating the creditworthiness of small businesses. First, it is clear that credit scoring is more appropriate for use by larger than by smaller banks. It has been found that, in order to serve as accurate guides for credit decisions, credit scoring systems must be based on performance data for a large body of loans over a period of at least two business cycles or ten to 15 years. Moreover, to ensure sensitivity to changes in local market conditions, the variables and standards embedded in credit scoring systems must be routinely re-evaluated and continually updated. As a result, banks with more industry depth and loan volume by line of business will have a greater potential to generate accurate decision standards.

Second, while credit scoring systems have made it easier and faster to obtain business loans for more established small businesses, they have not helped banks deal with the credit needs of smaller, less established and less capitalized businesses. Credit scoring systems on the whole do not have the capacity to consider a wide range of secondary credit issues that may increase the likelihood that a small business will be considered creditworthy. For smaller banks in particular, where relationships with small business owners very often form much of the basis on which many loans are made, the use of credit scoring systems does not necessarily encourage nor augment such relationships.

The use of credit scoring systems is, therefore, not necessarily a substitute for the development of relationships between lenders and small business customers. To this end, many banks have retained consulting firms to help them identify potential small business customers, develop a more personal approach, develop more appealing product lines, and place senior level managers in more visible and accessible positions (Morrall, 1997). Other banks that have been unable to improve their service and product lines have had to negotiate strategic partnership arrangements and outsourcing with nonbanks. And, still, others have put more loan officers "on the street" and given them greater latitude to call on small business customers (Morrall, 1997).

Although there has been a good deal of theorizing about the impacts, both positive and negative, of credit scoring systems on small business lending, the literature on this practice is fairly new and has not produced much analysis of actual impact. To date, the literature has largely focused on the variety of ways these systems can be utilized by lending institutions.

Credit scoring must be seen in the context of other technology-based enhancements in the banking industry. Many new, technology-based products such as credit scoring are emerging in the banking industry in ways that have substantial implications for small businesses. The new Automated Loan Machine, (ALM) for example, processes a loan application from $1,000 to $5,000 and delivers the money in about 10 minutes. The ALM looks like an ATM machine, does not require a large bank investment in equipment, and serves as a loan outlet in locations where banks cannot afford to staff a loan officer. Additionally, more advanced credit scoring systems are being introduced to the banking industry such as credit scoring systems that allow banks to geo-code for CRA compliance when reviewing loan applications.

While the ALM and other similar technology-based products are new, have only been used in a small number bank sites, and are still largely targeted at individual banking consumers rather than small business, the development of banking services in this area is important. These kinds of technology-based automations, coupled with reduction of regulatory restrictions on the kinds of products banks can sell (such as insurance products), are expected to provide banks with increased flexibility in dealing with small business customers, increase larger banking product lines, and move banks toward becoming "one-stop" resources for many small business customers as well (Banking Strategies, 1996).

2.4 Conclusions

The literature on the performance of rural financial markets offers a mixed picture of their ability to meet the credit and capital needs of rural businesses. Specific findings include:

- ***Most assessments of financing availability to rural businesses have concluded that these firms are not at a disadvantage in terms of acquiring necessary financing.***
- ***Rural businesses remain heavily dependent on commercial banks for financing.*** They are more dependent on commercial banks and less likely to use nonbank lenders and other external financing sources than their urban counterparts.
- ***Business lending has increased in recent years in urban and rural banks alike, and the financial performance of rural banks has been roughly comparable to that of urban banks.***
- ***Rural businesses have a choice of banking organizations, but not as great as their urban counterparts, primarily because of the sparseness of rural areas.*** The nature of banking choice also varies between rural and urban markets. Rural areas are much more likely to be served only by small banks. These institutions offer a narrower range of financial services than larger institutions. As a result, rural banking markets are somewhat less competitive than urban markets.

- *The cost of credit is roughly comparable in urban and rural areas overall.* However, credit costs in some rural areas can be higher because of the risks associated with a more homogeneous client base. In addition, transaction costs for large or complex financings can be higher in rural areas.

- *Despite fewer banking choices and lower levels of competition in rural markets, rural businesses tend to be much more satisfied with their lenders and have better personal relationships with their lenders than urban businesses.* Their assessment of their banking relationship is dependent less on the terms of financing than on other factors such as their relationship with their banker, the reliability of credit, and the speed of loan decision-making. They are more likely to establish relationships with small, locally-based institutions than larger non-local institutions, in part because these institutions are more flexible in underwriting loans.

- *Financial market conditions are least favorable for businesses in persistent poverty areas.* These areas have fewer banking choices and lower levels of competition, and businesses in these areas have more trouble accessing financing. Other areas with less favorable conditions include those where there is a mismatch between the size structure of businesses and banking organizations;

- *Rural businesses that are most likely to have problems obtaining financing include those in emerging or overcrowded industries, startup firms, women- and minority-owned firms, and businesses with non-traditional management structures.* This is also the case in urban areas.

- *The most significant financing gap for rural businesses is in the availability of risk financing.* Rural businesses have more difficulty than their urban counterparts in identifying and securing this form of financing.

With respect to small business lending, the literature generally indicates that, at the present time, small business customers are being well served by commercial lenders and by the intense competition that has emerged from recent regulatory and market changes. Specific findings include:

- *The number of financing entities targeting small business customers has dramatically increased over the last decade.* These entities are geographically, philosophically, and structurally diversified, which has translated into greater flexibility and choice for small business customers. For example, the entrance of nonbanks into the small business market has meant more streamlined underwriting through the use of credit scoring and faster approval processes. In the process of competing with nonbanks and other banks alike as well as responding to regulatory changes, banks are redefining themselves in ways that on the surface appear to be advantageous to small businesses.

- *The variety of products designed and targeted for small businesses has dramatically increased.* For example, the entrance of credit card issuers into the small business lending market has meant lower costs on other business expenses such as airlines tickets and office supplies.

- *The competition for small business customers has resulted in more relaxed credit standards, better credit terms, less collateral requirements, and increased lines of credit.* Increased competition has also meant that small businesses are in a slightly better position to negotiate the terms of their loans and other business products.
- *Lenders are casting wider nets to attract small businesses, which has meant that many small businesses that have previously had difficulty obtaining credit or have not been targeted by lenders, have greater opportunities to obtain credit.*
- *While regulatory reforms appear to have had generally positive effects on small business lending in the short run, the long-run impacts are still uncertain.* Because impacts may vary as the structure and performance of the economy changes, regulatory reforms should be closely monitored for their impacts on the credit availability for small businesses. The Small Business Regulatory Enforcement Fairness Act, enacted in 1996 to ensure that small business are not being unfairly burdened by regulatory excess, may prove an important tool in this regard.

Chapter Three: Analysis of Demand for Financing Among Businesses in the Appalachian Region

3.1 Introduction

As noted earlier, there are no practical analytic methodologies for accurately measuring the absolute level of demand for business financing, much less for particular types or amounts of financing. In the absence of such methodologies, indirect indicators of financing demand must be relied upon. This chapter synthesizes analysis of three indirect sources of data on financing demand. These sources are:

1. *Broad measures of the structure and performance of the Appalachian regional economy.* Data on economic structure includes the relative share of economic activity comprised by firms of different sectors, sizes, and ownership characteristics. Data on economic performance includes employment growth, unemployment rates, and rates of enterprise formation. This data is analyzed at the county level and also by urban vs. rural status.
2. *Results of a survey of over 200 Appalachian region businesses with five or more employees.* This includes data on the types and amounts of financing sought in the recent past by businesses and financing needs projected for the near future. This data is broken down by firm size and by urban vs. rural location.
3. *Results of telephone interviews with development finance professionals, and face-to-face interviews with development finance professionals, economic developers, local officials, and bankers in three diverse parts of the Appalachian region served by regional economic development districts.* These interviews provided informed perceptions of business financing needs in the region.

The analysis and synthesis of data from these sources enable us to develop the following indirect indicators of financing demand:

- the overall demand for financing in counties of the Appalachian region ***relative*** to the rest of the nation, as evidenced by measures of economic performance;
- the level of demand for financing by different types of businesses in the region ***relative*** to the rest of the nation, as evidenced by measures of economic structure;
- the relative importance of different types and amounts of financing to businesses in the region;
- projected trends in demand for financing based on expectations of future economic performance and the investment plans of businesses; and

- differences in the nature and magnitude of demand for financing between smaller and larger businesses, and between businesses in urban and rural locations.

The analysis in this chapter will be viewed in relation to the analysis of the supply of business financing, to be presented in Chapters Four and Five, to identify if and how the demand for and supply of business financing in the Appalachian region are out of balance.

3.2 Broad Measures of Demand for Capital and Credit

In this section, broad measures of economic structure and performance in the region are looked at briefly and their relationship to business demand for capital and credit is considered. These broad measures are not, of course, precise indicators of business financing demand. However, they do provide some indication of the extent, nature, and trends in demand.

These economic measures have both short-term and long-term implications for business financing needs. For the short-term, they can identify the types of companies that currently play an important role in a region's economy. For the long-term, they can highlight issues that call for long-term development strategies to improve economic performance, of which business financing may be an important component.

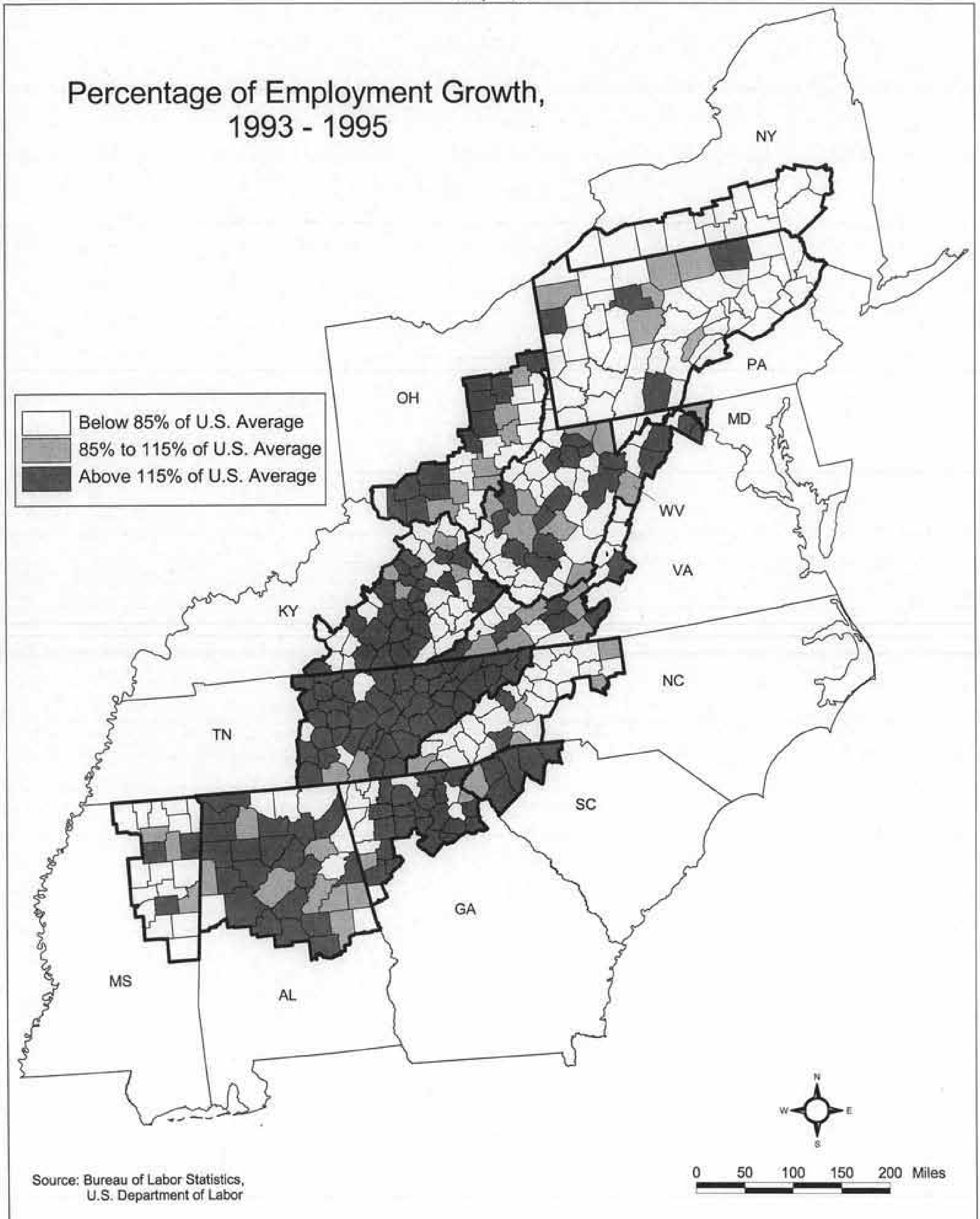
In general, county-by-county analysis of the region's economic performance in relation to national averages shows a moderate pace of growth but still high levels of need for economic stimulus. The employment growth picture is mixed. Employment data for the 1993 to 1995 period shows a high pace of growth in some parts of the region, a moderate pace in others, and a slow pace in still others. Some of the largest growth clusters are in Tennessee, Alabama, Kentucky, South Carolina, and Georgia. Other areas, notably New York and Pennsylvania, show relatively slow employment growth. (See Map 3.1.)

The unemployment picture is also mixed. In general, average unemployment rates for the 1993 to 1995 period were at or above the national average in most counties. Unemployment rates tended to be particularly high in Maryland, West Virginia, Pennsylvania, Ohio, and Kentucky counties. The lowest rates of unemployment were found in North Carolina, South Carolina, and Georgia counties. (See Map 3.2.)

Regions with both high employment growth and high unemployment rates indicate both a strong economy and a potential for further growth because of an underutilized labor force. These areas might benefit from additional business capital and credit infusions to enable firms to accommodate growth and hire additional workers. Of course, there may be other factors, such as insufficient labor force skills, that retard firm expansion.

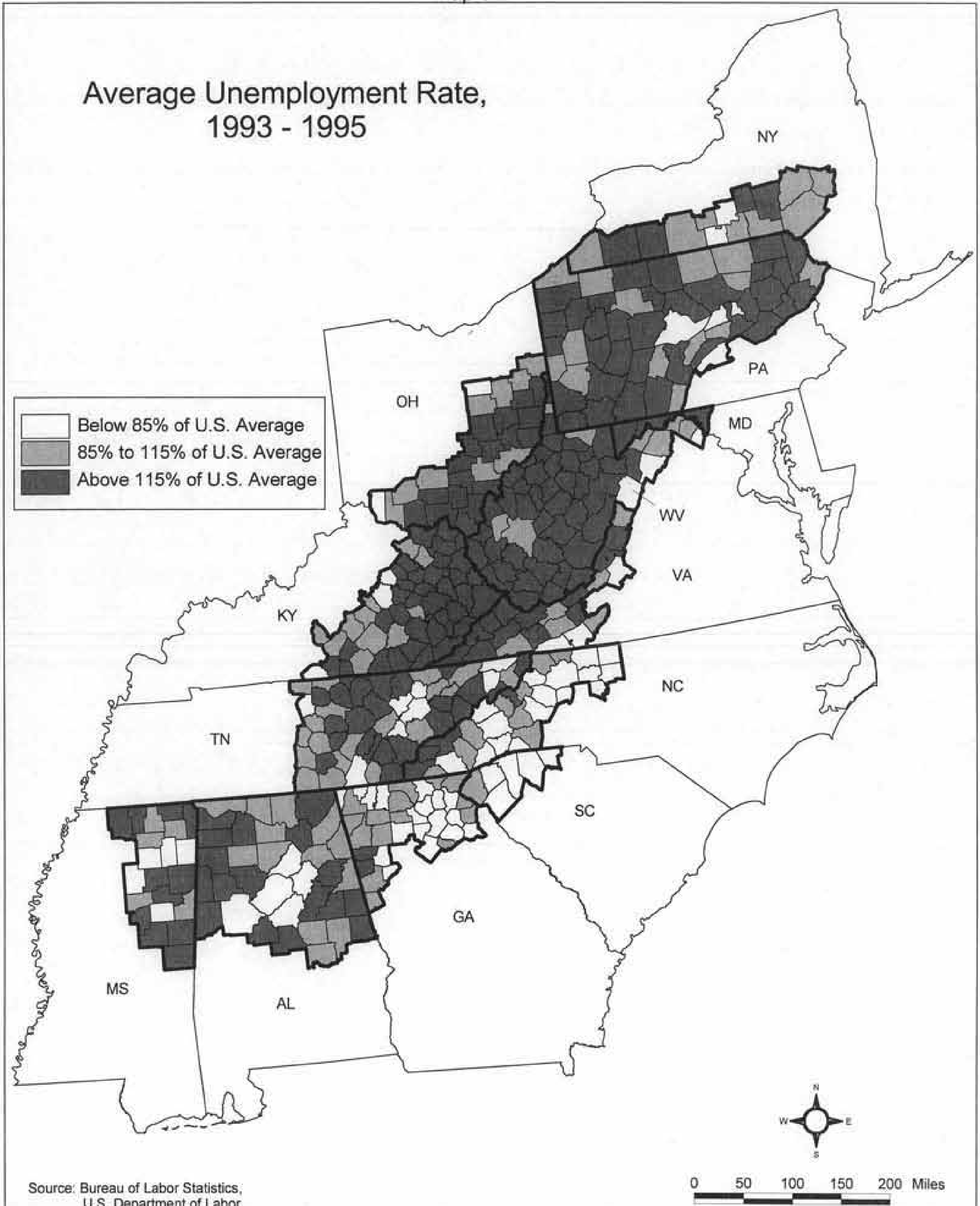
On the other hand, regions with low growth and high unemployment are likely to require long-term, comprehensive economic development strategies to address economic stagnation or decline. Initiatives to increase the supply of business capital and credit, particularly longer-term financing, can be one important component of such strategies.

Map 3.1



Percentage of Employment Growth,
1993 - 1995
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: Bureau of Labor Statistics,
U.S. Department of Labor

Map 3.2


Average Unemployment Rate, 1993 - 1995
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: Bureau of Labor Statistics, U.S. Department of Labor

The rate of enterprise formation is relatively low throughout the Appalachian region. The rate of enterprise formation is another important indicator of demand for financing. High rates of enterprise formation indicate a dynamic, entrepreneurial economy that needs risk financing to fuel startups, but also is succeeding at some level in supplying this type of financing. Additional startup capital may stimulate additional enterprise formation among startup firms that have been unable to tap existing capital sources.

Low rates of enterprise formation may indicate either sluggish growth, the exodus of entrepreneurs because of a lack of business opportunities, or the inability of potential entrepreneurs to take advantage of increasing market opportunities because of the lack of a critical capacity or resource, one of which may be capital (often key resources include entrepreneurial training and management assistance). Increased supplies of capital can thus play a role in a long-term strategy to address barriers to increased rates of enterprise formation.

In the Appalachian region, rates of enterprise formation, as measured by the percentage of establishments classified as startups, are generally low throughout the region in relation to the national average. With a few exceptions, enterprise formation is either at or, more frequently below, the national average in counties throughout the region. This is true even in areas experiencing high employment growth, such as parts of Kentucky and Tennessee. Particularly in these areas, low rates of enterprise formation may indicate the shortage of appropriate forms of capital to finance startup businesses. (See Map 3.3.)

Although a primarily rural region, Appalachia does not have a high proportion of small companies. In almost every county in the region, the percentage of establishments[1] with one to nine employees is at or near the national average. This fact may well be related to the low rate of enterprise formation in the region. The implication for financing needs is that, in the short-run, there are fewer very small established and startup firms requiring very small loans. For the longer run, it may indicate that additional "micro" financing can contribute to the formation of more microenterprises. (See Map 3.4.)

The importance of larger firms in Appalachia varies throughout the region. Certain parts of the region have a high proportion of large establishments (defined as having 250 or more employees). These include all of the South Carolina counties in the region, and several clusters of counties in Alabama, Tennessee, New York, Mississippi, Georgia, and North Carolina. Other parts of the region, particularly large clusters of counties in Kentucky and West Virginia, have a relatively low proportion of large establishments. The demand for large-scale financing is likely to be influenced by this distribution of larger companies. (See Map 3.5.)

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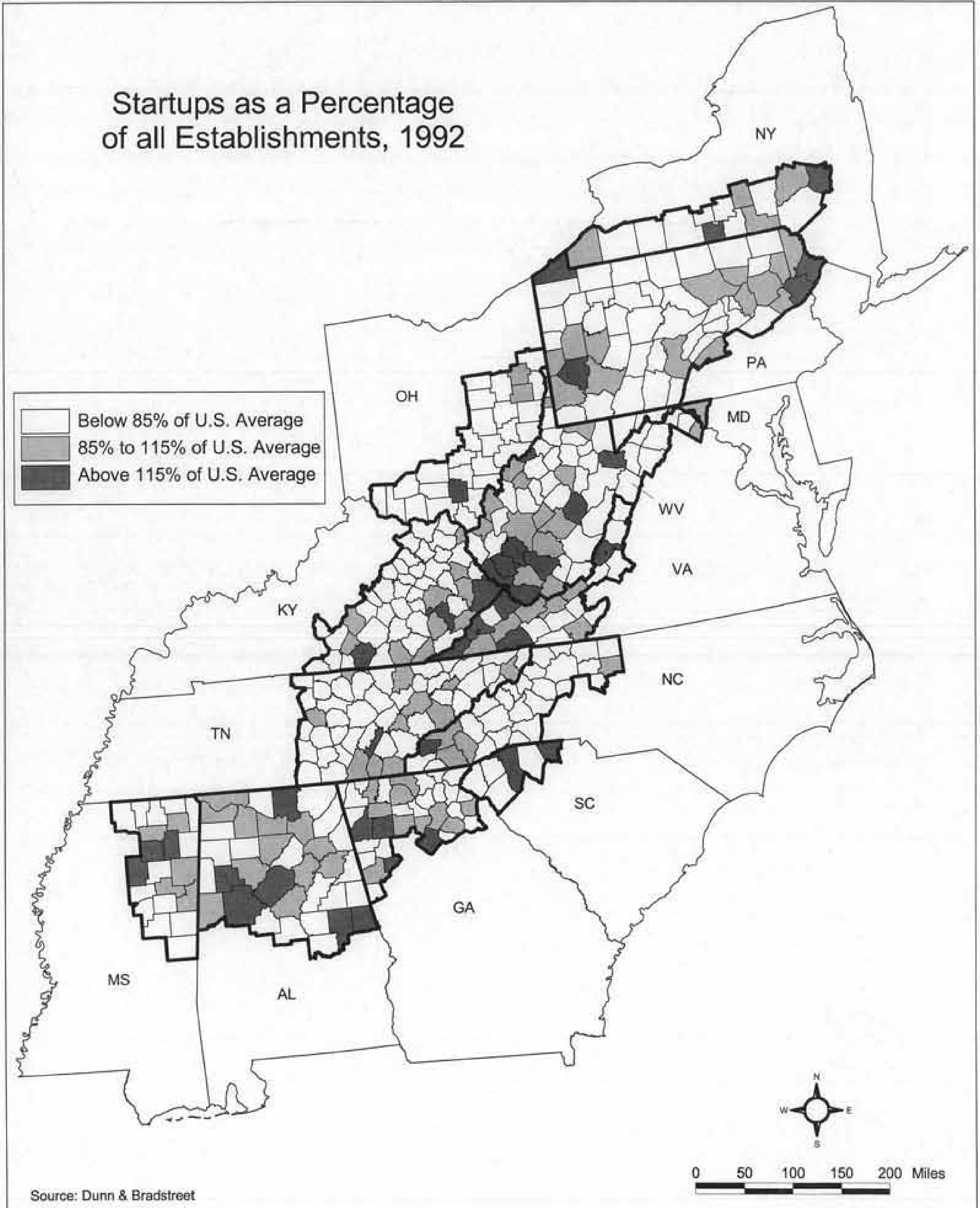
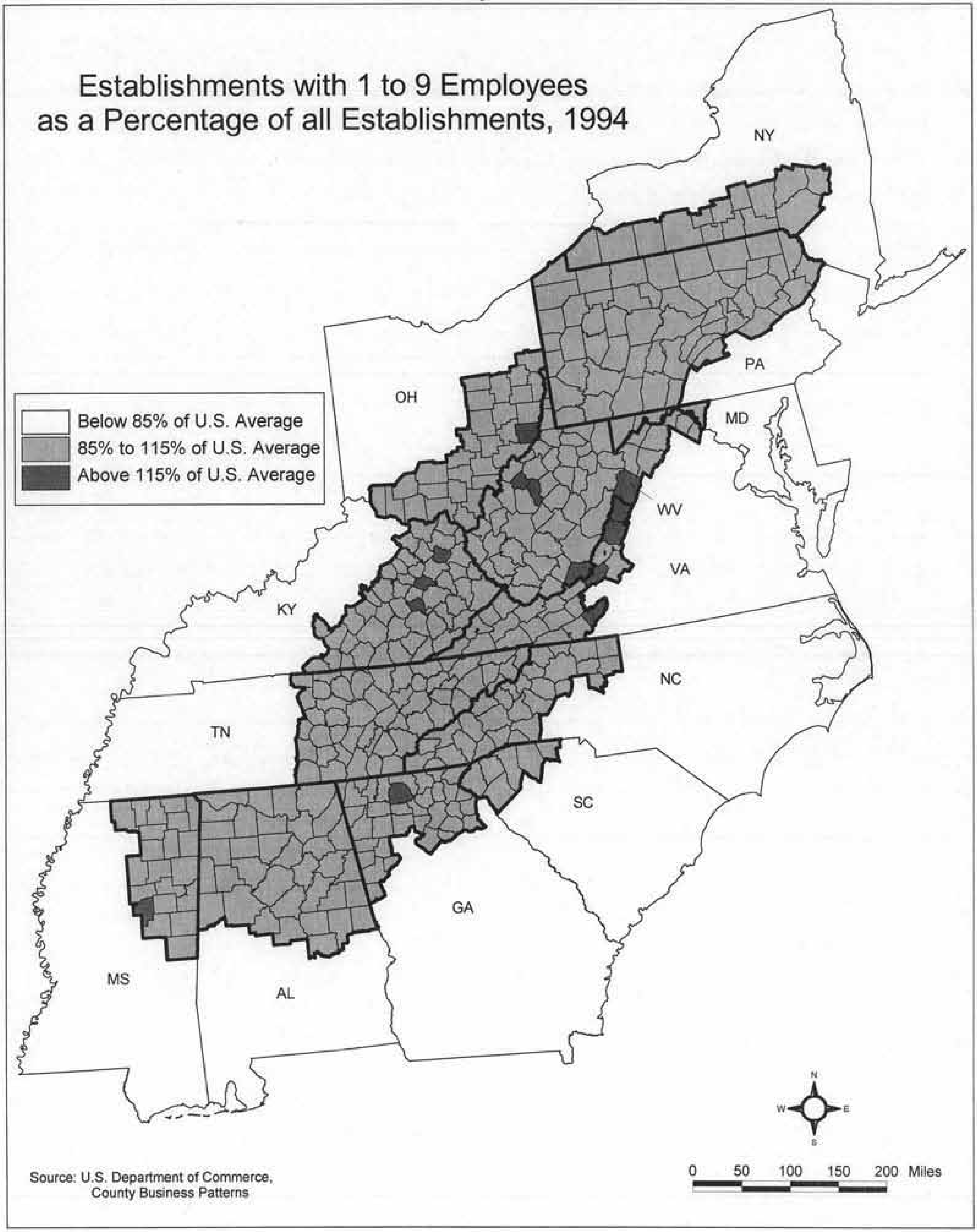
[1] The number of establishments is used here as a proxy for enterprises. The term establishments refers to single-site business facilities. One enterprise can be composed of more than one establishment. Therefore, there are more small establishments than small enterprises. However, since the majority of enterprises have a single establishment (and the number of multi-establishment enterprises is fairly evenly geographically distributed), use of establishment data provides a good comparative measure of the relative importance of large and small firms in a local economy.

Map 3.3



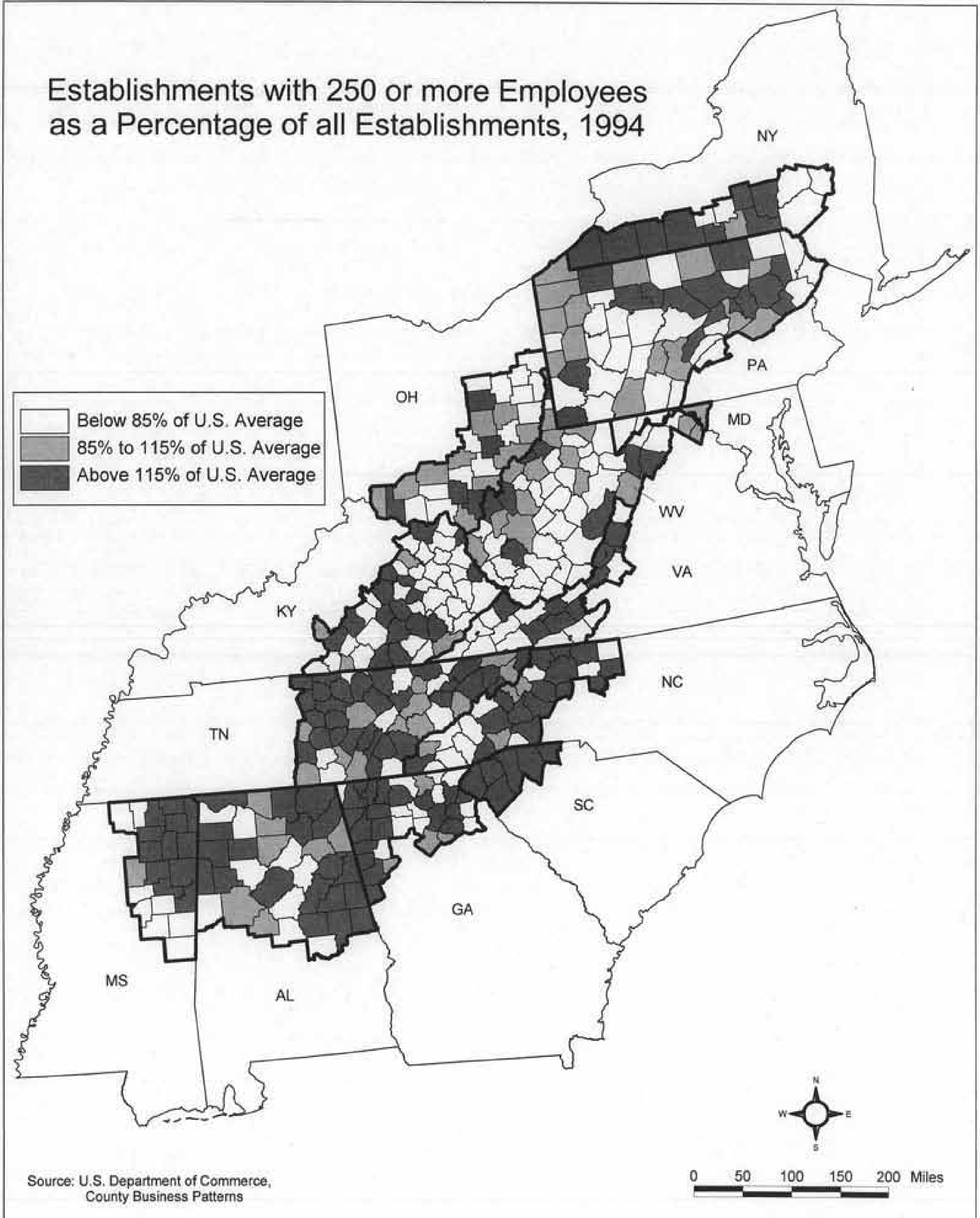
Source: Dunn & Bradstreet

Map 3.4



Establishments with 1 to 9 Employees
as a Percentage of all Establishments, 1994
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: U.S. Department of Commerce,
County Business Patterns

Map 3.5



Establishments with 250 or more Employees as a Percentage of all Establishments, 1994
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0
50
100
150
200 Miles
Source: U.S. Department of Commerce, County Business Patterns

Much of the Appalachian region remains a strong manufacturing region relative to the nation as a whole. Many parts of the region have a substantially higher proportion of manufacturing establishments[2] than the national average. These include most of the Appalachian counties in Mississippi, Alabama, and South Carolina, as well as many counties in Tennessee, Georgia, North Carolina, northern West Virginia, and northwestern Pennsylvania. Only a few parts of the region, notably a cluster of counties spanning southern West Virginia, southwestern Virginia, eastern Kentucky, and the southern tip of Ohio, have a relatively low proportion of manufacturing establishments. The clustering of large establishments and manufacturing establishments appears to be closely related. Suitable forms of financing should be available to maintain this important component of the region's economic base. (See Map 3.6.)

The service sector in Appalachia remains relatively undeveloped. Nationally, the service sector is becoming an increasingly important part of the "traded sector" traditionally dominated by manufacturing. The "traded sector" refers to firms that export products and services to consumers outside a region, thus importing income and stimulating economic activity. Traded services include components of financial and business services, transportation services, and tourism.

The region has generally lagged the nation in the shift to a service economy. Only one county in the region substantially exceeds the national average in its proportion of service establishments. Most counties have a lower than average proportion of service establishments. It is also likely that the bulk of service firms in the region is in the "non-traded" sector, that is, serves primarily local markets, not in the economically more important traded sector, which serves non-local markets and thus draws new income into the region. Therefore, financing for service firms is not likely to be as important to promoting economic development as financing for manufacturing firms, at least in the short run. In the longer run, as the nation continues to shift to a service economy, the availability of financing for service firms in the region is likely to take on greater importance. (See Map 3.7.)

The participation of non-traditional entrepreneurs in the region's economy is relatively low. Throughout the U.S., representation of non-traditional and socially or economically disadvantaged entrepreneurs among small business owners has been growing. While this is true in Appalachia, the region is lagging behind the country in the level of business ownership within at least one such group, women entrepreneurs. In most counties of the region, the percentage of women-owned enterprises is well below the national average. There are some parts of the region in which the rate is at or near the national average, notably New York State's Appalachian counties, and in some parts of West Virginia and Ohio. In no county in the region does the percentage of women-owned enterprises substantially exceed the national average.[3] (See Map 3.8.)

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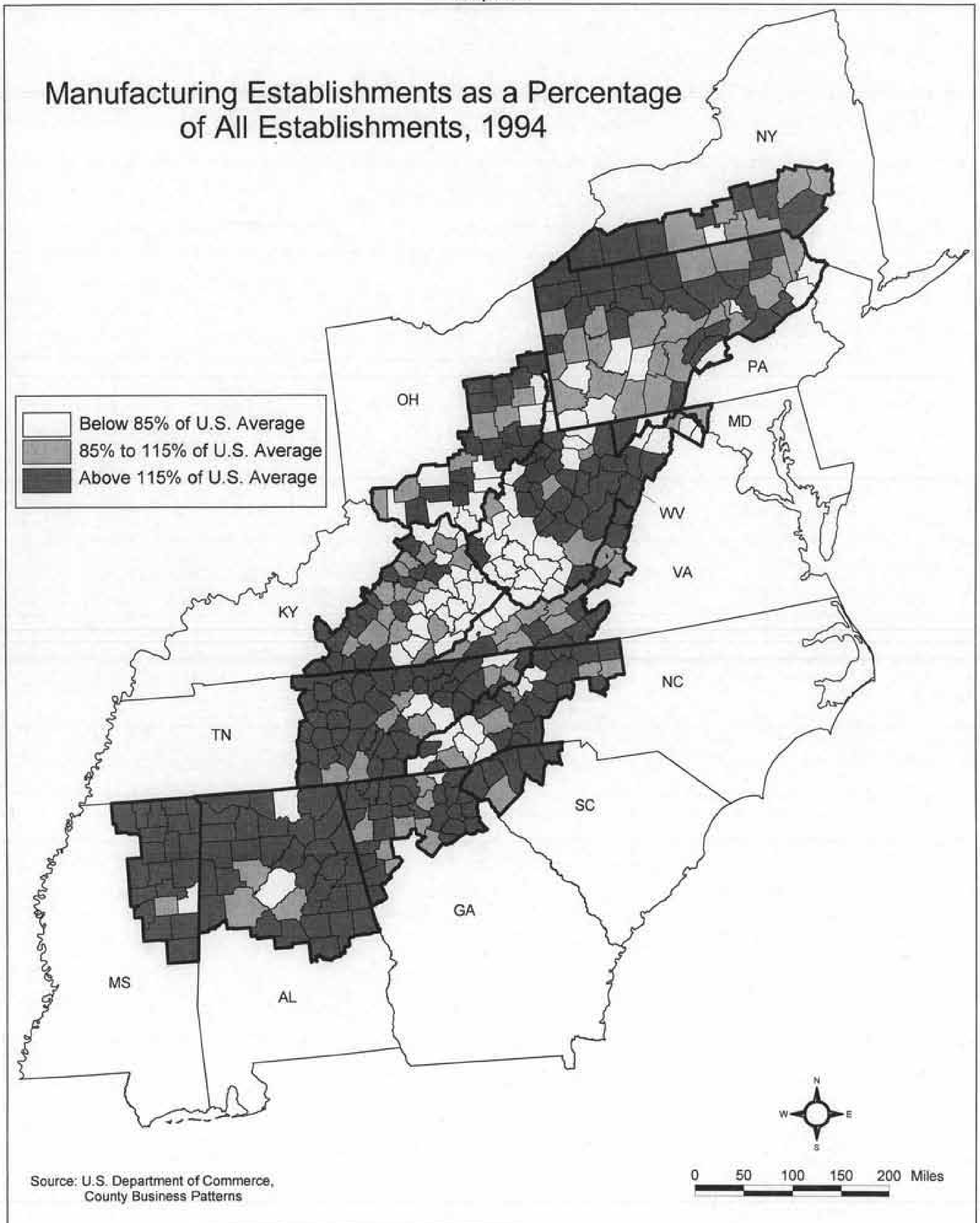
[2] Note that we are measuring the proportion of manufacturing *establishments*, a better indicator of demand for financing than the proportion of manufacturing *employment*.

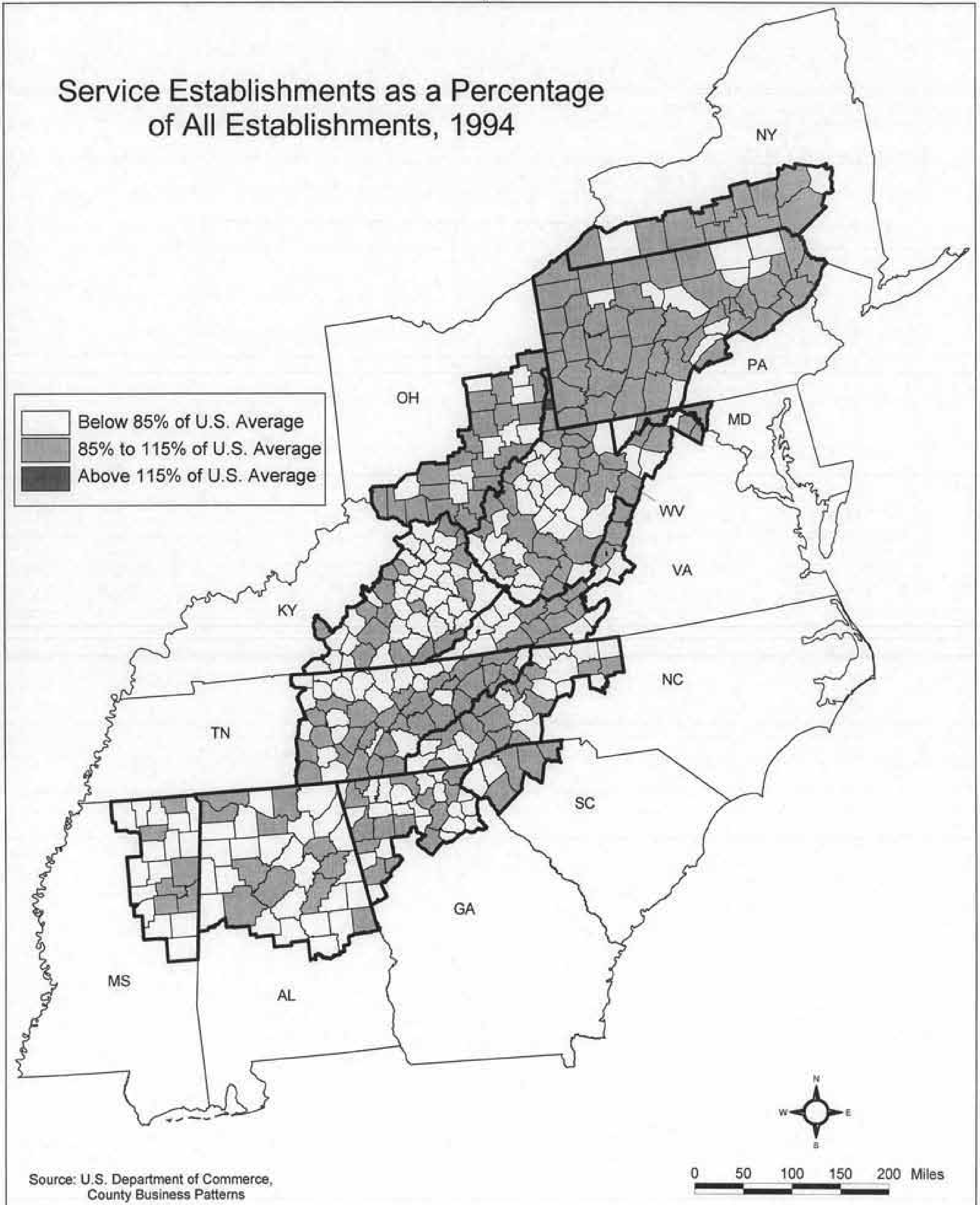
[3] Data on minority business ownership was not available for a majority of Appalachian counties because the number of such firms was below the threshold required for public release.

Map 3.6



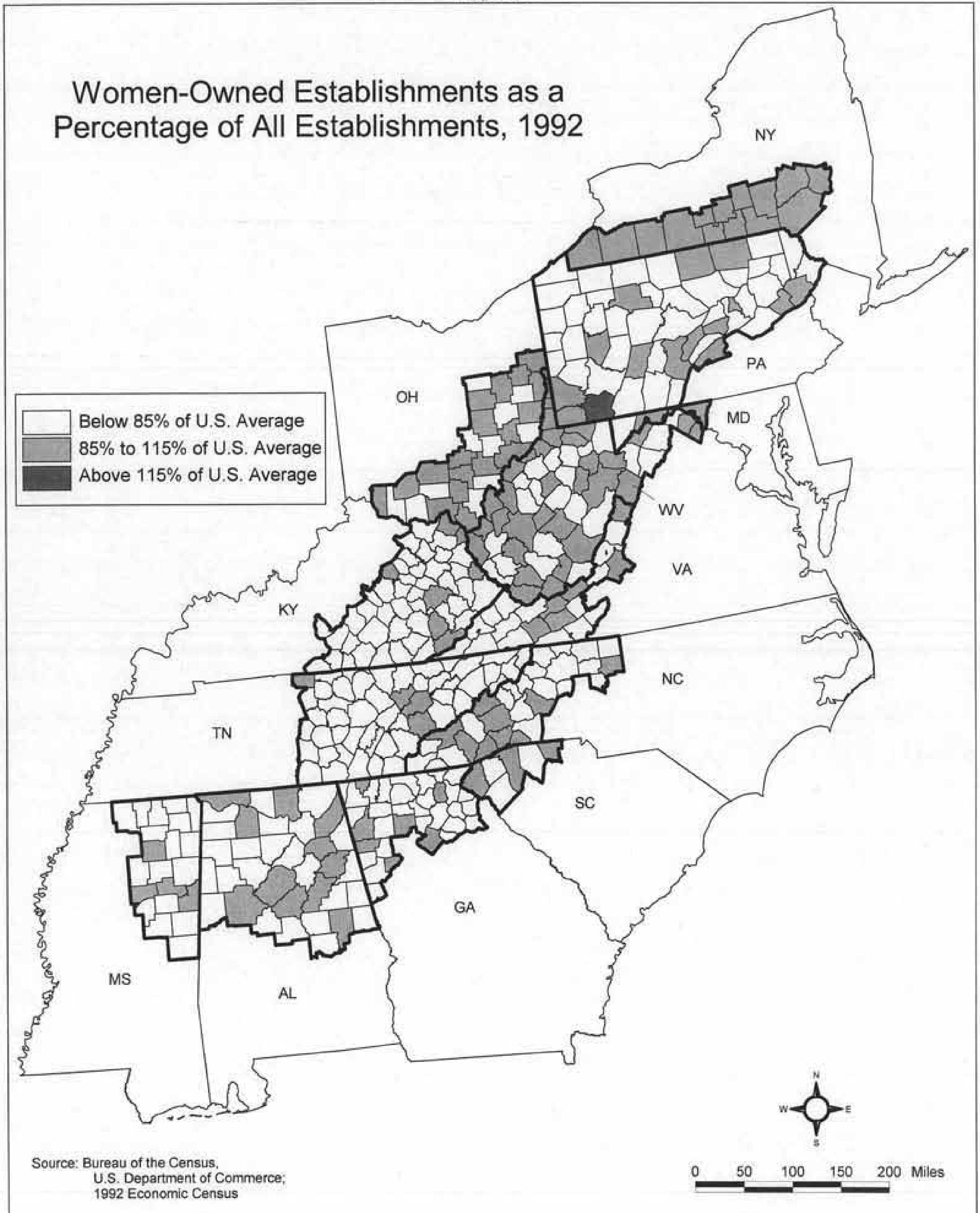
Manufacturing Establishments as a Percentage of All Establishments, 1994
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: U.S. Department of Commerce, County Business Patterns

Map 3.7



Service Establishments as a Percentage of All Establishments, 1994
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: U.S. Department of Commerce, County Business Patterns

Map 3.8



Women-Owned Establishments as a Percentage of All Establishments, 1992
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: Bureau of the Census, U.S. Department of Commerce; 1992 Economic Census

3.3 The Importance of Financing to Business Competitiveness

In considering the need for measures to expand the availability of capital and credit in the Appalachian region, it is important to take into account the importance placed on financing availability to business competitiveness relative to other factors. Mt. Auburn has gained some insights into this issue, mainly from the business survey and interviews with development finance professionals.

The responses to the business survey indicate that availability of financing is only one of many factors that have an important influence on business competitiveness. When asked about the importance of eight major factors affecting business competitiveness to their ability to do business at their current location, respondents ranked financing, on average, sixth out of eight factors. Of the eight factors, the five considered more important (in order of rank) were: availability and/or quality of labor; general quality of life; state and local tax levels; transportation links; and cost and/or availability of utilities. The two considered less important were: availability and/or cost of sites and buildings; and availability and/or cost of housing. While availability of financing was not ranked among the most important factors, still 35 percent of respondents said it had a strong impact, and 23 percent said it had a moderate impact on their competitiveness. (See Table 3.1.)

Table 3.1
Factors Affecting Doing Business (%)

	IMPACT				Weighted Average
	Strong	Moderate	Little or None	Don't Know	
Availability and/or cost of housing	11.7	31.5	55.3	1.5	1.6
Availability and/or cost of sites and buildings	26.2	27.2	45.1	1.5	1.8
Availability of financing	35.4	23.3	40.3	1.0	2.0
Availability and/or cost of utilities	33.5	35.4	30.6	0.5	2.0
Transportation links	39.8	23.3	35.4	1.5	2.0
State and local tax levels	42.7	35.4	20.9	1.0	2.2
General quality of life	39.5	42.2	21.4	0.5	2.3
Cost, availability, and/or quality of labor	52.0	28.6	19.4	0.0	2.3

Note: Total number of respondents = 206
Source: Mt. Auburn Business Survey

Development finance professionals have a somewhat different perspective, ranking the availability of financing among the most important factors affecting competitiveness. Among those we interviewed, obtaining financing was generally considered either the most significant challenge or comparable in importance to other challenges facing their clients. Other challenges most frequently mentioned were, in order of frequency: lack of suitable infrastructure (i.e., water and sewer, roads, as well as buildable sites, especially in mountainous areas); an inadequately skilled labor force; lack of access to markets; and unfavorable local permitting/zoning regulations or practices.

3.4 The Nature of Capital and Credit Demand

The responses from the business survey provide a good overview of the relative importance of different types and amounts of financing to Appalachian businesses.[4]

3.4.1 Types of Financing

Asked what types of financing they had sought during the past three years, respondents answered as follows: (See Table 3.2.)

- the most frequently sought types of financing were revolving lines of credit (36 percent), equipment loans (32 percent), equipment leases (25 percent), and fixed-rate mortgages (25 percent);
- other frequently sought types were medium-term working capital (18 percent) and short-term working capital (16 percent); and
- the least frequently sought were export trade financing (2 percent), and equity or debt with equity features (about 2 percent).

Table 3.2
Experience in Obtaining Financing in the Past Three Years (%)

	Needed				
	Sought		Did Not Seek	Did Not Need	Don't Know/ Refused to Answer
	Obtained	Turned Down			
Fixed rate commercial mortgage	21.4	3.4	3.4	68.0	3.9
Variable rate commercial mortgage	10.7	1.0	5.8	79.1	3.4
Equipment loan	30.1	1.5	2.9	61.6	3.9
Equipment lease	24.3	1.0	2.9	67.5	4.4
Medium-term working capital (1-5 years)	16.5	1.5	6.3	69.4	6.3
Short-term working capital (under 1 year)	13.6	1.9	5.8	72.3	6.3
Revolving line of credit	33.5	2.4	4.9	55.3	3.9
Asset-based financing	8.7	1.5	1.9	81.1	6.8
Export trade financing	1.5	0.5	0.5	92.2	5.4
Equity of debt with equity features	2.9	1.0	1.0	86.3	8.8

Note: Total number of respondents = 206
Source: Mt. Auburn Business Survey

3.4.2 Amounts of Financing

Among those who had sought financing, the amounts of financing varied considerably. Among the amounts of financing most frequently requested for each type of financing were the following: (See Table 3.3.)

[4] It should be noted that the survey included only existing businesses and requested information only about financing experiences during the previous three years. The results, therefore, do not reflect the financing experiences of most startup firms and tend to under-emphasize the demand for early-stage equity or equity-like financing among such firms.

Table 3.3
Amounts of Financing Sought and/or Obtained (%)

	Amount Sought/Obtained						
	Under $10,000	$10,000 to $49,000	$50,000 to $99,000	$100,000 to $499,000	$500,000 to $999,000	$1 Million or More	Total Number of Respondents
Fixed rate commercial mortgage	2.4	14.3	16.7	40.5	9.5	16.7	42
Variable rate commercial mortgage	5.6	22.2	16.7	27.8	0.0	27.8	18
Equipment loan	11.3	41.5	22.6	13.2	1.9	9.4	53
Equipment lease	21.6	45.9	10.8	8.1	0.0	13.5	37
Medium-term working capital (1-5 years)	9.1	36.4	4.5	31.8	9.1	9.1	22
Short-term working capital (under 1 year)	8.3	29.2	25.0	29.2	0.0	8.3	24
Revolving line of credit	14.5	30.9	14.5	21.8	5.5	12.7	55
Asset-based financing	0.0	41.7	0.0	33.3	0.0	25.0	12
Export trade financing	33.3	0.0	0.0	33.3	0.0	33.3	3
Equity of debt with equity features	0.0	20.0	0.0	0.0	0.0	80.0	5

Source: Mt. Auburn Business Survey

- *Commercial mortgages:* Among those seeking fixed-rate commercial mortgages, two-thirds sought $100,000 or more, most of those in the $100,000 to $499,000 range. Among those seeking variable rate commercial mortgages, over half sought $100,000 or more, half of those in the $100,000 to $499,000 range.
- *Equipment loans and leases:* Among those seeking equipment loans, over half sought less than $50,000, while almost one-quarter sought $50,000 to $99,000. Among those seeking equipment leases, two-thirds sought less than $50,000.
- *Working capital loans:* Among those seeking medium-term working capital loans, 45 percent sought less than $50,000, most of those in the $10,000 to $49,000 range. About one-third sought $100,000 to $499,000. Among those seeking short-term working capital, 38 percent sought less than $50,000, 25 percent $50,000 to $99,000, and 29 percent $100,000 to $499,000.
- *Revolving lines of credit:* 45 percent sought less than $50,000, 14 percent sought $50,000 to $99,000, and 22 percent sought $100,000 to $499,000.

It is also useful to assess the nature of demand for financings of particular sizes. The relative importance of different financing sizes for particular types of financings was as follows: (See Table 3.3.)

- *Financings of under $10,000:* The main source of demand in this financing size was for equipment loans and leases. This financing size was not particularly important in any financing category (as a proportion of the total number of financing sought in that category), except export trade financing (33 percent of total requests), for which there was only a total of three financing requests among respondents. Other than for that type of financing, this size range was most important for equipment leases (22 percent of total requests), revolving lines of credit (14 percent), and equipment loans (11 percent).

- *Financings of $10,000 to $49,000:* This was generally the most frequently requested size of financing. The main source of demand in this financing size was for equipment loans and leases, working capital loans, and revolving credit lines. This financing size was particularly important for the following categories of financings: equipment leases (46 percent of total requests in that category), equipment loans (42 percent), and asset-based financing (42 percent). Also frequently sought were medium-term working capital loans (36 percent), revolving lines of credit (31 percent), and short-term working capital loans (29 percent).
- *Financings of $50,000 to $99,000:* The main source of demand in this financing size was for equipment loans, commercial mortgages, revolving lines of credit, and short-term working capital. This financing size was particularly important for the following categories of financing: short-term working capital (25 percent of total requests in that financing category) and equipment loans (23 percent). Seventeen percent of commercial mortgage requests were also in this amount.
- *Financings of $100,000 to $499,000:* The main source of demand in this financing size was for commercial mortgages, working capital, and revolving credit lines. This financing size was particularly important for the following categories of financings: fixed-rate commercial mortgages (40 percent of total requests in that category), asset-based financing (33 percent), export trade financing (33 percent), medium-term working capital (32 percent), short-term working capital (29 percent), and variable-rate commercial mortgages (28 percent).
- *Financings of $500,000 or greater.* The main source of demand in this financing size was for commercial mortgages and revolving lines of credit. This financing size was particularly important for the following categories of financings: equity or debt with equity features (80 percent of total requests in that category), export trade financing (33 percent), variable-rate commercial mortgages (28 percent), fixed rate commercial mortgages (26 percent), and asset-based financing (25 percent).

3.5 Recent and Projected Trends in Demand for Financing

Anecdotal evidence indicates that demand for credit in the region has been increasing. Among development finance professionals interviewed, the general observation was that demand for credit is increasing as a result of one or more of several factors: downsized professionals seeking to launch new businesses; in-migration; increasing outsourcing and job shops; and an overall improving economy (the latter observation consistent with national and regional trends in employment growth). A few respondents indicated that consolidation trends in the banking industry have affected demand for credit as merged banks have purged their portfolios, prompting businesses to seek credit from other sources.

Case studies of three areas of the Appalachian region served by multi-county economic development organizations with ARC RLFs confirm and provide more detailed illustrations of this improving economic picture. The three areas -- north central Pennsylvania, southeastern Kentucky, and northeast Mississippi -- are all benefiting from the strength of the national economy. While traditional industries in these areas have continued to decline, notably the primary metals industry in north central Pennsylvania, the coal mining industry in eastern Kentucky, and the apparel industry in northeast Mississippi, new industries are emerging to replace them. North central Pennsylvania has experienced very strong growth in the powder metallurgy industry, which uses a compacting process to form metal parts, primarily for the automotive, appliance, and hardware industries. Likewise, northeast Mississippi has experienced growth in the furniture industry. Southeastern Kentucky, while not as economically robust as these other two areas and still dependent on a declining number of high-wage coal mining jobs, has seen some hopeful trends in manufacturing supplier firms, secondary hardwood, and tourism. Because of infrastructure improvements and new telecommunications technologies, these areas seem increasingly linked to and dependent on larger national and global economic forces. According to development finance professionals and bankers in these areas, demand for business credit and capital, particularly in north central Pennsylvania and northeast Mississippi, has been strong.

Development finance professionals also generally report that demand for risk capital has been either constant or growing, particularly where economies are expanding or the pace of startups is increasing. Several respondents indicated that demand from technology businesses is increasing. Bankers and development finance professionals in the three case study areas all noted trends in the development of home-based and other microenterprises in their areas, particularly among downsized managers and professionals, some recently having moved or returned to the area. These individuals often seek small amounts of startup financing.

Based on the survey responses, the near-term investment plans of Appalachian businesses are oriented heavily toward fixed asset financing needs. The most likely activities requiring financing planned by respondents during the next two to three years are: replacement of old or outmoded equipment (60 percent very or somewhat likely to undertake), expansion/modernization of an existing facility (56 percent very or somewhat likely), and construction of a new facility (39 percent very or somewhat likely). (See Table 3.4.)

Other, less frequently mentioned plans may require "softer," higher-risk kinds of financing. These include general sales expansion (34 percent very or somewhat likely to undertake), development of new products or production technologies (28 percent very or somewhat likely), refinancing existing loans (22 percent very or somewhat likely), acquisition of other firms (16 percent very or somewhat likely), and exporting (7 percent very or somewhat likely). (See Table 3.4.)

Table 3.4 Likelihood of Need for Financing in the Near Future (%)					
	Very Likely	Somewhat Likely	Unlikely	Not Applicable	Don't Know
Replacement of old/outmoded equipment	33.2	27.3	35.6	1.9	2.0
Expansion/modernization of existing facility	27.3	28.3	39.0	2.4	2.9
General sales expansion	17.6	16.6	52.7	11.7	1.5
Development of new products/production technologies	11.7	16.6	53.2	16.6	2.4
Construction of a new facility	20.5	18.5	56.1	2.9	2.0
Exporting	2.9	4.4	61.8	29.4	1.5
Refinancing of an existing loan	10.7	11.7	66.3	9.8	1.5
Acquisition of other firms	6.3	10.2	67.8	14.1	1.5

Note: Total number of respondents = 205
Source: Mt. Auburn Business Survey

A substantial majority of these firms do not anticipate having trouble obtaining financing for these plans. Only about 12 percent of survey respondents anticipate having trouble obtaining financing.

3.6 Variations in Demand for Financing

3.6.1 Differences Between Urban and Rural Parts of the Region

A breakdown of the analysis between counties in metropolitan areas and counties in non-metropolitan areas indicates substantial differences in factors affecting demand for financing.

Non-metro counties tend to have higher employment growth but also higher unemployment rates. While about the same percentage of metro and non-metro counties have experienced substantially higher growth than the U.S. average, a higher percentage of non-metro counties have experienced average growth (36 percent vs. 13 percent) and a higher percentage of metro counties have experienced substantially lower than average growth (49 percent vs. 24 percent). At the same time, a substantially higher proportion of non-metro counties have experienced substantially higher than average unemployment (61 percent vs. 29 percent). While the factors influencing these conditions are complex, the combination of high employment growth and high unemployment in rural parts of the region may indicate a near-term potential for business expansion that could be supported by additional flows of capital. (See Table 3.5.)

Non-metro counties tend to have lower rates of enterprise formation. A lower proportion of non-metro counties have substantially higher than average rates of enterprise formation (6 percent vs. 10 percent), while a higher proportion have substantially lower than average rates (77 percent vs. 60 percent). This may indicate a lesser short-term need for risk financing, but a greater long-term need for development strategies (including development finance tools) that promote new enterprise formation. (See Table 3.5.)

Table 3.5
Measures of Demand For Financing:
Comparison of Urban and Rural Counties

	Below 85% of U.S. Average	85% to 115% of U.S. Average	Above 115% of U.S. Average	Total
Percent Employment Growth, 1993-1995				
Metro counties	48.6%	12.8%	38.5%	99.9%
Non-metro counties	24.1%	35.5%	40.3%	99.9%
Average Unemployment Rate, 1993-1996				
Metro counties	39.4%	31.2%	29.4%	100.0%
Non-metro counties	12.4%	26.9%	60.7%	100.0%
Startups as a Percentage of All Establishments, 1992				
Metro counties	59.6%	30.3%	10.1%	100.0%
Non-metro counties	76.6%	17.6%	5.9%	100.1%
Establishments With 1-9 Employees as a Percentage of All Establishments, 1994				
Metro counties	0.0%	100.0%	0.0%	100.0%
Non-metro counties	0.0%	94.1%	5.9%	100.0%
Establishments With 250+ Employees as a Percentage of All Establishments, 1994				
Metro counties	38.5%	28.4%	33.0%	99.9%
Non-metro counties	43.8%	13.4%	42.8%	100.0%
Manufacturing Establishments as a Percentage of All Establishments, 1994				
Metro counties	25.7%	30.3%	44.0%	100.0%
Non-metro counties	17.9%	16.6%	65.5%	100.0%
Service Establishments as a Percentage of All Establishments, 1994				
Metro counties	24.8%	74.3%	0.8%	99.9%
Non-metro counties	58.3%	41.7%	0.0%	100.0%
Women-Owned Establishments as a Percentage of All Establishments, 1994				
Metro counties	49.6%	49.6%	0.8%	100.0%
Non-metro counties	75.2%	24.8%	0.0%	100.0%

Metro and non-metro counties have about the same proportion of small establishments. However, a different pattern emerges in the proportion of large establishments. There is very little difference between metro and non-metro counties in the proportion of total establishments comprised by small establishments (1 to 9 employees). With respect to large establishments (250+ employees), metro counties are more likely to mirror the national average (28 percent in the middle tier vs. 13 percent), while non-metro counties are more likely to be substantially above the national average (43 percent vs. 33 percent in the top tier), or below the national average (44 percent vs. 38 percent in the bottom tier). This indicates that rural counties tend to break into two distinct groups -- large-establishment-dominated and small-establishment-dominated. (See Table 3.5.)

Non-metro counties tend to have higher percentages of manufacturers and lower percentages of service firms. A higher proportion of non-metro counties has a substantially higher share of total establishments comprised by manufacturers than the national average (66 percent vs. 44 percent), while a substantially higher proportion has a substantially lower share of total establishments comprised by service establishments (58 percent versus 29 percent). This indicates that, while manufacturing is still relatively important throughout the Appalachian region and the service economy is relatively undeveloped, these phenomena are particularly pronounced in the more rural parts of the region. (See Table 3.5.)

Non-metro counties tend to have lower women enterprise ownership rates. Women enterprise ownership is far more frequently below the national average in non-metro counties than in metro counties. Seventy-five percent of non-metro counties have lower than average rates of women enterprise ownership compared to 50 percent of metro counties. This indicates a lesser near-term demand for financing by women-owned firms, but also a greater need to develop strategies to support women entrepreneurship (of which financing is one component). (See Table 3.5.)

According to the business survey results, businesses located in non-metro counties are less likely to seek financing than businesses located in metro counties. The survey data suggest, although not conclusively, that respondents from non-metro counties have sought many types of financing less frequently than those from metro counties. The most notable difference is in the demand for medium-term working capital. Only 12.5 percent of respondents from non-metro counties have sought this type of financing during the past three years compared to 23 percent from metro counties. (See Table 3.6.)

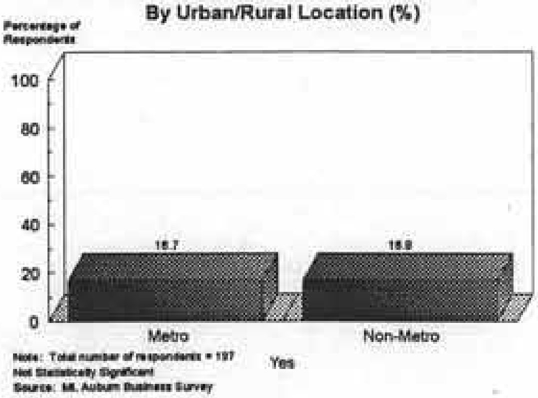
Table 3.6
Experience in Obtaining Financing in the Past Three Years
By Urban or Rural Location (%)

	Needed									
	Sought				Did Not Seek		Did Not Need			
	Obtained		Turned Down							
	Metro	Non-Metro	Metro	Non-Metro	Metro	Non-Metro	Metro	Non-Metro	N=	Statistical Significance
Fixed rate commercial mortgage	25.0	18.5	2.9	4.3	5.8	1.1	66.3	76.1	196	Not Significant
Variable rate commercial mortgage	14.3	6.5	1.0	1.1	6.7	5.4	78.1	87.0	197	Not Significant
Equipment loan	32.4	29.7	1.9	1.1	3.8	2.2	61.9	67.0	196	Not Significant
Equipment lease	27.6	23.3	1.9	0.0	3.8	2.2	66.7	74.4	195	Not Significant
Medium-term working capital (1-5 years)	21.4	12.5	1.9	1.1	9.7	3.4	67.0	83.0	191	Significant at .1 level
Short-term working capital (under 1 year)	16.5	11.4	2.9	1.1	6.8	5.7	73.8	81.8	191	Not Significant
Revolving line of credit	59.4	55.6	3.8	5.6	4.7	0.0	32.1	38.8	196	Not Significant
Asset-based financing	1.8	6.7	2.9	0.0	2.0	2.2	82.4	91.0	191	Not Significant
Export trade financing	1.9	1.1	0.0	1.1	1.0	0.0	97.1	97.7	192	Not Significant
Equity of debt with equity features	3.0	3.5	2.0	1.0	2.0	0.0	92.9	96.5	185	Not Significant

Note: Metro = Inside federally-defined metropolitan statistical area.
Non-Metro = Outside federally-defined metropolitan statistical area.

According to the business survey results, there are few difference in the financing needs anticipated by metro and non-metro borrowers, or in the proportion of metro and non-metro borrowers who either have been recently affected by inability to obtain financing or anticipate trouble obtaining financing in the near future. The only significant difference is in the likelihood of needing refinancing. While a similar proportion of respondents considered it likely that they would need this type of financing, a higher proportion in metro area businesses considered it "very likely," while a higher proportion in non-metro area businesses considered it "somewhat likely." (See Graphs 3.1 and 3.2, and Table 3.7.)

Graph 3.1
Recent Plans to Expand, Modernize, or Renovate Affected By Inability to Obtain Financing By Urban/Rural Location (%)



Graph 3.2
Anticipation of Trouble Obtaining Financing By Urban/Rural Location (%)

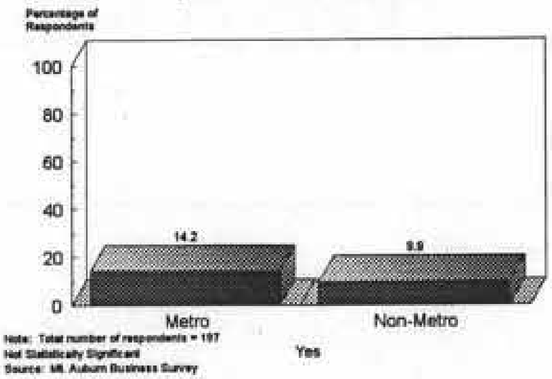


Table 3.7
Future Financing Needs for Different Types of Business Activity By Urban or Rural Location (%)

	Very Likely		Somewhat Likely		Unlikely or N/A to Business			
	Metro	Non-Metro	Metro	Non-Metro	Metro	Non-Metro	N=	Statistical Significance
Construction of a new facility	24.1	17.6	14.8	23.1	61.1	59.3	199	Not Significant
Expansion/modernization of existing facility	29.0	27.8	25.2	33.3	45.8	38.9	197	Not Significant
Replacement of old/outmoded equipment	33.3	35.2	26.9	28.6	39.8	36.3	199	Not Significant
Development of new products/production technologies	12.2	12.1	16.8	16.5	71.0	71.4	198	Not Significant
Exporting	4.6	1.1	3.7	5.6	91.7	93.3	199	Not Significant
Acquisition of other firms	7.3	5.5	13.8	6.6	78.9	87.9	200	Not Significant
Refinancing existing loans	14.7	5.5	9.2	15.4	76.1	79.1	200	Significant at .01 level
General sales expansion	21.1	14.3	16.5	17.6	62.4	68.1	200	Not Significant

Note: Metro = Inside federally-defined metropolitan statistical area.

Non-Metro = Outside federally-defined metropolitan statistical area.

Source: Mt. Auburn Business Survey

3.6.2 Differences Between Smaller and Larger Firms

According to the business survey results, the level of demand for most types of financing products is similar among smaller and larger firms.[5] Among ten types of financing products, larger firms (those with 10 or more employees) are more likely to seek three types of products than smaller firms (those with fewer than 10 employees): fixed-rate mortgages (30 percent sought during the past three years versus 20 percent of smaller firms), equipment leases (37 percent versus 15 percent), and revolving lines of credit (46 percent versus 28 percent). These differences are statistically significant. The percentages seeking the other seven products were roughly the same. While slightly higher percentages of larger firms sought most of these products, the differences were not statistically significant. (See Table 3.8.)

Table 3.8
Experience in Obtaining Financing in the Past Three Years
By Firm Size (%)

	Needed									
	Sought									
	Obtained		Turned Down		Did Not Seek		Did Not Need			
	Small	Large	Small	Large	Large	Small	Large	Small	N=	Statistical Significance
Fixed rate commercial mortgage	13.4	28.4	6.1	1.8	3.7	3.7	76.8	66.1	191	Significant at .05 level
Variable rate commercial mortgage	8.5	12.7	1.2	0.9	8.5	4.5	81.7	81.8	192	Not Significant
Equipment loan	29.3	33.9	2.4	0.9	2.4	3.7	65.9	61.4	191	Not Significant
Equipment lease	14.8	34.9	0.0	1.8	6.2	0.9	79.0	62.4	190	Significant at .05 level
Medium-term working capital (1-5 years)	15.2	19.6	1.3	1.9	11.4	3.7	72.2	74.8	186	Not Significant
Short-term working capital (under 1 year)	11.4	16.8	2.5	1.9	8.9	4.7	72.2	76.6	186	Not Significant
Revolving line of credit	24.1	44.4	3.6	1.9	7.2	2.8	65.1	50.9	191	Significant at .05 level
Asset-based financing	8.9	10.3	2.5	0.9	2.5	1.9	84.8	86.9	186	Not Significant
Export trade financing	0.0	2.8	0.0	0.9	0.0	0.9	98.8	94.5	189	Not Significant
Equity of debt with equity features	3.9	1.9	1.3	0.9	1.3	0.9	93.4	96.2	180	Not Significant

Note: Small = 5-9 employees
Large = 10+ employees
Source: Mt. Auburn Business Survey

In terms of future needs, larger firms are more likely to anticipate the need for certain types of investments than smaller firms. These include expansion or modernization of a facility (45 percent of larger firms very or somewhat likely versus 33 percent of smaller firms), and acquisition of other firms (26 percent versus 6 percent). While a higher proportion of

[5] While the "large firm" category includes businesses that are typically considered small, the division was selected because over 40 percent of survey respondents had fewer than 10 employees. Therefore, including more firms in the "small firm" category would likely not have yielded statistically valid comparisons. About three-quarters of the firms in the large firm category have between 10 and 99 employees. (Note that the survey included only businesses with five or more employees.)

larger firms also appears to anticipate the need for equipment replacement and the development of new products or production technologies, these differences are not statistically significant. (See Table 3.9.)

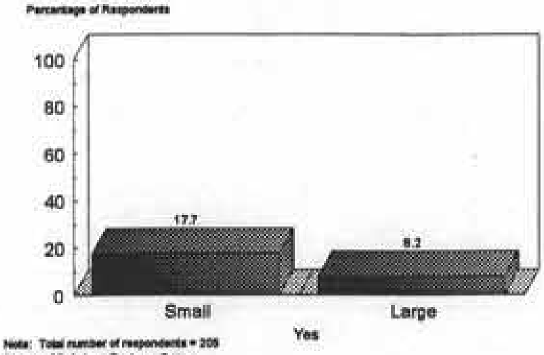
Table 3.9
Future Financing Needs for Different Types of Business Activity
By Firm Size (%)

	Very Likely		Somewhat Likely		Unlikely or N/A to Business			
	Small	Large	Small	Large	Small	Large	N=	Statistical Significance
Construction of a new facility	19.5	22.0	13.4	23.0	67.1	55.0	191	Not Significant
Expansion/modernization of existing facility	19.5	36.4	35.4	22.4	45.1	41.1	189	Significant at .05 level
Replacement of old/outmoded equipment	26.8	38.2	30.5	26.4	42.7	35.5	192	Not Significant
Development of new products/production technologies	9.9	11.8	13.6	19.1	76.5	69.1	191	Not Significant
Exporting	2.5	3.6	4.9	3.6	92.6	92.7	191	Not Significant
Acquisition of other firms	1.2	10.9	4.9	15.5	93.9	73.6	192	Significant at .01 level
Refinancing existing loans	8.5	12.7	14.6	10.9	76.8	76.4	192	Not Significant
General sales expansion	17.1	18.2	19.5	14.5	63.4	67.3	192	Not Significant

Note:
Small = 5-9 employees
Large = 10+ employees
Source: Mt. Auburn Business Survey

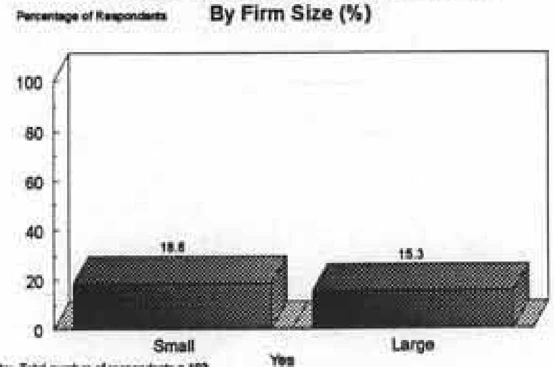
According to the business survey results, smaller firms in the region are more likely to anticipate future problems obtaining financing than larger firms. About twice as many smaller firm anticipate having trouble obtaining needed financing over the next two to three years than larger firms -- almost 18 percent versus about 8 percent. This difference is statistically significant. A slightly higher proportion of small firms also reported that recent plans to expand, modernize, or renovate were affected by inability to obtain financing. However, the difference is not statistically significant. (See Graphs 3.3 and 3.4.)

Graph 3.3
Anticipation of Trouble Obtaining Financing
By Firm Size (%)



Note: Total number of respondents = 205
Source: Mt. Auburn Business Survey

Graph 3.4
Recent Plans to Expand, Modernize, or Renovate
Affected By Inability to Obtain Financing
By Firm Size (%)



Note: Total number of respondents = 192
Not Statistically Significant
Source: Mt. Auburn Business Survey

3.7 Summary of Findings

- *The demand for business financing has to be seen in the context of other business needs.* Businesses and development finance professionals note a number of factors aside from financing that significantly affect business development, including labor force and infrastructure.

- *Data measuring economic structure and performance vary greatly throughout the region, making broad generalizations about demand for financing difficult.* However, the data can be useful in developing economic profiles of various parts of the region and in considering the implications of these profiles for business financing needs. For example, areas with both high employment growth and high unemployment rates might benefit from additional business financing to enable expanding firms to accommodate growth and hire additional workers. Regions with low growth and high unemployment may require more long-term financing as part of comprehensive economic development strategies to address economic stagnation or decline.

- *Generally high rates of unemployment throughout the region and the corresponding high levels of surplus labor indicate a continuing need for economic stimulus, particularly in areas of low employment growth.* Access to business financing for startup and expanding firms can play a role in broader economic development strategies to address these conditions.

- *Enterprise formation rates are generally low throughout the region. In addition, the proportion of smaller firms is only average, surprising for a heavily rural area.* A shortage of small-scale risk financing could be one factor contributing to this situation.

- *Some parts of the region, notably New York, northern Pennsylvania, and parts of Tennessee, North Carolina, and states to the south, have high proportions of large firms. This is often correlated with high proportions of manufacturing firms. This may indicate a relatively high demand for larger-scale and more complex financings in these areas.*

- *The role of non-traditional industries and entrepreneurs in the region's economy remains relatively undeveloped.* This includes firms in the service sector and women-owned firms. If these segments of the economy are to expand, additional financing for firms with which local financing sources are less familiar than their traditional clients is likely to be required.

- *Other than for commercial mortgage financing, most businesses need financing in the $50,000 and under range.*

- *The most frequently sought types of business financing are for equipment and for short-term working capital needs.*

- *Anecdotal evidence indicates that demand for financing in the region has generally been increasing, driven by a number of factors, including downsized professionals seeking to launch new businesses, in-migration, increasing outsourcing and job shops, and an overall improving economy.* Based on the survey responses, the near-term investment plans of Appalachian businesses are oriented heavily toward fixed-asset financing needs.

- *There are some differences in financing demand between urban and rural parts of the region.*

  - Non-metro counties tend to have higher employment growth but also higher unemployment rates, indicating a near-term potential for business expansion that could be supported by additional flows of capital.

  - Non-metro counties also tend to have lower rates of enterprise formation, higher percentages of manufacturers, lower percentages of service firms, and lower women-enterprise-ownership rates.

  - Businesses located in non-metro counties are less likely to seek financing than their metro area counterparts.

  - There are few difference in the financing needs anticipated by metro and non-metro borrowers, or in the proportion of metro and non-metro borrowers who either have been recently affected by inability to obtain financing or anticipate trouble obtaining financing in the near future.

- *The level of demand for most types of financing products is similar among smaller and larger firms.* However, there are notable differences in their expectations regarding future financing. Larger firms are more likely to anticipate future financing needs, while smaller firms are more likely to anticipate future problems obtaining financing.

Chapter Four: The Supply of Business Financing From Private Sector Sources in the Appalachian Region

4.1 Introduction

This chapter assesses the supply of business financing from private sector sources in the Appalachian region. It synthesizes analysis of three sources of data on the supply of financing. These sources are:

1. *Statistical data on financing resources.* This data is primarily drawn from the banking industry, the only major business financing source from which data is widely available because of data collection by banking regulators. The data indicate the levels of bank deposits, the number of banking institutions operating in local markets, the number of banking offices, lending activity, and overall financial performance. Per capita income data is also used to indicate the levels of personal wealth potentially available for business investment either directly or through financial intermediaries. This data is analyzed at the county level, and is compared for urban and rural areas, and, when available, for economically distressed and non-distressed areas.
2. *Results of the business survey conducted for this study.* This data indicate the levels of use of different sources of financing by businesses in the region, and the ability to obtain different types of financing. This data is broken down by firm size and by urban vs. rural location.
3. *Results of telephone interviews with development finance professionals, and case study interviews conducted with development finance professionals, economic developers, local officials, and bankers.* These interviews are used to supplement statistical and survey data by providing anecdotal information on the activity levels, products, and financing preferences of different financing sources.

The analysis and synthesis of data from these sources enables us to develop the following indirect indicators of the supply of business financing:

- the overall supply of private sector financial resources in counties of the Appalachian region relative to the rest of the nation;
- the relative importance of different types of financing sources as providers of business financing;
- the relative ability of businesses to obtain different types of business financing;

- the degree of banking market competition and bank accessibility in Appalachian counties relative to the rest of the nation;
- recent and projected trends in the availability of business financing; and
- differences in financing availability between smaller and larger businesses, urban and rural areas, and economically distressed and non-distressed areas.

The chapter is divided into three sections:

1. The first section assesses the availability of *debt financing* or *credit*, with particular attention to the banking industry.
2. The second section assesses the supply of formal and informal *risk capital.*
3. The third section assesses *recent trends in the availability of credit and capital* in the Appalachian region.

4.2 Banks and Other Sources of Credit

Debt, or credit, is an essential source of financing for less risky forms of business activity. Debt is used to finance "hard" assets like land, buildings, and equipment. It is also often used to finance "soft" assets like business inventories and accounts receivable. While debt financing can be used by firms in all stages of development, it is most typically used for expansion or general operations by businesses with established operating track records. Debt financing is usually secured by collateral as a second source of repayment if the borrower cannot repay the loan through earnings. Its use by established businesses and its collateral dependence give debt its low risk level relative to equity. Debt is distinguished from equity by its fixed repayment terms (interest rate, maturity, etc.), reflecting its lower risk level.

The major private source of debt financing for small- and medium-sized businesses is the commercial and savings bank industry. Other private sources of business debt financing are commercial finance companies, factors, insurance companies, and credit unions. Many new entrepreneurs and small businesses also rely on personal credit through the use of credit cards and obtaining home equity loans.

4.2.1 The Relative Importance of Different Credit Sources

Based on the results of the business survey, banking institutions are considered the most important source of credit for Appalachian businesses by a substantial margin.[1] Forty-two percent of respondents to the survey have found small banks to be a very important source of financing, and 20 percent have found them to be a somewhat important source. With regard to large banks, 31 percent have found them to be an important financing source, and 18 percent have found them to be somewhat important. (See Table 4.1.)

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[1] Note that financing from a business owner's personal savings and from family, friends, and business associates is discussed under risk financing in Section 4.3.

Secondary sources of credit include equipment dealers and suppliers, and credit cards. Twenty-eight percent of respondents have found equipment dealers and suppliers to be a very important source of financing, while another 28 percent have found them to be somewhat important. Fifteen percent have found credit cards to be a very important source of financing and 25 percent have found them to be somewhat important. (See Table 4.1.)

Less important sources of credit are leasing companies, commercial finance companies, and credit unions. Nine percent of respondents have found leasing companies to be very important and 27 percent have found them somewhat important. Only 5 percent have found commercial finance companies to be very important, while 15 percent have found them somewhat important. And only 5 percent have found credit unions to be very important, while 8 percent have found them to be somewhat important. (See Table 4.1.)

Table 4.1
Importance of Financing Sources (%)

	Very Important	Somewhat Important	Unimportant	Not Applicable	Don't Know
Owner's personal savings	38.5	18.5	25.8	13.7	3.4
Small commercial or savings banks with headquarters in or near community	41.5	19.5	29.3	7.8	1.9
Equipment dealers or suppliers	27.5	27.9	35.8	7.3	1.5
Larger commercial or savings banks operating throughout the state or in several states	31.2	18	39	9.3	2.4
Loan secured by owner's home	22.4	11.7	41.5	19	5.4
Owner's family members or friends	15.6	12.7	47.8	20	3.9
Leasing companies	9.3	26.8	48.3	12.7	2.9
Credit cards	15.1	24.9	49.3	8.3	2.4
Government loan programs or loan programs operated by local economic development organizations	17.6	11.7	51.2	16.1	3.4
Owner's business colleagues	13.2	11.2	53.7	18.5	3.4
Other private investors	8.8	15.1	57.1	16.6	2.4
Venture capital firms or small business investment companies	5.8	8.8	64.4	17.6	3.4
Commercial finance companies	4.9	14.6	65.8	12.7	2
Credit unions	4.9	7.8	69.3	15.7	2.4

Note:
Total Number of Respondents = 205
Source: Mt. Auburn Business Survey

Results from interviews with development finance professionals confirm that the activity of nonbank credit sources in the region is limited. Those interviewed reported that they were generally aware of and occasionally encountered lease financing activity, often from equipment suppliers, although the frequency of lease financing appeared to diminish in more rural areas. With few exceptions, respondents reported limited activity among non-regulated lenders. The level of activity of these lenders appears directly related to proximity to urban areas. Development finance professionals and bankers interviewed in the course of the three case studies also reported that, with the exception of some equipment leasing by vendors and a few nonbank SBA lenders, activity among nonbank credit sources is very limited.

The relative importance of different nonbank credit sources does not vary significantly between urban and rural parts of the region. Among respondents to the business survey, there were no statistically significant differences in the importance of five major nonbank credit sources -- credit unions, commercial finance companies, leasing companies, equipment dealers and suppliers, and credit cards -- among respondents in metro and non-metro counties. (See Table 4.2.)

Table 4.2
Importance of Financing Sources
By Urban or Rural Location (%)

	Very Important		Somewhat Important		Unimportant orN/A to Business			
	Metro	Non-Metro	Metro	Non-Metro	Metro	Non-Metro	N=	Statistical Significance
Owner's personal savings	38.3	41.6	20.6	18	41.1	40.4	196	Not Significant
Loan secured by owner's home	23.8	23	13.3	11.5	62.9	65.5	192	Not Significant
Owner's family members or friends	11.3	21.3	18.9	6.7	69.8	71.9	195	Significant at .05 level
Owner's business colleagues	11.2	16.9	12.2	11.2	76.6	71.9	196	Not Significant
Venture capital firms or small business investment companies	7.5	4.4	4.7	14.4	87.7	81.1	196	Significant at .05 level
Other private investors	11.2	6.6	12.2	19.8	76.6	73.6	198	Not Significant
Small commercial or savings banks with headquarters in or near community	36.1	49.5	19.4	20.9	44.4	29.7	199	Significant at .01 level
Larger commercial or savings banks operating throughout the state or in several states	36.7	26.7	15.6	22.2	47.7	51.1	199	Not Significant
Credit unions	5.6	3.4	8.3	7.9	86.1	88.8	197	Not Significant
Commercial finance companies	5.6	4.4	16.7	13.3	77.8	82.2	198	Not Significant
Leasing companies	11	8	30.3	25	58.7	67	197	Not Significant
Equipment dealers or suppliers	25.7	31.1	29.4	27.8	45	41.1	199	Not Significant
Credit cards	11.9	20	30.3	20	57.8	60	199	Not Significant
Government loan programs or loan programs operated by local economic development organizations	9.3	29.2	12.2	12.4	78.5	58.4	196	Significant at .01 level

Note:
Metro = Inside federally-defined metropolitan statistical area.
Non-Metro = Outside federally-defined metropolitan statistical area.
Source: Mt. Auburn Business Survey

The relative importance of most nonbank credit sources does not vary significantly among smaller and larger firms in the region. Among the business survey respondents, there were no statistically significant differences between smaller and larger firms in the importance attributed to four of the five major nonbank credit sources. The only exception was for leasing companies. Twice as many larger firms consider them very or somewhat important credit sources than smaller firms -- 48 percent versus 24 percent. (See Table 4.3.)

Table 4.3
Importance of Financing Sources
By Firm Size (%)

	Very Important		Somewhat Important		Unimportant or N/A to Business			
	Small	Large	Small	Large	Large	Small	N=	Statistical Significance
Owner's personal savings	50	34.3	24.4	16.7	49.1	25.6	190	Significant at .01 level
Loan secured by owner's home	33.3	16.7	15.4	11.1	72.2	51.3	186	Significant at .01 level
Owner's family members or friends	20	13.8	15	12.8	73.4	65	189	Not Significant
Owner's business colleagues	15.9	13	11	13	74.1	73.2	190	Not Significant
Venture capital firms or small business investment companies	6.3	6.3	10.1	8.1	85.6	83.5	190	Not Significant
Other private investors	7.4	10.8	9.9	19.8	69.4	82.7	192	Significant at .01 level
Small commercial or savings banks with headquarters in or near community	43.9	42.3	22	18.9	38.7	34.1	193	Not Significant
Larger commercial or savings banks operating throughout the state or in several states	30.9	34.8	12.3	23.2	42	56.8	193	Significant at .01 level
Credit unions	4.9	4.5	9.9	7.3	88.2	85.2	191	Not Significant
Commercial finance companies	7.5	3.6	15	16.1	80.4	77.5	192	Not Significant
Leasing companies	2.5	14.3	21.5	33.9	51.8	75.9	191	Significant at .01 level
Equipment dealers or suppliers	32.9	25.2	22	35.1	39.6	45.1	193	Not Significant
Credit cards	15.9	15.3	28	25.2	59.5	56.1	193	Not Significant
Government loan programs or loan programs operated by local economic development organizations	14.8	22	8.6	14.7	63.3	76.5	190	Not Significant

Note:
Small = 5-9 employees
Large = 10+ employees
Source: Mt. Auburn Business Survey

4.2.2 The Banking Industry

Overview of Banking Industry Characteristics and Lending Performance

The major source of secured debt financing for Appalachian businesses remains the banking industry. The following discussion focuses on the banking industry, both because of its relative importance and the greater availability of local data on the industry than for other sources of credit.

Banking industry resources are generally low throughout the Appalachian region. For combined commercial bank and savings institution deposits, deposits per capita in most counties of the region are substantially below the U.S. average.[2] Scattered counties throughout the region, particularly in central and southwestern Pennsylvania, southeastern West Virginia/southern Virginia, and northwest Alabama, equal or exceed the U.S. average. For commercial bank deposits alone[3], the region is in a somewhat better position, with most counties either equaling or exceeding the U.S. average. Counties that lag the U.S. average are most frequently found in New York, Ohio, Kentucky, and South Carolina. Low levels of per capita deposits appear to be highly correlated with the low levels of per capita income prevalent throughout the region. (See Maps 4.1, 4.2, and 4.3.)

While resources are somewhat low, the number of institutions in relation to population tends to be relatively high, indicating a relatively high level of banking market competition. Almost every county in the region has a substantially higher ratio of the combined number of commercial banks and savings institutions in relation to population than the U.S. average. The same is true for commercial banks. The relatively large number of banking institutions throughout most of the region is related to the relatively large number of small independent banks typically present in rural banking markets, as discussed in Chapter Two. (See Maps 4.4 and 4.5.)

The number of banking offices in relation to population is also high in many counties compared to the U.S. average, although not as frequently as in the case of banking institutions. The number of banking offices in relation to population is an indication of the relative ease of access to banking institutions for an area's residents. In the Appalachian region, most counties have either about the same or a substantially higher ratio of combined commercial bank and savings institution offices in relation to population than the U.S. as a whole. This is true of even more counties when considering only commercial bank offices. Only in scattered counties, notably in east central Kentucky and in Georgia, are these ratios substantially below the U.S. average. (See Maps 4.6 and 4.7.)

The financial performance of commercial banks headquartered in the Appalachian region is comparable to national industry averages. In selected measures of bank financial performance, the average performance of commercial banks headquartered in the region[4] equals or exceeds national industry averages. These measures include net interest margins (the spread between interest paid on deposits and interest earned on loans), return on assets, and capitalization ratios. (see Table 4.4)

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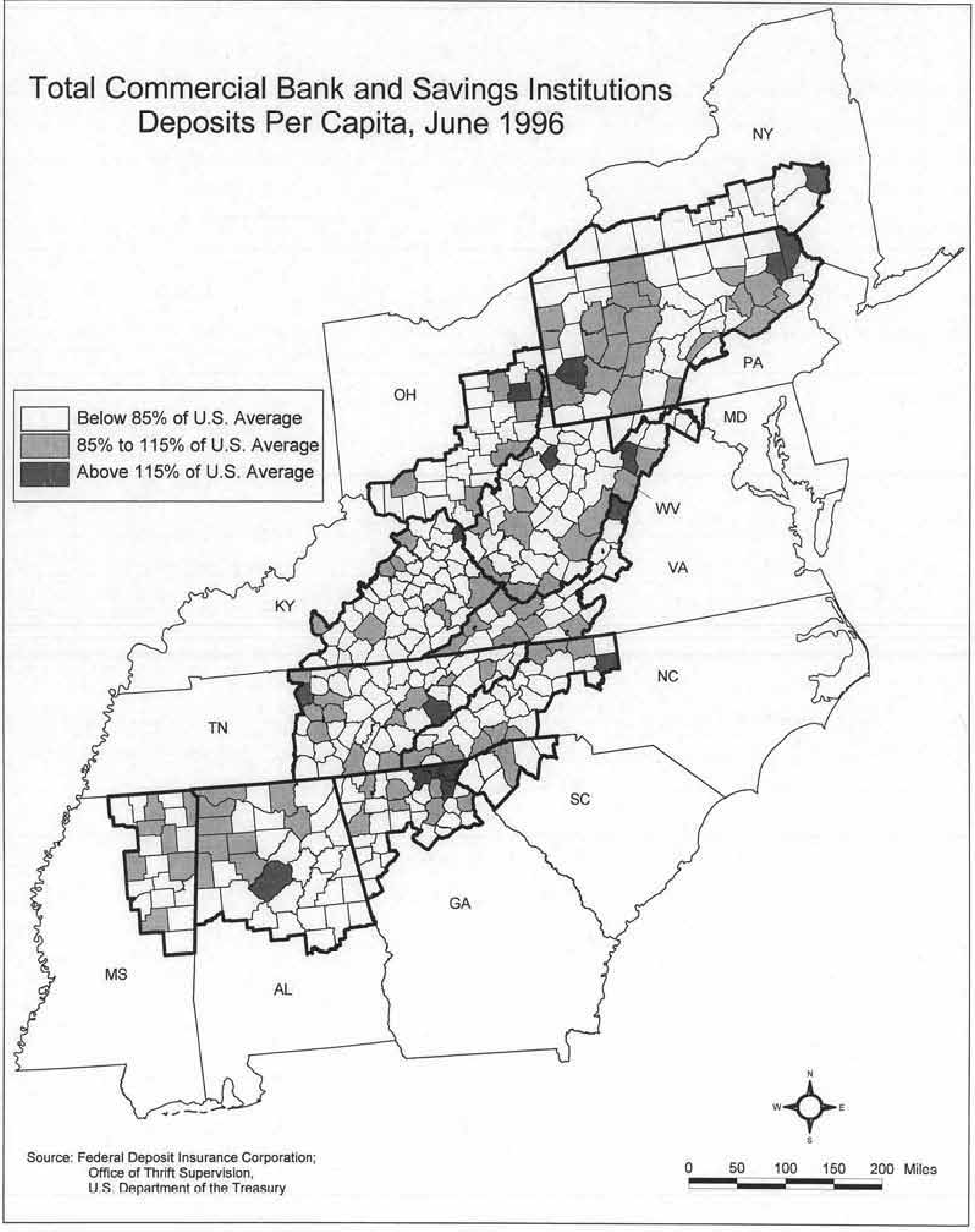
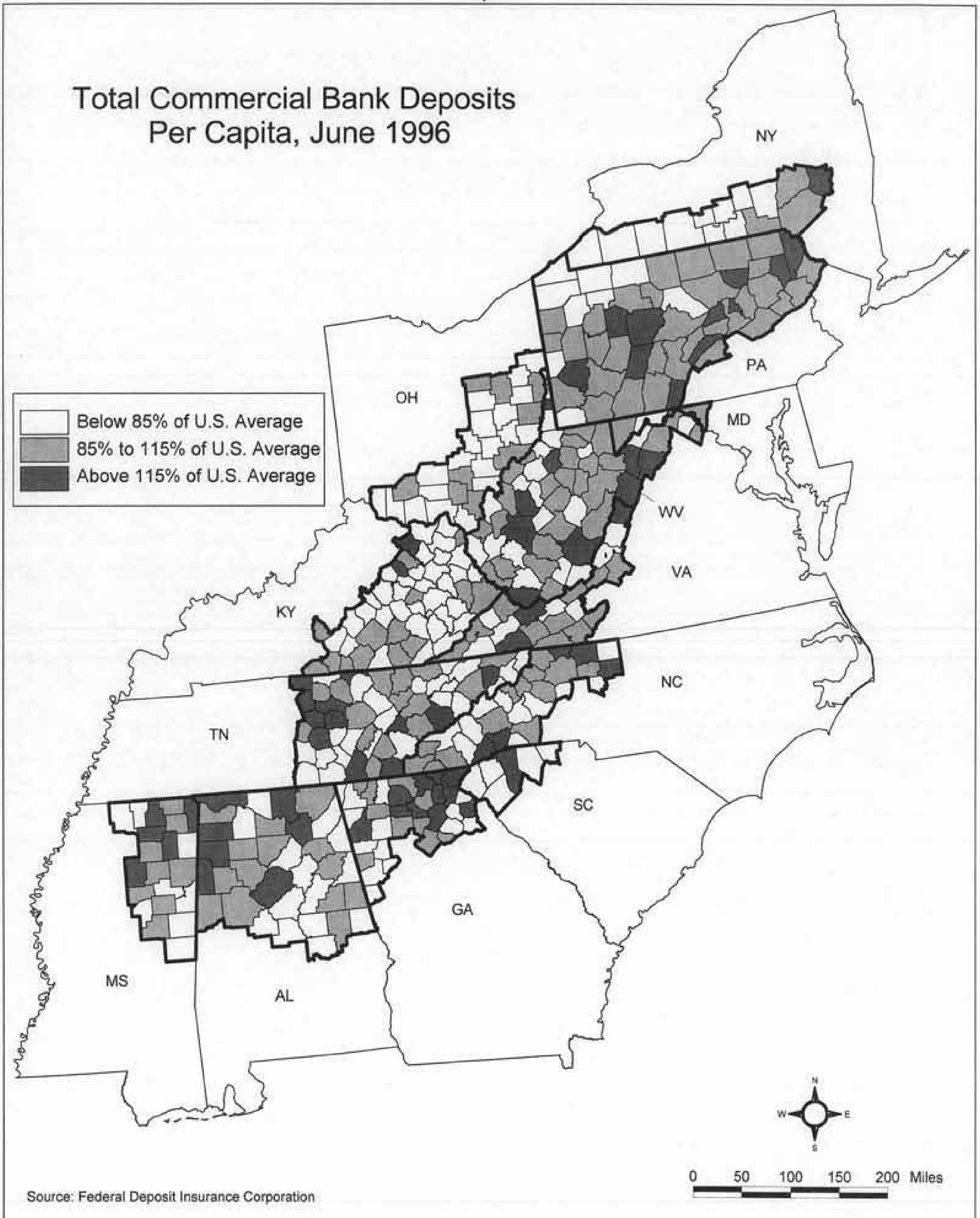
[2] Note that while deposits-per-capita is a good measure of core banking resources in relation to an area's population, banks have a number of means to draw in non-local financial resources to meet loan demand. This is particularly true of larger regional banks.

[3] Commercial banks have traditionally been more important sources of business loans than savings institutions, although this distinction has become less pronounced as savings institutions have diversified their lending markets.

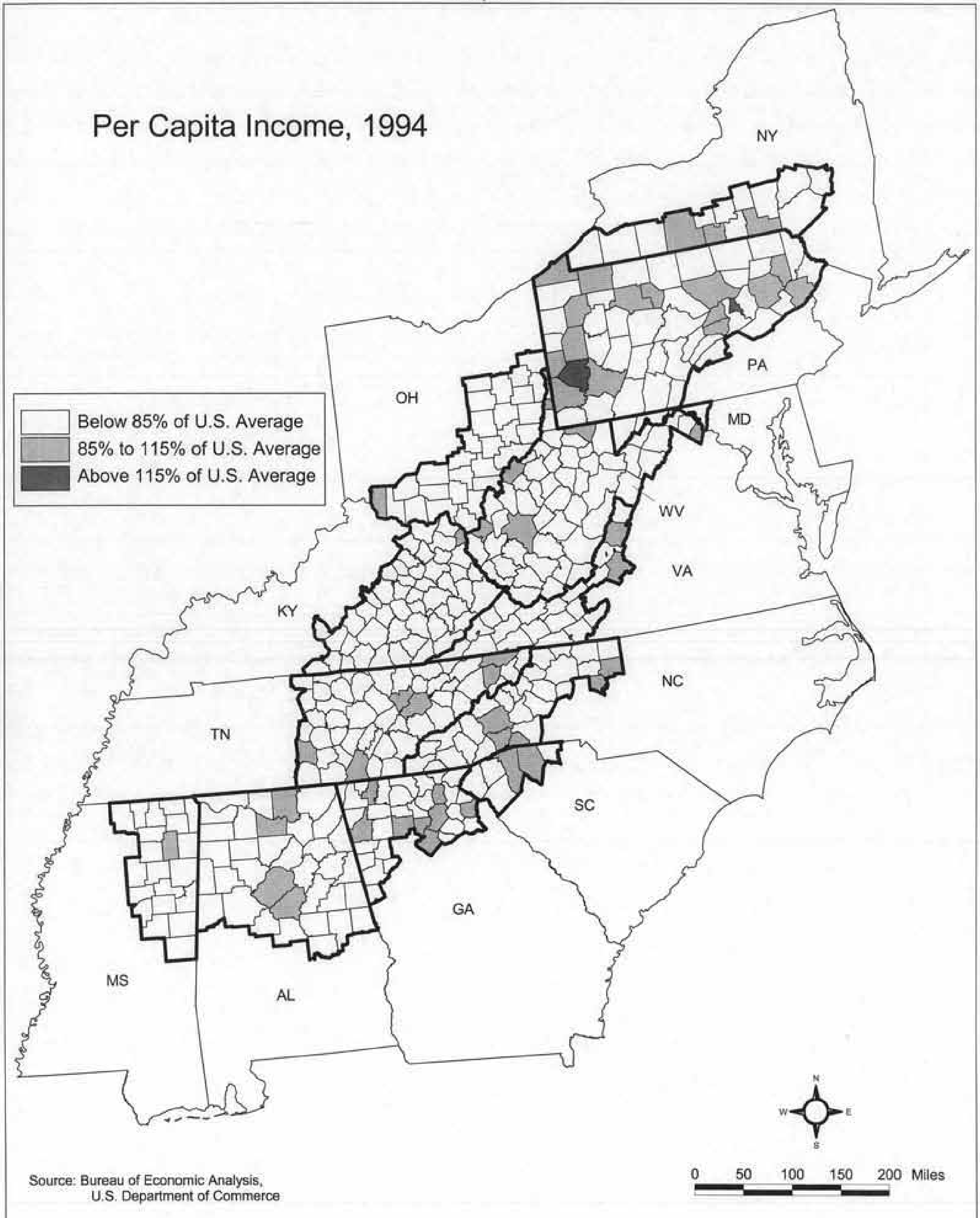
[4] This data does not include savings institutions or commercial banks with offices in the region but headquartered elsewhere.


Total Commercial Bank and Savings Institutions Deposits Per Capita, June 1996
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
E
S
W
0
50
100
150
200 Miles
Source: Federal Deposit Insurance Corporation; Office of Thrift Supervision, U.S. Department of the Treasury

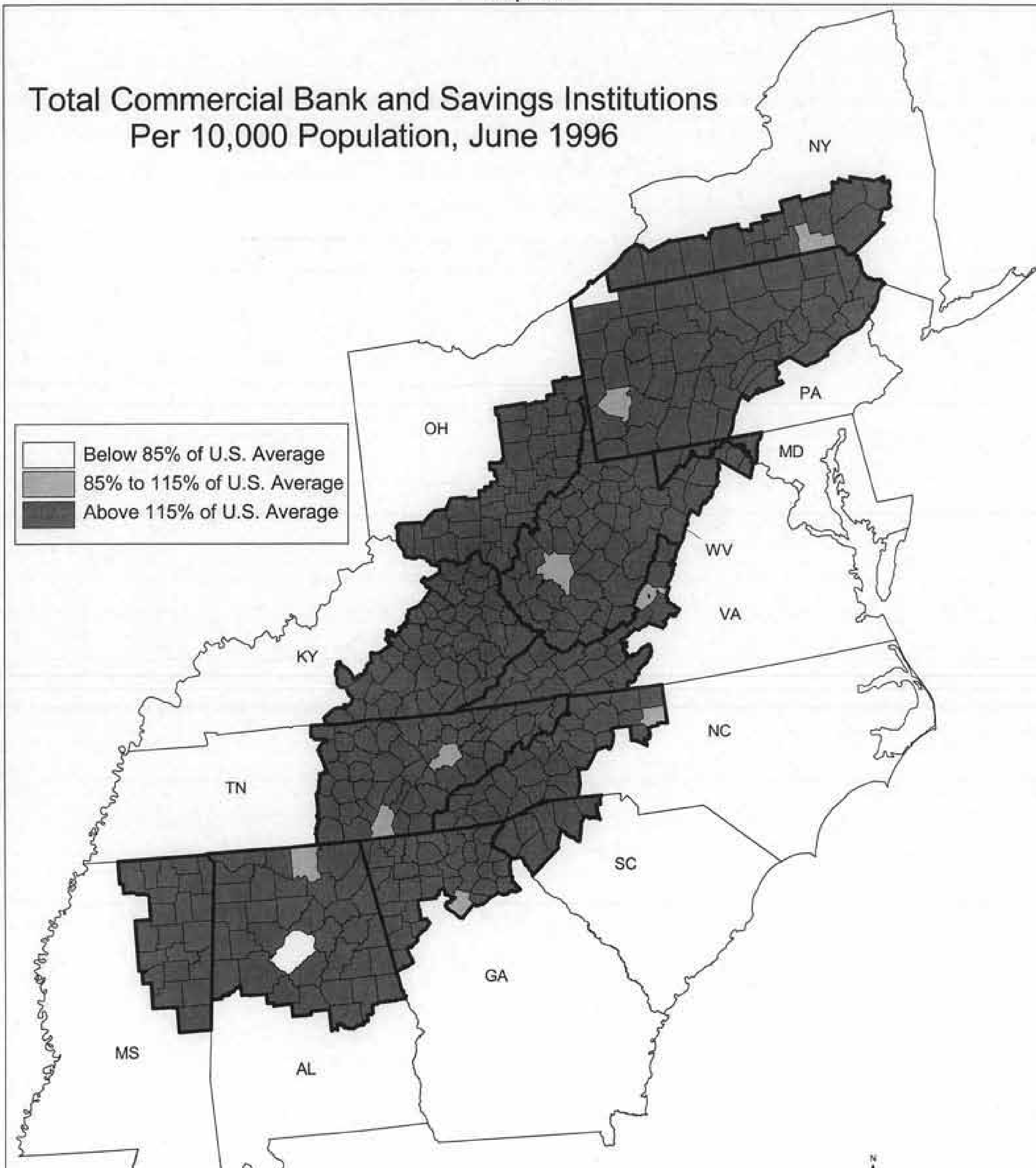
Map 4.2



Total Commercial Bank Deposits
Per Capita, June 1996
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: Federal Deposit Insurance Corporation

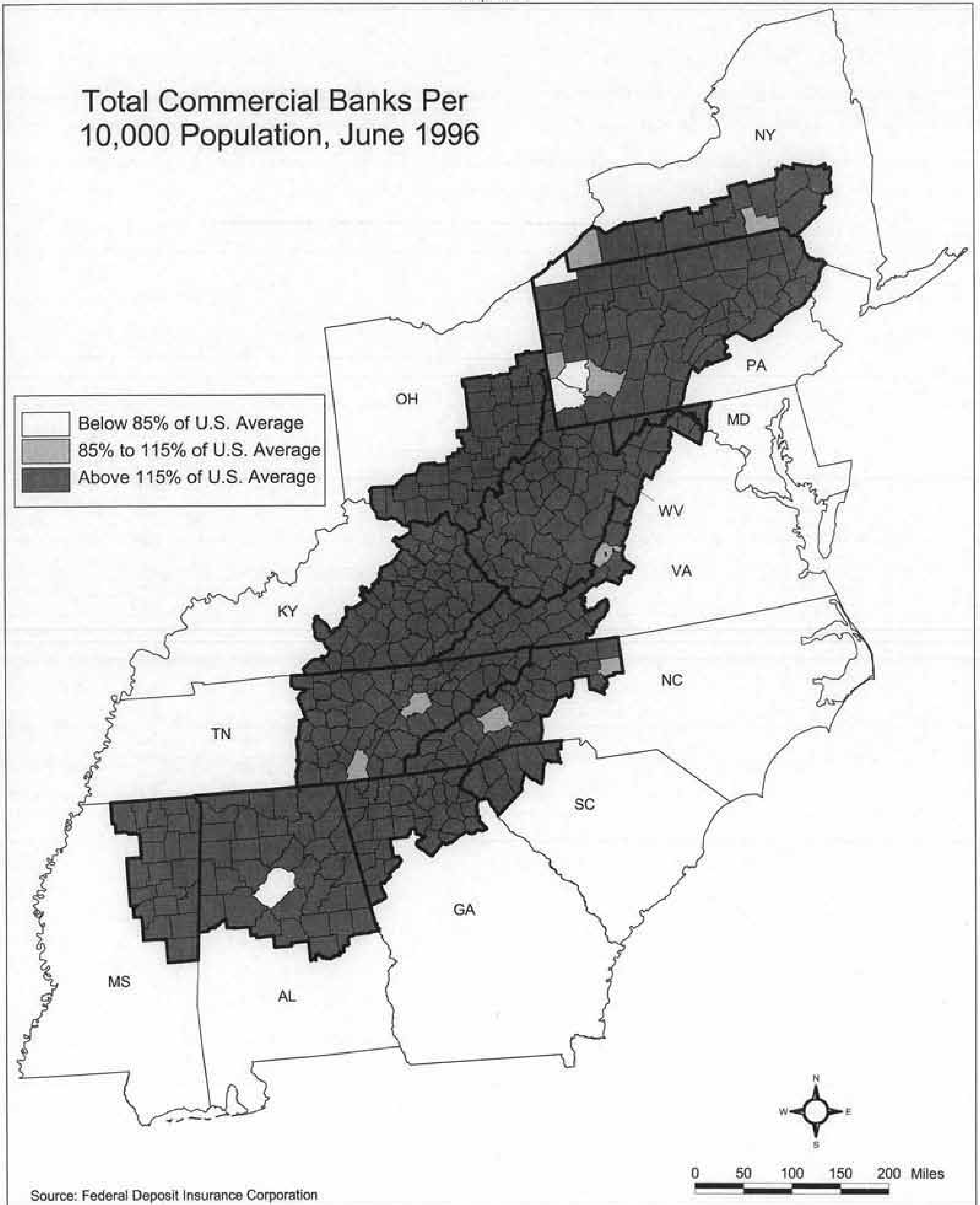

Per Capita Income, 1994
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: Bureau of Economic Analysis,
U.S. Department of Commerce

Map 4.4

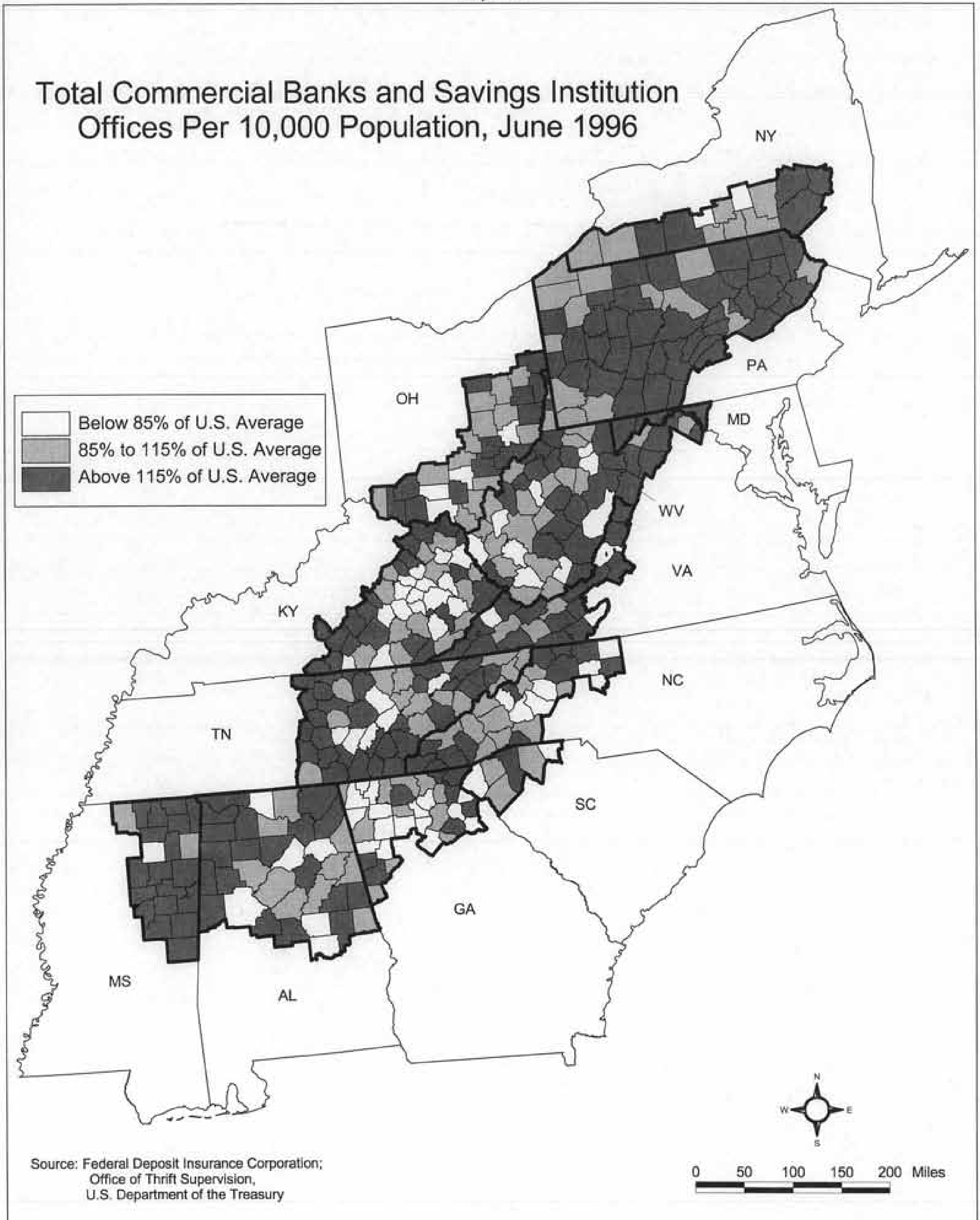


Source: Federal Deposit Insurance Corporation;
Office of Thrift Supervision,
U.S. Department of the Treasury

Map 4.5

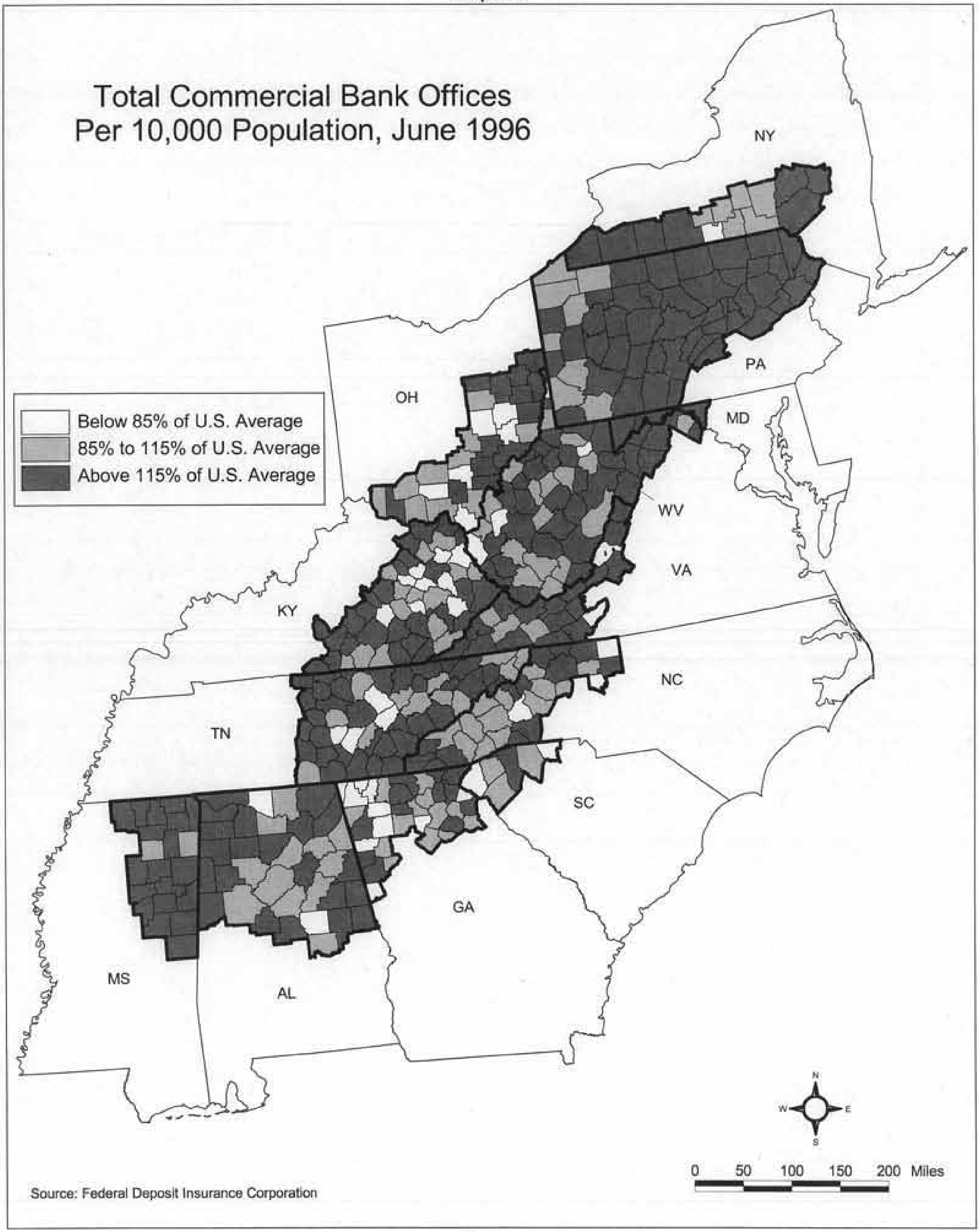

Total Commercial Banks Per
10,000 Population, June 1996
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: Federal Deposit Insurance Corporation

Map 4.6



Total Commercial Banks and Savings Institution
Offices Per 10,000 Population, June 1996
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
S
E
W
0 50 100 150 200 Miles
Source: Federal Deposit Insurance Corporation;
Office of Thrift Supervision,
U.S. Department of the Treasury

Map 4.7



Total Commercial Bank Offices
Per 10,000 Population, June 1996
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: Federal Deposit Insurance Corporation

Table 4.4: Measures of Commercial Bank Performance (12/31/96)		
	Appalachian Region	U.S. Average
Average Assets ($000)	$419,981	$480,882
Net Interest Margin	3.65%	3.54%
Return on Assets	1.29%	1.14%
Equity Capital/Asset Ratio	8.51%	8.18%
Loan/Deposit Ratio	89.89%	87.86 %
Loan Loss Provision	0.22%	0.56%
Problem Loans/Equity Capital	6.24%	7.68%

Source: Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. Calculated by ERS from the Federal Reserve Board's Report of Condition and Report of Income files, December 31, 1996.

Commercial banks headquartered in the region appear, on average, to lend as aggressively as banks across the U.S. while maintaining superior loan portfolio quality. The average loan-to-deposit ratio for Appalachian-based commercial banks slightly exceeds the national average. At the same time, portfolio quality, as measured by provisions for loan losses and the ratio of problem loans to equity capital, also exceeds the U.S. average. (See Table 4.4.) There are a number of reasons that the region's banks may be able to use their deposits as aggressively for lending as banks outside the region while maintaining higher portfolio quality. One is that they may simply be better managed. Another is that, because they have relatively low levels of deposits, they use a relatively high proportion of these deposits for less risky loans like residential mortgages or loans to highly creditworthy businesses and consumers.

Differences in Banking Industry Characteristics and Lending Performance by Bank Location, Bank Size, and Business Size

There are no substantial differences in measures of banking resources between urban and rural parts of the region. The distribution of Appalachian counties around average U.S. measures of deposits per capita is about the same for metro and non-metro counties, although a slightly higher proportion of metro counties exceeds the U.S. average for combined commercial bank and thrift institution deposits per capita. With respect to both the number of institutions and number of offices in relation to population, a somewhat higher proportion of non-metro counties substantially exceed the national average. (See Table 4.5.)

Table 4.5
Measures of Supply of Financing:
Comparison of Urban and Rural Counties

	Below 85% of U.S. Average	85% to 115% of U.S. Average	Above 115% of U.S. Average	Total
Per Capita Income, 1994				
Metro counties	69.7%	29.4%	0.9%	100.0%
Non-metro counties	93.8%	5.9%	0.3%	100.0%
Total Commercial Bank & Savings Institution Deposits Per Capita, June 1996				
Metro counties	71.6%	21.1%	7.3%	100.0%
Non-metro counties	72.4%	26.9%	0.7%	100.0%
Total Commercial Bank Deposits Per Capita, June 1996				
Metro counties	45.0%	39.4%	15.6%	100.0%
Non-metro counties	44.8%	37.9%	17.2%	99.9%
Total Commercial Banks & Savings Institutions Per 10,000 Population, June 1996				
Metro counties	1.8%	7.3%	90.8%	99.9%
Non-metro counties	0.0%	1.7%	98.3%	100.0%
Total Commercial Banks Per 10,000 Population, June 1996				
Metro counties	3.7%	7.3%	89.0%	100.0%
Non-metro counties	0.0%	0.3%	99.7%	100.0%
Total Commercial Bank & Savings Institution Offices Per 10,000 Population, June 1996				
Metro counties	19.3%	38.5%	42.2%	100.0%
Non-metro counties	17.6%	26.6%	55.9%	100.1%
Total Commercial Bank Offices Per 10,000 Population, June 1996				
Metro counties	12.8%	36.7%	50.5%	100.0%
Non-metro counties	10.7%	24.1%	65.2%	100.0%
Total Number of SBA 504 Loans Outstanding Per 1,000 Enterprises, June 1996				
Metro counties	46.8%	7.3%	45.9%	100.0%
Non-metro counties	69.3%	2.8%	27.9%	100.0%
Total Number of SBA 7(a) Loans Outstanding Per 1,000 Enterprises, June 1996				
Metro counties	3.7%	7.3%	89.0%	100.0%
Non-metro counties	19.3%	9.3%	71.4%	100.0%

Substantial disparities in banking resources do exist between the most economically distressed areas of the region and other areas. Distressed counties[5] in the region are much more likely to have levels of per capita deposits that are substantially below U.S. averages. In addition, while the distribution of the number of banking organizations in relation to population is roughly the same for distressed counties as other counties, distressed counties are slightly more likely to have fewer banking offices, making access to banks a little more difficult. However, over half of distressed counties still have substantially more banking offices in relation to population than the U.S. average. (See Table 4.6.)

[5] The Appalachian Regional Commission classifies counties as "distressed" based on a formula taking into account unemployment, per capita income, and poverty. Under this formula, each county is placed in one of four economic classifications -- distressed, transitional, competitive, or attainment.

Table 4.6
Measures of Supply of Financing:
Comparison of Distressed and Other Counties

	Below 85% of U.S. Average	85% to 115% of U.S. Average	Above 115% of U.S. Average	Total
Total Commercial Bank & Savings Institution Deposits Per Capita, June 1996				
Distressed counties	80.4%	17.5%	2.1%	100.0%
Other counties	52.3%	36.8%	10.9%	100.0%
Total Commercial Bank Deposits Per Capita, June 1996				
Distressed counties	66.0%	30.9%	3.1%	100.0%
Other counties	38.1%	40.7%	21.2%	100.0%
Total Commercial Banks & Savings Institutions Per 10,000 Population, June 1996				
Distressed counties	0.0%	0.0%	100.0%	99.9%
Other counties	0.7%	2.0%	97.4%	100.0%
Total Commercial Banks Per 10,000 Population, June 1996				
Distressed counties	0.0%	0.0%	100.0%	100.0%
Other counties	1.3%	2.6%	96.0%	100.0%
Total Commercial Bank & Savings Institution Offices Per 10,000 Population, June 1996				
Distressed counties	15.5%	29.9%	54.6%	100.0%
Other counties	6.6%	24.8%	68.5%	100.1%
Total Commercial Bank Offices Per 10,000 Population, June 1996				
Distressed counties	14.4%	30.9%	54.6%	100.0%
Other counties	10.6%	25.5%	63.9%	100.0%
Total Number of SBA 504 Loans Outstanding Per 1,000 Enterprises, June 1996				
Distressed counties	86.6%	0.0%	13.4%	100.0%
Other counties	55.6%	5.3%	39.1%	100.0%
Total Number of SBA 7(a) Loans Outstanding Per 1,000 Enterprises, June 1996				
Distressed counties	30.9%	1703%	58.8%	100.0%
Other counties	9.9%	8.3%	81.8%	100.0%

The financial performance of urban and rural banks in the region appears to be roughly comparable, with rural banks slightly outperforming urban banks on some key measures. Among commercial banks headquartered in the region, rural-based banks have, on average, higher net interest margins, slightly higher returns on assets, higher capitalization levels, and a lower proportion of problem loans. An exception is the higher average loan loss provision for rural banks, which could indicate either more conservative financial management or expectation of higher future portfolio losses. (See Table 4.7.)

Table 4.7
Comparison of Commercial Bank Performance in the ARC Region, by Urban or Rural Headquarters Location (12/31/96)

	Headquarters Location	
	Metro County	Non-Metro County
Assets ($000)	$929,258	$137,814
Net Interest Margin	3.51%	4.17%
Return on Assets	1.27%	1.34%
Equity Capital/Asset Ratio	8.11%	9.99%
Loan/Deposit Ratio	94.07%	76.83%
Loan Loss Provision	0.19%	0.36%
Problem Loans/Equity Capital	6.45%	5.59%

Source: Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. Calculated by ERS from the Federal Reserve Board's Report of Condition and Report of Income files, December 31, 1996.

Rural-based banks tend to lend less aggressively than urban banks, but this appears more related to differences in bank size than location. The lower average loan-to-deposit ratio is consistent with differences in bank asset size, as discussed in Chapter Two. (See Table 4.7.)

With respect to bank size, small banks headquartered in or near a business' home community are considered more important by business survey respondents than larger statewide or multi-state banking organizations. As noted earlier, 62 percent of respondents to the survey have found small banks to be a very important or somewhat important source of financing, compared to only 49 percent for larger banks. Borrowers in non-metro counties have found small locally-owned banks to be particularly important. Seventy percent of non-metro respondents have found small banks to be very or somewhat important, while only 49 percent attribute the same level of importance to large banks. (See Table 4.1.)

Larger statewide and regional banks tend to be considered more important by businesses in metro areas than those in non-metro areas. About the same proportion of metro respondents have found large and small banks to be very or somewhat important in meeting their financing needs (52 percent for large banks versus 56 percent for small banks). (See Table 4.2.)

Correspondingly, larger statewide and regional banks are more likely to be considered important sources of financing by larger than by smaller firms. Fifty-eight percent of larger firms consider these banks very or somewhat important sources of financing versus 42 percent of smaller firms. And a roughly equal proportion of larger firms consider the large banks and local banks as important sources of financing, while smaller firms favor local banks by a large margin. At the same time, an approximately equal proportion of smaller and larger firms consider local banks as important sources of financing. (See Table 4.3)

In part reflecting the dichotomy between urban and rural banking markets, and smaller and larger firms, development finance professionals have differing views on what types of banks are most responsive to small business credit needs. Some indicated that smaller, local banks are more responsive. Typical rationales underlying this perception were that these banks understand that small local businesses comprise their marketplace and community. On the other hand, other respondents reported that regional banks are more responsive. Factors noted as contributing to this perception were the efforts of regional banks competing to gain market share in an evolving marketplace, and their ability to offer greater sophistication in responding to borrowers' increasingly sophisticated demands. At the same time, community banks were sometimes seen as taking themselves out of the competition by focusing on the consumer and home mortgage market to the exclusion of commercial credits. An oft repeated qualification to this positive assessment of regional banks was the importance of decentralized branches and decision-making to provide access and timely decision-making. Exceptions to the community/regional bank dichotomy are new banks, which uniformly were seen as being aggressive in small business lending in order to establish a foothold in the marketplace.

Bank Participation in Development Finance Programs

Bank participation in development finance programs varies. While it differs from nationwide patterns, it is not clearly either higher or lower than that of banks outside the region. While data on bank participation is not easily available for all development finance programs, particularly state and local programs, data from two major SBA programs, the 7(a) Guarantee program[6] and the 504 Certified Development Company program,[7] can provide some indication of the relative aggressiveness of banks in the region in the use of development finance programs. This data provides conflicting results, with participation in the 7(a) program generally high, but participation in the 504 program generally low.

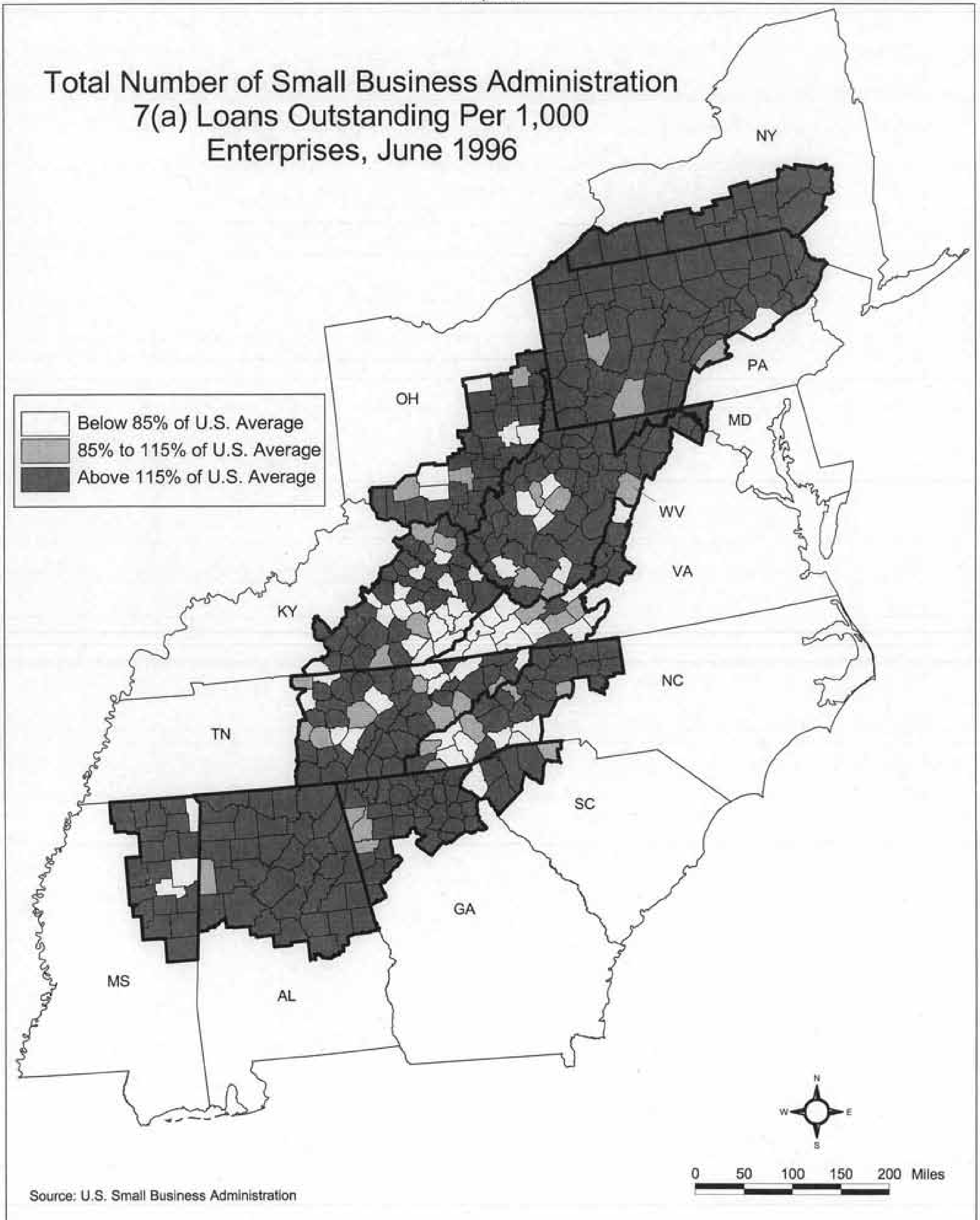
Bank participation in the SBA 7(a) program tends to be relatively high. As measured by number of loans outstanding per 1,000 enterprises, most counties in the region substantially exceed the national average. (See Map 4.8.)

There is one glaring exception to this pattern. In all of the Appalachian region's Tennessee counties, as well as counties in bordering areas of Kentucky and Virginia, almost every county is substantially below the U.S. average. This may indicate that banks in that area are resistant to using the program or that there is a problem in the SBA district office serving that area. (See Map 4.8.)

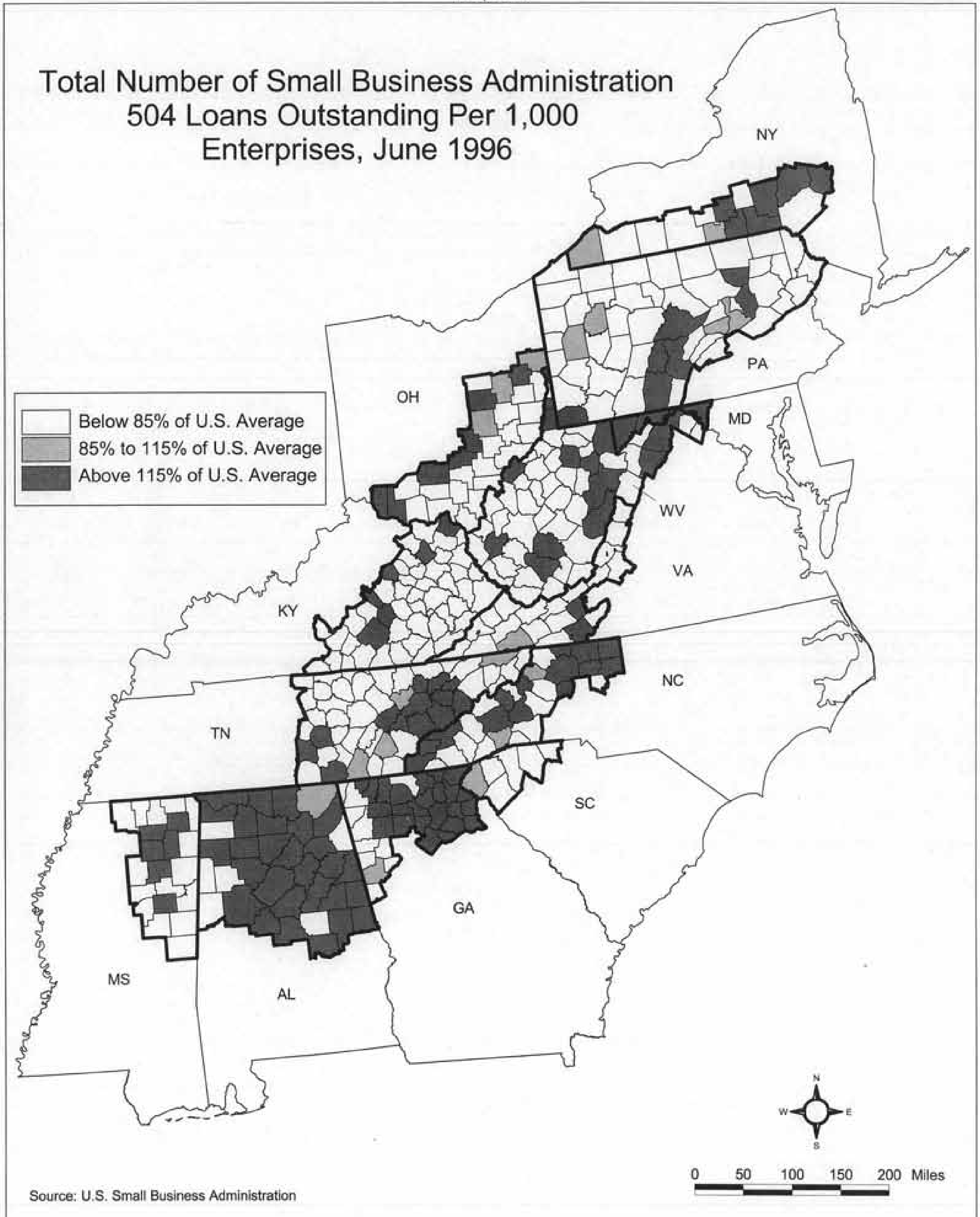
In contrast to use of the 7(a) program, use of the 504 program tends to be relatively low. In most counties in the region, use of the 504 program, as measured by number of loans outstanding per 1,000 enterprises, is substantially below the U.S. average. There are a few notable exceptions to this, particularly in the state of Alabama, where use of the program substantially exceeds the U.S. average in most counties. Other patterns of high 504 use occur in the Appalachian counties of Georgia, around Knoxville, Tennessee, and in smaller clusters in parts of North Carolina, West Virginia, Pennsylvania, and New York. (See Map 4.9.) These

[6] Under the 7(a) program, the SBA guarantees repayment of up to 90 percent of outstanding principal on secured loans made to small businesses by private lenders. The maximum guaranty amount is $750,000.

[7] Under the 504 program, statewide and sub-state development finance organizations, certified by SBA to participate in the program, make loans to small businesses for real estate and equipment in conjunction with private lenders. The certified development companies finance up to 40 percent of project costs and take a junior collateral position to private lenders. Loans are at fixed, below-market rates, and the maximum loan amount is $750,000.


Total Number of Small Business Administration
7(a) Loans Outstanding Per 1,000
Enterprises, June 1996
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
S
E
W
0
50
100
150
200 Miles
Source: U.S. Small Business Administration

Map 4.9



Total Number of Small Business Administration
504 Loans Outstanding Per 1,000
Enterprises, June 1996
Below 85% of U.S. Average
85% to 115% of U.S. Average
Above 115% of U.S. Average
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: U.S. Small Business Administration

differences cannot be attributed wholly to bank behavior. They are also likely to reflect local industry characteristics, the relative aggressiveness of different CDCs, or whether a particular area is served by or accessible to a CDC at all. (See Section 5.2.1.)

Use of these programs tends to be lower in rural Appalachia. Use of the 7(a) program tends to be somewhat lower in non-metro counties than in metro counties. Eighty-nine percent of metro counties substantially exceed the national average, compared to only 71 percent of non-metro counties. Likewise, only 4 percent of metro counties substantially trail the national average, compared to 19 percent of non-metro counties. The disparities in 504 program use are similar. Forty-six percent of metro counties substantially exceed the national average compared to only 30 percent of non-metro counties. Likewise, only 47 percent of metro counties substantially trail the national average, compared to 69 percent of non-metro counties. This may indicate a lesser willingness to use development finance programs among rural bankers, but may also indicate a greater willingness to be flexible with conventional financing. (See Table 4.5.)

Use of these programs also tends to be lower in economically distressed parts of the region. Use of the 7(a) program tends to be much lower in distressed counties than in other counties. Eighty-two percent of other counties substantially exceed the national average, compared to only 59 percent of distressed counties. Likewise, only 10 percent of other counties substantially trail the national average, compared to 31 percent of distressed counties. The disparities in 504 program use are similar. Thirty-nine percent of other counties substantially exceed the national average, compared to only 13 percent of distressed counties. Likewise, only 56 percent of other counties substantially trail the national average, compared to 87 percent of distressed counties. This likely indicates a lower demand for these programs among borrowers because of poor economic conditions. It may also indicate a higher level of conservatism among lenders developed in response to these conditions. (See Table 4.6.)

Development finance professionals point to a number of factors that affect bank aggressiveness in participating in development finance programs. These include: 1) bank knowledge of programs; 2) the size of the loans (following a trend of more competitiveness for larger loans); and 3) a bank's past experience working with the SBA. Some respondents report that banks hesitate to do business with SBA because of concerns about loan terms, paperwork, or the SBA's follow-through on commitments.

4.3 Risk Financing Sources

Risk capital is the patient capital enabling firms to make long-term investments that do not produce immediate cash flows. It is generally invested over long time periods and only generates returns if the firm is profitable. As such, it is an essential element of financing for startup, expansion, product development, and modernization. Risk capital includes equity (common stock) and near-equity (preferred stock, convertible, and subordinated debt) financing.

The largest sources of risk capital for businesses are owner-managers, their families, friends, business associates, and informal investors (often known as "angels"). Institutional sources of risk capital include formal venture capital partnerships and the public stock market. Venture capital firms tend to concentrate their investments in a narrow range of industrial sectors, most of them technology-oriented, and in the relatively small number of locations where their preferred industries are clustered. The public stock market, while much more broadly based, is generally only accessible to larger firms with established operating histories.

Among risk financing sources in the Appalachian region, the owner's personal financial resources, either in the form of savings or loans secured by personal assets, are by far the most important sources. Thirty-eight percent of respondents have found their own personal savings to be very important sources of financing and 18 percent have found them somewhat important. Twenty-two percent have found home equity loans to be very important and 12 percent have found them to be somewhat important. (See Table 4.1.)

Not surprisingly, smaller firms are more likely to depend on these sources than larger firms. One-half of smaller firms responding to the business survey considered the owner's personal savings as very important financing sources and almost one-quarter considered these as somewhat important. This compares to 34 percent and 17 percent, respectively, among larger respondents. Likewise, one-third of smaller respondents considered home equity loans as very important and 15 percent as somewhat important, compared to 17 percent and 11 percent, respectively, among larger respondents. These differences were statistically significant. (See Table 4.3.)

Secondary sources of risk capital include the owner's family members, friends, and business colleagues. Sixteen percent have found family members and friends to be very important and 13 percent have found them to be somewhat important. Thirteen percent have found business colleagues to be very important and 11 percent have found them to be somewhat important. (See Table 4.1.)

Businesses in rural areas have found friends and family members to be a somewhat more important sources of risk financing than those in urban areas. Among survey respondents, more non-metro respondents have found them to be a very important source of financing (21 percent versus 11 percent), while more metro respondents have found them to be somewhat important (19 percent versus 7 percent). About the same proportion have found them to be unimportant or not applicable to their businesses. (See Table 4.2.)

Development finance professionals confirm that the most important sources of risk capital are the owner's personal assets, family, friends, and retained business earnings.

Far less important sources of risk capital are other formal and informal investors. Informal private investors have been found to be very important by 9 percent of respondents and somewhat important by 15 percent. Venture capital firms and small business investment companies (SBICs) have been found to be very important by only 6 percent of respondents and somewhat important by 9 percent. (See Table 4.1.)

Firms in urban and rural parts of the region attribute different levels of importance to these types of investors, but the differences are not as clear cut as might be expected. Survey respondents located in metro areas were more likely then non-metro respondents to consider venture capital firms and SBICs as very important (7.5 percent to 4.4 percent), but less likely to consider them somewhat important (5 percent versus 14 percent). These differences were statistically significant. A similar pattern held for other private investors, but the differences were not statistically significant. (See Table 4.2.)

Larger firms tend to attribute a higher degree of importance to informal private investors than smaller firms. Almost 31 percent of larger respondents to the business survey considered informal private investors as very important or somewhat important sources of financing versus 17 percent of smaller respondents. However, there was no difference in the importance attributed to venture capital firms and SBICs. (See Table 4.3.)

The level of personal financial resources within the Appalachian region is very low, limiting the supply of informal investment capital. A large majority of counties within the region have per capita income levels substantially below the national average, and almost none have levels substantially above the national average. (See Map 4.3.) The scarcity of personal financial resources is particularly extreme in the region's more rural areas. About 94 percent of the region's non-metro counties have per capita income levels that are substantially below the national average. In contrast, almost 30 percent of metro counties have per capita income levels that are at or near the national average. (See Table 4.5.)

Development finance professionals report very little activity among formal risk capital sources. Some venture capital firms were reported to very occasionally venture out from their urban centers. Few respondents, however, could identify sources of formal risk capital outside of the nearest big city. They also noted that businesses are often reluctant to use venture capital because it typically requires them to give up a sizable piece of the business as a condition of financing.

Our experience trying to interview SBICs indicates that these nominally development-oriented organizations operate largely outside the rural parts of the Appalachian region. Several SBICs located in or near the region were not willing to be interviewed. Those that did indicated that they were not very active outside urban centers, and did not partner with, and in fact were unaware of, development finance institutions in their areas. As one SBIC manager noted, "We are looking for people capable of creating wealth. These people don't want to be in depressed areas where development finance programs operate."

Development finance professionals have very little knowledge about informal risk capital investors. Many were vaguely aware of informal investment activity, but knew little about preferred investments or investment terms. Those familiar with informal investors reported that they tend to be successful retired executives, professionals, or business people. A few respondents indicated that informal investors were successful people seeking to reinvest the products of their success in their community. Several respondents noted that venture capital networks were active in their areas, although some considered them ineffective. More frequently, respondents indicated that such networks had not been established.

Mt. Auburn's case studies indicate that informal investors can play an important role in financing high-growth local industries. In both north central Pennsylvania and northeast Mississippi, there has been a fairly high level of informal investment activity in the dominant growth industries -- powder metallurgy and furniture, respectively. Investors primarily include individuals already involved in the industry, but also sometimes include other wealthy area residents. However, interest in these particular industries does not appear to attract entrepreneurs in other, less familiar lines of business. Also, in the case of powder metallurgy, the increasing cost of initial capital investments for startups has begun to outstrip the financial capacity of informal investors.

4.4 Recent Trends in Business Financing

Based on the survey responses, the availability of financing does not, on balance, appear to have changed greatly over the past three years. Thirty-two percent of respondents said availability is about the same, 30 percent said financing is much or a little easier to obtain, and 24 percent said it is much or a little harder to obtain. Sixteen percent were not sure. Note that businesses' perceptions about changes in the availability of financing might be a result of changes in their own financial condition as well as changes in the financial market environment. (See Table 4.8.)

Table 4.8
Change in Availability of Financing
Over the Past Three Years

	Number of Respondents	Percentage of Respondents
Much harder to obtain now	29	14.1
A little harder to obtain now	20	9.7
About the same	66	32.0
A little easier to obtain now	33	16.0
Much easier to obtain now	25	12.1
Don't know	33	16.0
Total	206	100.0

Source: Mt. Auburn Business Survey

There is no difference in the perceptions of metro and non-metro respondents regarding changes in the availability of financing. (See Table 4.9.)

Table 4.9
Availability of Financing
Over the Past Three Years
By Urban or Rural Location (%)

	Metro	Non-Metro
Much harder to obtain now	9.4	7.6
A little harder to obtain now	5.3	5.8
About the same	22.2	15.8
A little easier to obtain now	11.1	8.2
Much easier to obtain now	5.8	8.8

n = 171
Note:
Metro = Inside federally-defined metropolitan statistical area.
Non-Metro = Outside federally-defined metropolitan statistical area.
Not statistically significant
Source: Mt. Auburn Business Survey

A higher proportion of smaller than larger business survey respondents appears to believe that obtaining financing has recently become more difficult. Thirty-six percent of smaller firms indicated increasing difficulty over the past three years versus 24 percent of larger firms. These differences were not statistically significant, however. About the same proportion indicated declining difficulty. (See Table 4.10.)

Table 4.10
Availability of Financing
Over the Past Three Years
By Firm Size (%)

	Small	Large
Much harder to obtain now	20.3	15.3
A little harder to obtain now	15.9	8.2
About the same	29.0	42.9
A little easier to obtain now	18.8	20.4
Much easier to obtain now	15.9	13.3

n = 167
Not statistically significant
Note: Small = 1-9 employees
Large = 10+ employees
Source: Mt. Auburn Business Survey

As in the rest of the U.S., the major trend affecting financial markets in the Appalachian region is the consolidation occurring within the banking industry. While this phenomenon has occurred at a slightly slower pace in the region than in the nation as a whole, particularly in urban parts of the region, many previously independent local banks have been purchased by larger statewide and regional banking organizations. (See Table 4.11.)

Table 4.11
Change in Number of Commercial Banks, 1990-1996
(by Bank Headquarters Location)

	12/31/90	12/31/96	Percent Change
All Counties			
Appalachian Region	999	805	-19.42
U.S.	12,257	9,413	-23.2
Metro Counties			
Appalachian Region	371	287	-22.64
U.S.	5,788	4,117	-28.87
Non-Metro Counties			
Appalachian Region	628	518	-17.52
U.S.	6,469	5,296	-18.13

Source: Rural Economy Division, Economic Research Service, U.S. Department of Agriculture. Calculated by ERS from the Federal Reserve Board's Report of Condition and Report of Income files, December 31, 1990-1996.

Development finance professionals agree that recent bank mergers and acquisitions in the region have led to significant changes in the credit environment, but offer divergent opinions on the impacts. In many cases, the consolidations are seen as having produced aggressive regional banks competing for commercial credit and providing more diverse lending products and sophistication. However, other respondents report a loss of local sensitivity and responsiveness flowing from consolidation trends. Some allege that the lack of proximity of the consolidated banks chills their interest in local businesses. Others indicate that shifting personnel among loan staffs makes it more difficult for lenders to familiarize themselves with local conditions. A number of respondents note a decided shift among local businesses to the remaining locally-owned banks.

While the impact of banking consolidation on credit availability for the region's small firms has been mixed to date, bankers and development finance professionals agree that the longer-term impacts are still uncertain. Bankers interviewed for our case studies, in particular, noted that some local banks are still "in play" and that additional acquisitions are likely to occur in the future. While competition among banks appears currently to be strong, there are some concerns that increasing market concentration and product standardization among larger banks create less favorable conditions for smaller firms.

Bankers in the region appear to be growing increasingly comfortable working with local and regional development finance organizations. This fact emerged particularly strongly from the three case studies. While some bankers continue to be reluctant to work with government-sponsored programs, many have become more sophisticated about using these programs (including obtaining SBA certified or preferred lender designation), view them both as competitive tool and a stimulus to the local economy, and have developed good working relationships with local development finance professionals. Some banks have taken an aggressive role in forming private sector development finance organizations, such as the consortium of banks in southeastern Kentucky that recently formed a bank CDC.

Development finance professionals see less in the way of recent changes in risk capital availability. Some note recent efforts to increase the supply (through such initiatives as venture capital networks and venture capital fairs), but generally do not see systematic change in either the system of providing such financing or in its availability to the region's businesses.

4.5 Summary of Findings

- *In spite of the growth of nonbank business credit sources nationwide, businesses in the Appalachian region remain heavily reliant on the banking industry as a source of debt financing.* Important nonbank credit sources, such as nonbank SBA lenders and commercial finance companies, are not very active in the region. However, businesses in the region do have access to other credit sources, including equipment dealers, suppliers, credit cards and, among larger firms, leasing companies.
- *Banks in the Appalachian region are as financially healthy as and have used their deposit base as aggressively as their peers in the rest of the U.S. to make loans. However, levels of bank deposits in the region are relatively low, and are particularly low in economically distressed areas.* This could potentially be constraining the level of bank lending, although banks experiencing strong credit demand do have access to funds in addition to local deposits.
- *Overall, businesses in the region are somewhat more reliant on small, local banks than on large statewide or regional banks.* However, larger businesses and businesses in urban areas are about equally reliant on small and large banks.
- *Banking industry consolidation in the Appalachian region has occurred at about the same pace as in the rest of the country. Despite this trend, competition in local banking markets generally remains strong and businesses continue to have banking options.* In most markets, small independent banks continue to compete with larger banks. In one important indicator of bank aggressiveness in meeting small business needs -- use of the SBA 7(a) loan guarantee program -- banks in most parts of the region outperform national averages.
- *As large banks increase their presence in the region, there are differing perceptions about their impacts.* Development finance professionals have varying opinions, both positive and negative, about how the changes in banking products and underwriting practices associated with larger banks have affected small businesses.

There is, however, agreement that larger banks are more responsive to local businesses when they grant some degree of flexibility to local loan decision-makers.

- *Entrepreneurs and businesses in the Appalachian region remain heavily reliant for risk capital financing on their personal savings, retained business earnings, and support from family members, friends, and business colleagues.* This is particularly true of very small businesses and businesses in rural areas. Informal local investors, or "business angels," are a much less important source of risk financing, and primarily target larger and higher-growth businesses. Formal risk capital sources, including venture capital firms and small business investment companies, make very few investments in the region. Because of generally low levels of personal wealth in the region, this reliance on informal investment from local sources indicates that risk financing is relatively scarce.

- *Despite recent innovation and structural change in the financial market, the overall ability of Appalachian region businesses to obtain financing does not appear to have changed substantially during the past three-to-five years, based on the reported experiences of businesses and development finance professionals.*

Chapter Five: Private Sector Financing Gaps in the Appalachian Region and the Role of Development Finance Institutions

5.1 Introduction

This chapter identifies current financing gaps resulting from imbalances in demand for and supply of business financing in the Appalachian region, and assesses the capacity of existing development finance programs to fill these gaps. Findings on private capital gaps are drawn from a synthesis of the findings in previous chapters along with the reported experiences and perceptions of businesses and development finance professionals in the region. Data on development finance programs is drawn from several sources: 1) directories and funder data on almost 400 development finance programs; 2) data collection from organizations operating over 200 of these programs; and 3) in-depth analysis of the current loan portfolios of ARC-funded revolving loan funds.

5.2 Gaps in Availability of Private Sector Financing

There is no evidence of widespread, systemic gaps in the availability of private sector financing for firms in the Appalachian region willing to pay the risk-adjusted market rate of return. Several observations form the basis for this conclusion.

- First, recent literature on rural business financing has generally found that rural businesses are not at a disadvantage in terms of access to or terms of financing.
- Second, recent regulatory and market trends in the financial services industry have, on balance, had a favorable impact on the availability of small business financing in urban and rural areas alike throughout the U.S, particularly by increasing competition within the banking industry and by introducing nonbank lenders to the business market.
- Third, the banking industry in Appalachia, the most important source of debt financing for the region's businesses, appears to perform generally as well as its counterparts in the rest of the U.S. Banks in the Appalachian region are as financially healthy and have used their deposit base as aggressively to make loans as their peers in the rest of the U.S. And despite banking industry consolidation that has occurred at about the same pace as in the rest of the county, competition in local banking markets generally remains strong and businesses continue to have banking options. Other research has found that rural businesses tend to be much more satisfied with their lenders and have better personal relationships with their lenders than their urban counterparts.

- Fourth, the vast majority of existing businesses in the Appalachian region do not identify lack of access to financing as a serious problem. As noted in Chapter Three, only about 12 percent of respondents to the business survey anticipated problems meeting their financing needs.
- Fifth, development finance professionals in the region generally agree that capital and credit availability is not an overriding concern and is not as critical to economic development as other issues such as infrastructure and workforce development.

Certain factors characterizing rural financial markets in general and the Appalachian region in particular make access to financing more problematic than in other parts of the U.S.

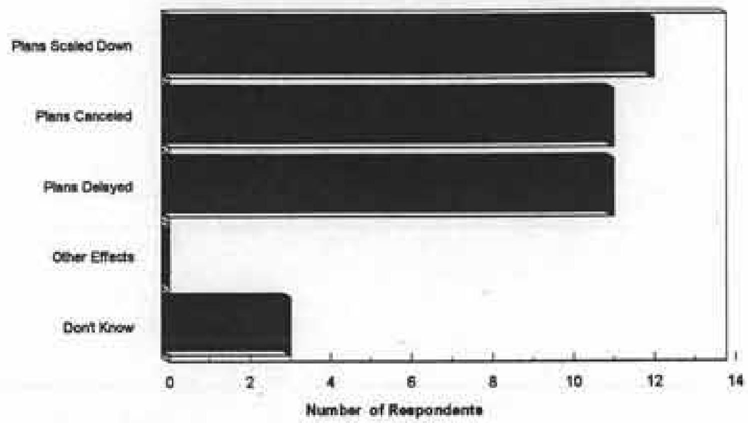
- First, businesses in Appalachia and other rural areas remain more heavily dependent on the banking industry than their urban counterparts. The literature on trends in the financial services industry indicates that nonbank lenders, which have greatly increased credit choices for small businesses, have not entered rural markets to the same degree as urban markets. Research specific to the Appalachian region conducted for this study is consistent with this finding.
- Second, rural businesses generally have fewer banking choices because the lower population density of rural areas cannot support the participation of as many banking organizations in local markets.
- Third, the smaller banking institutions that are more prevalent in rural areas offer a narrower range of financial services than larger institutions. This is a particular problem for businesses needing complex forms of financing or financing bundled with other financial services. Research specific to Appalachia confirms that businesses in the region are somewhat more reliant on small, local banks than on large statewide or regional banks.
- Fourth, levels of personal wealth in the Appalachian region are very low, reducing the level of financial resources that can be drawn from within the region for the purpose of business financing. This is a particular problem in segments of the financial market, such as small-scale risk capital financing, where intermediaries do not exist to import capital into the region when local resources are inadequate to meet demand.

A small but still significant proportion of established Appalachian firms, as well as a larger proportion of startup firms, are seriously affected by inability to obtain sufficient financing. Lack of the right types of capital in the right amounts and at the right times is slowing the pace of enterprise formation and business expansion. The responses to the business survey support this conclusion. Seventeen percent of survey respondents indicated that their plans to expand, modernize, or renovate during the past three years were affected by inability to get financing. Among those, about two-thirds said plans were either delayed or scaled back, and about one-third said plans were canceled.[1] (See Graph 5.1.) In addition, development finance

[1] The survey data does not address the impact of inability to get financing on business failure (since respondents were all existing firms) nor on the experience of firms with fewer than five employees (since they were not included in the survey).

professionals broadly agree that lack of access to financing prevents or retards potentially viable startup businesses.

Graph 5.1
Way in Which Plans to Expand, Modernize, or Renovate were Affected by Inability to get Financing in the Past Three Years (%)



Number of Respondents = 37
Source: Mt. Auburn Business Survey

5.2.1 Types and Amounts of Financing

The highest unmet financing needs among existing firms are for various kinds of working capital. Among respondents to the business survey, both medium-term and short-term working capital are needed but have not been obtained by almost 8 percent of respondents,[2] and revolving lines of credit by a little over 7 percent. (See Table 3.2.) Development finance professionals widely agree that working capital is the hardest type of credit to obtain. In more conservative banking areas, those interviewed reported that any financing collateralized by assets other than real estate was also difficult to obtain.

Next to working capital, the greatest unmet financing need is for commercial mortgages. Both fixed-rate and variable-rate commercial mortgages are reported by almost 7 percent of survey respondents to be needed but not obtained. In addition, a higher percentage of respondents, over 3 percent, were actually turned down for fixed-rate commercial mortgages than for any other type of financing. (See Table 3.2.)

The lowest unmet financing needs reported by respondents were for export trade financing and equity or debt with equity features. Only one percent reported needing but not having obtained export trade financing, and only 2 percent reported needing but not having

[2] Unmet need was calculated for each type of financing by adding the percentage of respondents turned down to the percentage who needed the financing but had not yet tried to get it.

obtained equity or debt with equity features. However, for those who sought such financing, the turn-down rate was very high -- 25 percent for both types.[3] (See Table 3.2.)

Larger loans are generally in more ample supply than smaller loans. With some important exceptions, development finance professionals generally agreed that competition was directly related to loan size. In general, the larger the loan, the more active the competition. Virtually every individual interviewed reported that competition is very active for loans greater than $250,000. Usually, but less uniformly than for larger loans, competition is moderate for loans in the $25,000 to $250,000 range. In contrast, competition is sparse for microloans. Bankers interviewed at the three case study sites generally agreed with this characterization. The business survey showed that, other than for commercial mortgage financing, the strongest demand for financing among businesses in the region is for financing in the $50,000 and under range

There are certain exceptions to this rule. In areas where small local banks still dominate the market, competition for large loans is limited and sometimes constrained by bank lending limits. In these instances, competition is more active for microloans. Small local banks are also more likely to make character loans based on their knowledge of their community, thus making it easier to provide microloans. In other instances, interest in smaller loans is a product of public programs, such as SBA's Low Doc Program, which has induced bank interest in lending in the $25,000 to $250,000 range.

The terms of bank financing are largely reasonable. Increasing competitiveness among banks and the low interest rate environment perhaps contribute to the perception of reasonable terms. High interest rates were not viewed as a constraint to obtaining bank financing. Occasionally, development finance professionals reported that the terms of loans were too short to suit borrower repayment needs. Research on rural financial markets indicates that rates and terms of bank financing in rural markets are comparable to those in urban markets and that rural businesses are no less satisfied with loan pricing than urban businesses.

While risk capital is needed by a relatively small subset of firms, it is scarce for those who do need it. Entrepreneurs and businesses in the Appalachian region remain heavily reliant for risk capital financing on their personal savings, retained business earnings, and support from family members, friends, and business colleagues. This is particularly true of very small businesses and businesses in rural areas. Because of generally low levels of personal wealth in the region, this reliance on informal investment from local sources indicates that risk financing is relatively scarce. The general literature on rural financial markets supports the finding that the most significant financing gap for rural businesses is in the availability of risk financing.

While it is impossible to measure this gap with any precision, interviews with development finance professionals and bankers strongly reinforce the notion that lack to risk

[3] As noted, this information is drawn from a survey of existing businesses. Since it reflects the financing experience of survey respondents during the past three years, it does not reflect the demand for equity financing during the business startup phase among respondents that have more than a three-year history. In addition, since the number of respondents seeking these types of financing was so small, these results should be interpreted very cautiously.

capital is one, if not the sole, constraint to new enterprise formation. In addition, while scarcity of risk capital does not appear to hinder most established firms, it is likely to pose the greatest problem for the relatively small number of firms with the high-growth potential that requires such financing.

5.2.2 Types of Firms

The research provides some evidence that smaller firms have more difficulty obtaining financing than larger firms, although this evidence is not conclusive. Among business survey respondents, a slightly larger proportion of small firms reported both having difficulty obtaining financing in the past and anticipating future problems, although these differences are not statistically significant. In addition, a higher proportion of smaller firms reported unmet needs for most types of financing. In three cases, these differences were statistically significant -- for fixed-rate mortgages (almost 10 percent versus 5.5 percent), equipment leases (about 6 percent versus less than 3 percent), and revolving lines of credit (almost 11 percent versus less than 5 percent). (See Table 3.8.) This data is bolstered by the perceptions of development finance professionals, who generally report that small amounts of financing (under $25,000 to 50,000) are more difficult to obtain. Some development finance professionals also report that financing is a problem, however, for the small firms that supply inputs or services to larger firms in important industries.

Low levels of risk capital availability strongly suggest a shortage of appropriately structured financing for startup and high-growth firms. While it is particularly difficult to assess whether potentially viable startup enterprises fail because of inability to obtain capital, this finding is supported by the perceptions of development finance professionals in the region and the general literature on rural financial markets.

There is some evidence that non-traditional industries and entrepreneurs have particular difficulty obtaining financing. The role of non-traditional industries and entrepreneurs in the region's economy remains relatively undeveloped, as data on the relatively low proportion of service sector firms and women-owned firms in the region's business base demonstrate. Development finance professionals identify several types of non-traditional firms that have difficulty obtaining credit. These include seasonal businesses, particularly in tourism, firms commercializing technology, and firms in emerging industries that are unfamiliar to local bankers and private investors. The literature on rural financial markets further supports these findings.

5.2.3 Firm Location

There are no substantial differences in measures of bank resources and financial performance between urban and rural parts of the region. In per-capita measures of deposits, number of institutions, and number of banking locations, rural counties perform as well or better than urban counties. The financial performance of urban and rural banks in the region appears to be roughly comparable, with rural banks slightly outperforming urban banks on some key measures. Rural-based banks tend to lend less aggressively than urban banks, but this appears more related to differences in bank size than location.

Firms in rural and urban parts of the region are about equally likely to be affected by inability to obtain financing. There was little difference reported by firms in metro and non-metro counties on the impacts of inability to obtain financing.

In general, a higher proportion of firms in urban parts of the region report having unmet financing needs than firms in rural parts of the region. A higher proportion of firms in metro areas reported unmet needs for almost all types of financing. However, the only statistically significant difference was in the case of medium-term working capital. Almost 12 percent of respondents in metro areas reported an unmet need for this type of financing versus 4.5 percent in non-metro areas. (See Table 3.6.)

Rural areas of the region lag urban areas in some key economic measures. More business financing may be one component in strategies to address these disparities. Rural areas have lower rates of enterprise formation, and lower proportions of non-traditional industries and entrepreneurs.

Distressed areas of the region lag other areas in certain measures of economic and financial market performance, which may indicate less availability of business financing. Distressed counties in the region, by nature, have lower levels of personal wealth and are much more likely than other counties to have levels of per capita deposits that are substantially below U.S. averages. Banks in distressed counties are also much less likely to use SBA financing programs. These findings are consistent with the general literature on rural financial markets which indicates that businesses in persistent poverty areas have more difficulty accessing financing.

5.3 The Role of Development Finance Institutions in Addressing Capital and Credit Gaps

5.3.1 Profile of Development Finance Resources

This section profiles some of the major sources of development finance available to businesses in the Appalachian region. These sources include sub-state regional revolving loan funds, microloan funds, SBA 504 Certified Development Companies, nonprofit development loan funds, and state and multi-state development finance programs.

Revolving Loan Funds

There are about 100 revolving loan funds in the region operated by sub-state regional economic development organizations. In addition to 27 active ARC funds, there are 46 sub-state EDA funds, 12 sub-state USDA IRP funds, and at least 15 funds capitalized with state government, local government, and/or private funds. In addition to these funds, there are a large number of RLFs operating at the county and municipal levels. Data on these RLFs are difficult to obtain and are, therefore, not included in Mt. Auburn's analysis.

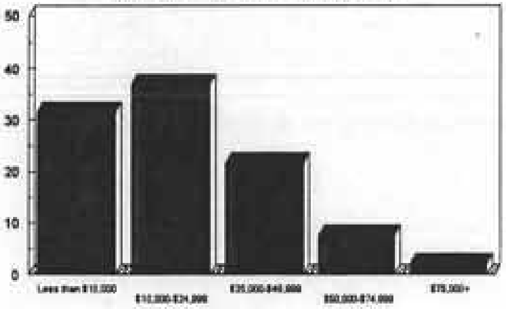
There are also 14 statewide RLFs, including four in Georgia, two each in Pennsylvania, North Carolina, and West Virginia, and one each in Kentucky, Maryland, South Carolina, and Virginia. Some of these are federally-funded, either through EDA or USDA, while others are state-funded.

The analysis yields the following profile of these RLFs.

Geographic coverage. Most counties in the region are served by at least one regional RLF. Many counties are served by two or more RLFs, and some are served by as many as six. The thinnest regional RLF coverage is in Tennessee, and Alabama, where most counties are served by either one regional RLF or none at all. (See Map 5.1.)

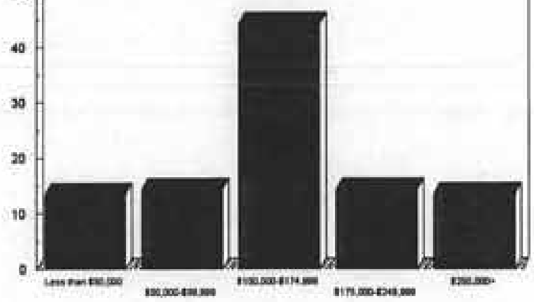
Loan size. Most eligible RLF loan amounts appear to be in the $10,000 to $150,000 range. About two-thirds of RLFs have a minimum loan amount of less than $25,000 and about one-third have a minimum of less than $10,000 or no minimum. (See Graph 5.2.) Almost three-quarters have a maximum loan amount of at least $100,000, and about one-quarter have a maximum of at least $175,000. (See Graph 5.3.) The average loan amount in 1996 was $94,500.

Graph 5.2
Minimum Financing Amounts Provided by RLFs in the ARC Region (%)



Number of Respondents = 82
Source: Mt. Auburn Associates Survey of Development Finance Institutions

Graph 5.3
Maximum Financing Amounts Provided by RLFs in the ARC Region (%)



Number of Respondents = 104
Source: Mt. Auburn Associates Survey of Development Finance Institutions

While data on individual loan amounts was not collected for all RLFs, data was analyzed on 420 outstanding loans by ARC RLFs (as of February 1997). About 70 percent of these loans are in the $10,000 to $99,999 range. The average loan amount was $68,000. While these amounts are relatively small, the total project funding from all sources is much larger. Over 60 percent of the loans involved total project funding of at least $100,000, and almost one-quarter involved total project funding of at least $500,000. (See Table 5.1.)

Loan types and uses. Most RLFs, over 90 percent, provide secured debt financing. Among these, a high proportion, almost three-quarters, are willing to take a junior collateral position to other lenders. Very few RLFs provide other types of financing. Fewer than one-third provide debt with equity features, and even fewer provide equity or unsecured debt. Also, very few provide loan guarantees. (See Graph 5.4.)

Map 5.1

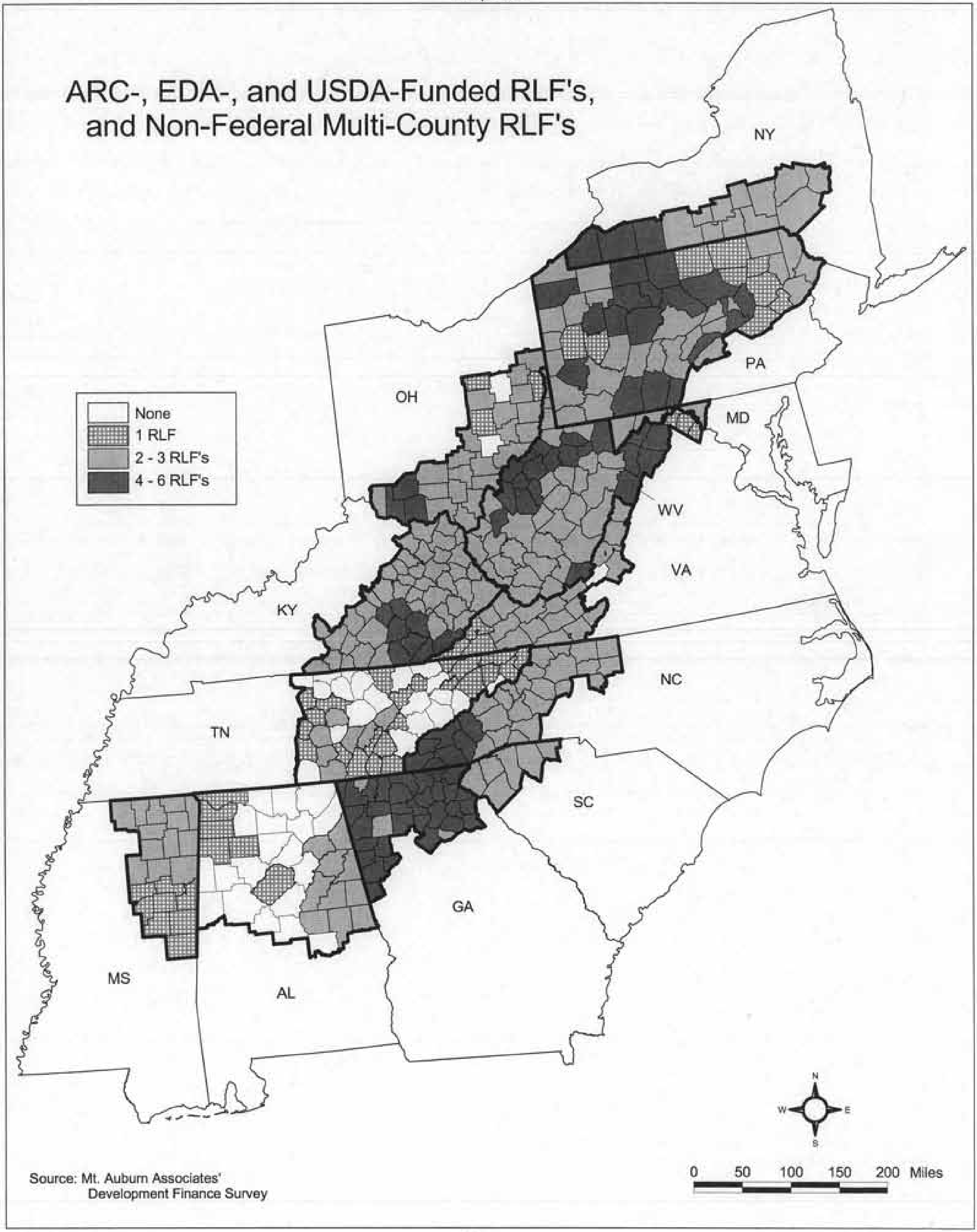
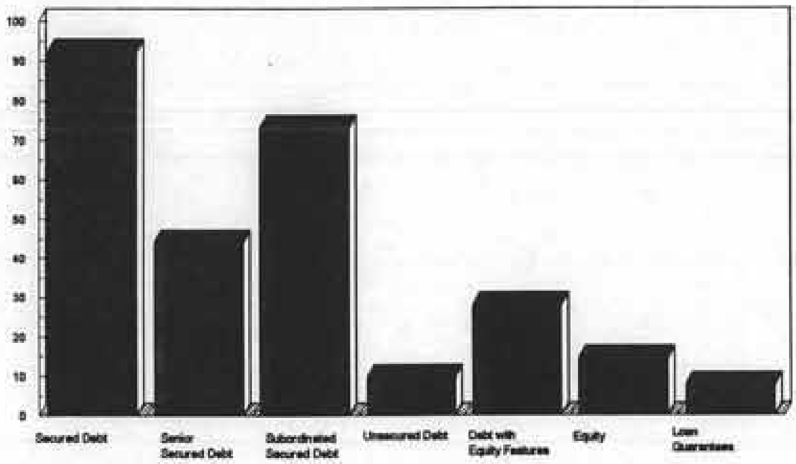

ARC-, EDA-, and USDA-Funded RLF's,
and Non-Federal Multi-County RLF's
None
1 RLF
2 - 3 RLF's
4 - 6 RLF's
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0
50
100
150
200 Miles
Source: Mt. Auburn Associates'
Development Finance Survey

Table 5.1
Size of Financings
By ARC RLFs (%)

	ARC RLF Funds	Total Project Funds
Less than $10,000	1.4	1.2
$10,000 to $49,999	29.8	2.6
$50,000 to $99,999	40.7	11
$100,000 to $499,999	28.1	61.9
$500,000 to $999,999	0	12.6
$1 million+	0	10.7
Total	100	100

Number of Respondents = 420
Source: Mt. Auburn Business Survey

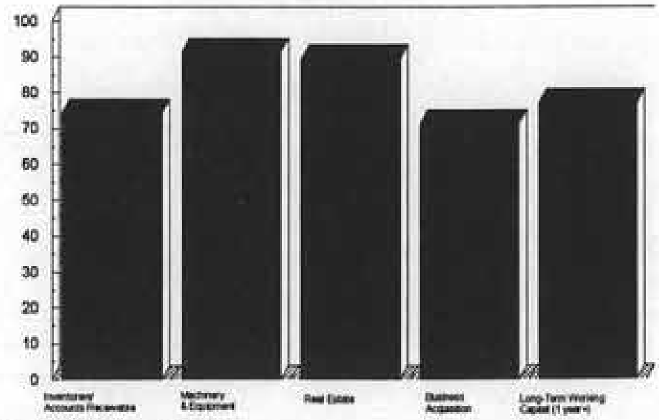
Graph 5.4
Types of Financing Provided by RLFs
in the ARC Region (%)



Note: Total number of respondents =104
Source: Mt. Auburn Associates Development Finance Survey

Most RLFs permit a range of uses for their financings. The most frequent allowable uses are for the purchase and improvement of land and buildings and for the purchase of machinery and equipment. About 90 percent of RLFs allow their loans to be used for these purposes. Between 70 and 80 percent of funds allow loans to be used for inventories and accounts receivable, business acquisition, and longer-term working capital. (See Graph 5.5.)

Graph 5.5
Allowable Uses of Financing Provided by RLFs in the ARC Region (%)



Note: Total number of respondents = 105
Source: Mt. Auburn Associates Development Finance Survey

The data on outstanding ARC loans shows the actual uses of financing on a subset of RLF loans. Taking into account total project financing, the highest proportion of loans were used for machinery and equipment (about three-quarters), followed by land and buildings (about 60 percent), and working capital (slightly under 50 percent). Analysis of the division of loan dollars among different uses shows that about 80 percent of funds were used for fixed assets -- about 40 percent each for land/buildings and machinery/equipment. Only 12.5 percent of funds were used for working capital. (See Table 5.2.)

Table 5.2
Uses of Financings
Involving ARC RLFs (%)*

	Percentage of Loans	Percentage of Loan $
Land and Buildings	61.4	41.9
Machinery and Equipment	74.8	39.9
Working Capital	47.9	12.5
Other	26.4	5.7
Total**	210.5	100

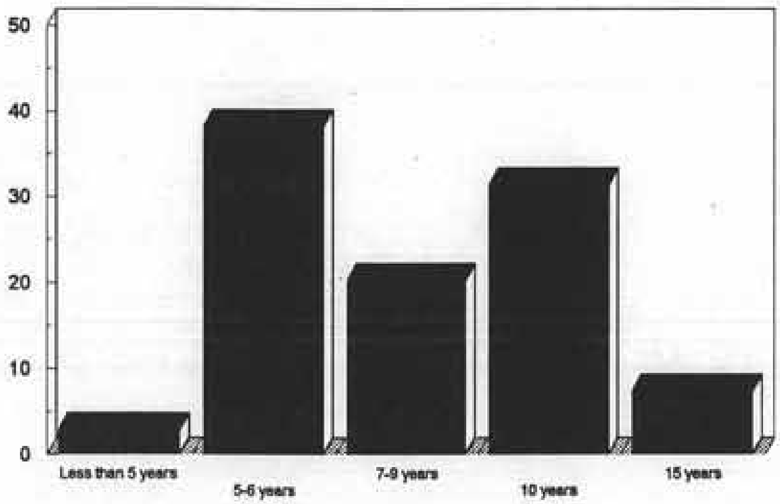
*Data based on funding from all sources
**Adds to more than 100% because some projects involve multiple uses
Number of Respondents = 420
Source: Mt. Auburn Business Survey

Interest rates. Most RLFs provide deeply subsidized interest rates. Of RLFs providing information on their interest rates, about 40 percent charged 4.5 percent or lower, about 25 percent charged 4.75 to 6.5 percent, about 20 percent charged 6.75 to 8.5 percent, and about 15 percent charged more than 8.5 percent. Prime rate is currently 8.5 percent, and bank interest rates are typically 1 to 3 percent over prime.

Interest rates set by RLFs are almost always fixed. Of RLFs providing this information, about 95 percent always or primarily offered their loans at fixed rates.

Maturities. While data on loan maturities were not collected on all RLFs, the ARC loan database provides data on maturities for this subset of loans. Most of these loans are for terms of five to nine years (almost 60 percent), and of ten to 15 years (almost 40 percent). This is consistent with the use of the loans for machinery/equipment and real estate. (See Graph 5.6.)

Graph 5.6
Maturity of Loans by ARC RLFs (%)



Note: Total number of respondents = 408
Source: Mt. Auburn Associates Development Finance Survey

Capitalization and loan volume. Average RLF capitalization is about $2.3 million. Among RLFs reporting 1996 financing activity, the mean number of loans made was eight and the median was four.

Other Local and Regional Development Finance Programs

Microloan Funds

There are at least 35 microloan funds scattered throughout the region. Among microloan funds reporting 1996 financing activity, the mean number of loans made was 20 and the median was nine. The average loan amount was about $8,500.

Regional coverage by microloan programs is spotty. The most thorough coverage is in Virginia, North Carolina, and West Virginia, where state programs support local funds, and in Pennsylvania and Ohio. The sparsest coverage is in Alabama, Mississippi, and Tennessee.

SBA 504 Certified Development Companies

SBA 504 certified development companies (CDCs) make subordinated fixed asset loans of up to $750,000 in partnership with banks or other senior lenders. The senior lender must contribute at least 50 percent of the total financing and the borrower must make a minimum 10 percent equity injection. There are 26 sub-state CDCs in the region. In addition, there are 18 associate development companies (ADCs). ADCs are not active lenders, but can assist borrowers to obtain financing through active CDCs.

Regional coverage by sub-state CDCs is spotty. The most thorough coverage is in Mississippi, Tennessee, and North Carolina. The sparsest coverage is in Kentucky, Ohio, Virginia, and West Virginia. (See Map 5.2.) While all states except Pennsylvania also have statewide CDCs (see below), these organizations are often located outside of the Appalachian region and may not be well positioned or attuned to serve businesses in the region.

Other Private Nonprofit Development Finance Organizations

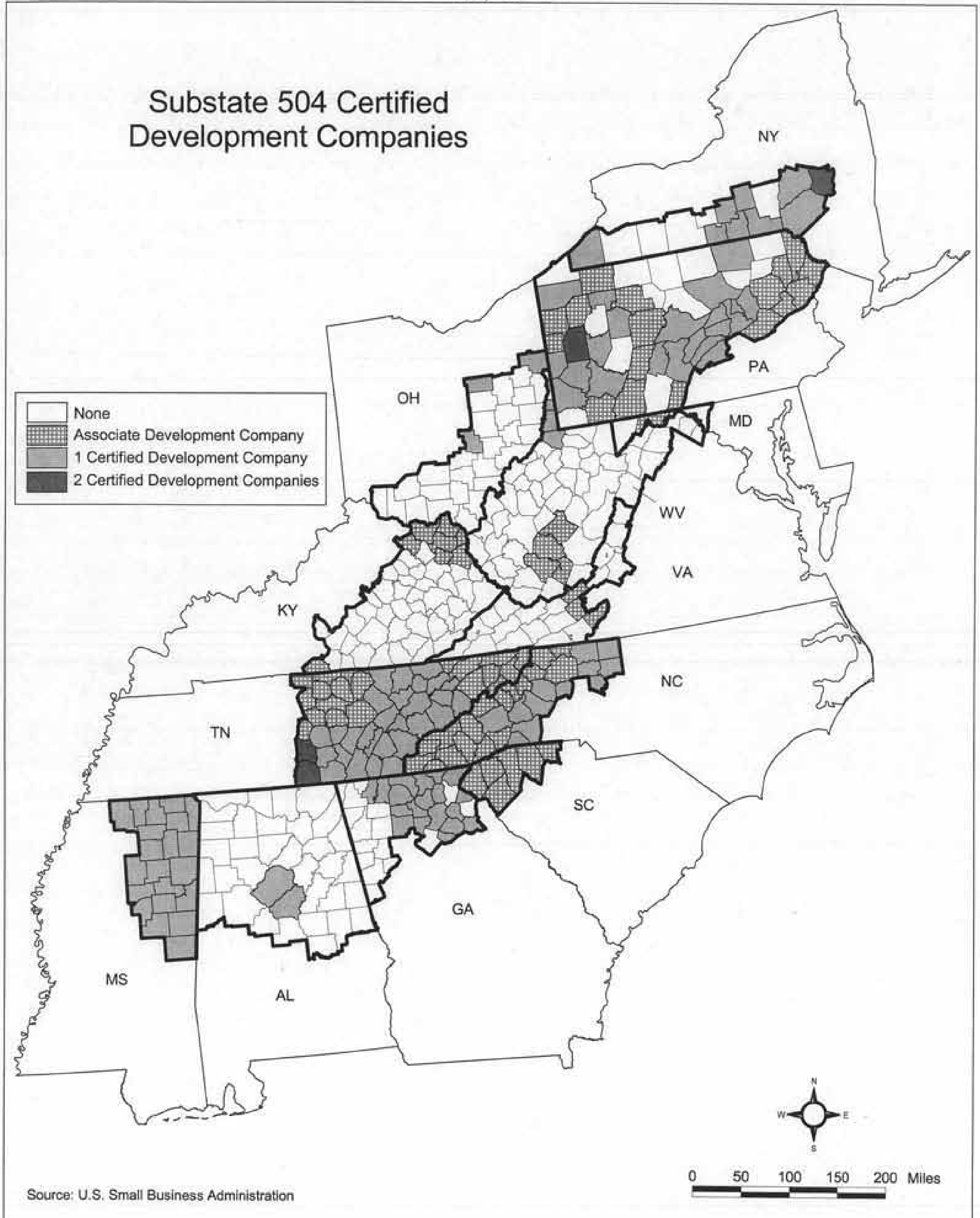
There are a small number of other private nonprofit development finance organizations throughout the region that make small business loans. These include:

- four nonprofit community development loan funds (CDLFs) serving parts of the region, including southwest Pennsylvania, west central Alabama, parts of four states in the Cumberland Valley region, and a region encompassing eastern Ohio, northwest Pennsylvania, and the West Virginia panhandle. CDLFs generally make small loans to low-income homeowners and small entrepreneurs;
- at least three community development credit unions, the largest of which is the Self-Help Credit Union, which has $50 million in assets and four offices in rural North Carolina. Another community development credit union is located in southern New York, and a third, which was recently established, in southeast Ohio; and
- while there are a number of private venture capital firms and small business investment companies based in or near the Appalachian region, only one was identified that has a clear economic development mission and an investment focus on rural areas. This was Mountain Ventures, a $5 million SBIC managed by Kentucky Highlands Investment Corporation of London, Kentucky. Mountain Ventures invests in businesses in a nine-county area of eastern Kentucky.

CDBG-Funded Local RLFs

There are likely to be many CDBG-funded local revolving loan funds throughout the region. No data is available on these funds.

Map 5.2


Substate 504 Certified Development Companies
None
Associate Development Company
1 Certified Development Company
2 Certified Development Companies
NY
PA
OH
MD
WV
VA
KY
NC
TN
SC
GA
MS
AL
N
W
E
S
0 50 100 150 200 Miles
Source: U.S. Small Business Administration

State and Multi-State Development Finance Programs

Statewide Certified Development Companies

Ten states have statewide SBA 504 certified development companies. Of the remaining three, Alabama and Mississippi are served by a multi-state CDC operated by the Southern Development Council, a private nonprofit organization. Only Pennsylvania is not served by a statewide or multi-state CDC.

Industrial Development Bonds

All states offer tax-exempt Industrial Development Bonds (IDBs), either through state agencies or county industrial development authorities. In general, IDBs are for amounts of $1 million or more because issuance costs and underwriting standards make smaller loans unfeasible. Two states, Virginia and South Carolina, have umbrella bond programs that allow pooling of smaller loans. However, even these loans generally exceed $100,000.

Statewide Loan Programs

Twelve states have statewide revolving loan programs or other direct small business loan programs, provided either through state agencies or quasi-public development finance institutions. Georgia, New York, Pennsylvania, West Virginia, and South Carolina are particularly active in this area. Only Tennessee has no statewide direct loan programs. However, Tennessee, along with the Appalachian region of Mississippi, and parts of the Appalachian regions of Kentucky, Virginia, North Carolina, Georgia, and Alabama, are served by the Tennessee Valley Authority's (TVA) Economic Development Loan Fund, a multi-million dollar RLF that makes low-interest loans of up to $2 million for industrial expansion and relocation projects. TVA, through its Special Opportunities Counties fund, also makes loans of up to $300,000 for industrial development projects in 50 economically distressed counties within its service area.

Seed and Venture Capital Funding

Four states, New York, Pennsylvania, West Virginia, and South Carolina, provide seed or venture capital directly through state quasi-public development finance institutions. Other states, including Virginia, Pennsylvania, West Virginia, and Ohio, have invested in or provided tax incentives to private venture capital funds and SBICs that promise to target investments in these states. In addition, the Tennessee Valley Authority has invested in a regional private venture capital fund, an SBIC, and a Specialized SBIC that targets minority-owned businesses.

Microloan Funding

Three states, Virginia, West Virginia, and North Carolina, provide capital and technical assistance to local microloan programs.

5.3.2 The Role of Development Finance Institutions in Meeting Business Financing Needs

Financing programs operated by government or local economic development organizations are viewed by established firms as a moderately important sources of financing. Eighteen percent of business survey respondents have found them to be very important while another 12 percent have found them to be somewhat important. (See Table 4.1.) During the past three years, almost 11 percent of respondents have applied to one of more of these programs for financing.

Rural borrowers in the region report that they are substantially more dependent on these programs than urban borrowers. Thirty-three percent of non-metro respondents found these programs to be very important, compared to only 12 percent of metro respondents. Only 53 percent of non-metro respondents found them to be unimportant, compared to 73 percent of metro respondents. (See Table 4.2.) This was the most substantial difference between rural and urban areas of the region regarding the relative importance of different financing sources. In seeming contradiction to this data, about the same percentage of rural as urban borrowers have used financing from development finance programs during the past three years. While the reasons for this contradiction are not clear, it may indicate that, despite placing greater importance on these financing sources, rural borrowers have greater difficulty obtaining their financing. Alternatively, it may indicate that, while rural borrowers have used these programs at about the same rate as urban borrowers in the past, they consider them more important to future plans.

With the exception of microenterprise funds, development finance organizations are oriented toward participation in larger-scale financings. Most of the financings in which RLFs, 504 Certified Development Companies, and state development finance organizations participate exceed $100,000.

There is some evidence from the business survey that larger firms are more likely to use development finance programs than smaller firms, although this evidence is inconclusive. Thirty-seven percent of larger firms responding to the survey considered development finance programs very or somewhat important, compared to 23 percent of smaller firms. (See Table 4.3.) In addition, 13.5 percent of larger respondents indicated that they had recently used a development finance program, compared to only 7.3 percent of smaller respondents. While neither of these differences was statistically significant, they are consistent with the data on the sizes of financings provided by the majority of development finance programs.

Most development finance programs are heavily oriented to secured debt financing, although some of this financing is provided on a subordinated basis. In addition, while some provide working capital financing, the bulk of the funding is used for fixed assets. This pattern is also reflected in the use of these programs. The types of financing most frequently sought from development finance programs by business survey respondents were commercial mortgages, primarily fixed rate (10 respondents). Other types of financing sought included equipment loans or leases (five respondents), short- or medium-term working capital (five respondents), equity or debt with equity features (four respondents), revolving lines of credit (three respondents), and asset-based financing (two respondents). Among those who sought development financing, the financing requests most likely to be denied were for unsecured financing or financing secured by "soft" assets. The highest turndown rates were for working capital loans (60 percent), equity or debt with equity features (50 percent), and asset-based financing (50 percent). (See Table 5.3.)

Table 5.3
Types of Financing Sought and/or Obtained
from State/Local Development Finance Organizations

	Sought	Obtained
Fixed rate commercial mortgage	9	6
Variable rate commercial mortgage	1	1
Equipment loan	4	4
Equipment lease	1	1
Medium-term working capital (1-5 years)	2	1
Short-term working capital (under 1 year)	3	1
Revolving line of credit	3	2
Asset-based financing	2	1
Export trade financing	0	0
Equity of debt with equity features	4	2

Note: Figures represent numbers of respondents, not percentages
Total number of respondents = 22 who sought financing
Source: Mt. Auburn Business Survey

Local development finance professionals, while generally positive about the system of development finance, identify a number of gaps remaining in the system. These include:

1. ***working capital*** -- many development finance programs lack the authority or expertise to provide such financing;
2. ***risk capital,*** either universally or in particular industry sectors;
3. ***financing for startups;*** and
4. ***microbusinesses financing*** -- this is difficult to provide because of the small loan amounts and the relatively high costs of origination and administration.

Other gaps less frequently mentioned include financing for young, rapidly growing firms, often in technology industries, financing for "Mom and Pop" businesses in the tourism industry, and financing for remote rural businesses.

Development finance professionals frequently assert that financing gaps are related more to the adequacy of the existing funds, than to the suitability or effectiveness of *programs.* The development financiers, in their view, need more money to plug identified gaps more completely. Many asserted they have worthy deals that they cannot finance simply due to lack of available capital. A few have had to time funding their loan commitments to correspond to scheduled repayments of outstanding loans. These financiers, in their opinion, are addressing real needs, but lack sufficient resources to get the job done. Two of the case studies reinforce these general observations. In both north central Pennsylvania and northeast Mississippi, strong demand for loans among key local industries has led to a shortage of RLF funds.

However, not all RLFs are experiencing loan demand in excess of resources. For example, among the 27 active ARC RLFs, about one-quarter of total capital, or $7 million, was available for lending as of August 1997. Thirteen of these funds have not drawn down the full amount of their ARC grant.

State development finance programs do not seem particularly well-tailored to the rural areas covering most of the Appalachian region. While the quantitative evidence on state development finance activity by geographic area is thin, development finance professionals generally see state programs as having a limited role in their regions. These programs tend to be either targeted to industrial recruitment, larger firms, or particular subsets of entrepreneurs (e.g., women and minorities). In addition, program management tends to be somewhat removed from rural areas. The exceptions are decentralized programs such as the microloan programs in North Carolina and Virginia that provide capital to local and regional development finance organizations to be managed locally.

Most development finance professionals feel that existing development finance activities are closely coordinated. The need for coordination is understood and coordination is increasing, although it is acknowledged that turf issues remain and there is room for improvement. Most coordination mechanisms are informal, that is, development finance personnel know one another as the result of conferences or previous joint efforts. They rely on this network to make referrals and arrange co-financings. Some of those interviewed report using more formal mechanisms, such as designating one agency as a formal coordinating body. Regional development finance organizations, in particular, are emerging as coordinating bodies. These organizations often operate multiple funds, take the lead role in packaging deals in which they partner with state or local development finance organizations, and are viewed by bankers as the contact point for public/private co-financings. For example, the regional development organizations in two of the case study areas, north central Pennsylvania and northeast Mississippi, were widely recognized within their regions as the lead organizations in development financing.

Although those relying on informal mechanisms generally believe these to be effective, they also generally believe that more formal coordination would be useful. Suggestions for improving formal coordination include:

- better integration of local governments that operate financing programs, usually with CDBG funds, into the system;

- more decentralized administration of state programs so that personnel are available to coordinate and make decisions; and
- use of computer systems (e.g., bulletin boards, home pages) to provide updates on programs and activities.

There is broad recognition among development finance professionals that development finance activities must be more effectively supported with other forms of business assistance. Business assistance is either viewed as insufficient or too loosely coordinated with development finance programs. Some development finance professionals believe that quality business assistance is simply in short supply in their areas, although many acknowledge growth in business assistance capacity, particularly among community colleges. Others feel that, while such assistance is available, it is not well coordinated with financial assistance. They point to the need for "one-stop" delivery systems that meet all business assistance needs. They also see this as a way to help bankers direct their customers to needed assistance. Although some of the stronger development finance organizations incorporate and coordinate the services of various business assistance providers, coordination of business services is generally viewed as too informal and haphazard. Some of those interviewed also expressed the concern that if they desire better coordination, the responsibility for identifying and bringing together different organizations will fall primarily on their shoulders.

Problems related to non-financial business assistance are viewed as a particular constraint to new enterprise formation. Startup entrepreneurs, many with very limited management assistance, need entrepreneurial training and one-on-one management assistance in order to develop and implement sound business plans and to institute effective management practices. Financing alone is viewed as insufficient for supporting these firms.

A number of suggestions were made for improving coordination between development finance and other business assistance providers. These include:

- formal mechanisms charged with this responsibility, limiting the burden placed on development financiers to organize coordination;
- central reporting mechanisms so financiers and other business assistance providers can learn about one another's activities; and
- reducing the number of entities involved in providing business assistance.

5.4 Summary of Findings

- *There is no evidence of widespread, systemic gaps in the availability of private sector financing for firms in the Appalachian region willing to pay the risk-adjusted market rate of return.* At the same time, certain factors characterizing rural financial markets in general, and the Appalachian region in particular, including heavier dependence on the banking industry, fewer banking choices, and the prevalence of the smaller banking institutions offering a narrower range of financial services, make access to business financing more problematic than in other parts of the U.S.

- *A small but still significant proportion of established Appalachian firms as well as a larger proportion of startups, high-growth firms, firms in non-traditional industries, and firms owned by non-traditional entrepreneurs, are seriously affected by inability to obtain sufficient financing.* In addition, firms in the more economically distressed parts of the region appear to face more severe financing constraints because of lower levels of financial resources and less competitive financial markets.

- *Businesses in the region do not appear to pay a premium in financing costs.* While providing subsidized financing may be justified by other factors constraining business development, it is not required to address inefficiencies in financial markets.

- *There is somewhat of a mismatch between the unmet financing needs of firms in the region and the financing tools emphasized by the region's development finance organizations.* While the most difficult types of financing to obtain include risk financing, working capital financing, and financing of less than $50,000, development finance sources place a stronger emphasis on providing secured debt financing, particularly for fixed assets, and on participating in financings of greater than $50,000 and, more typically, greater than $100,000. Development finance professionals themselves generally support this finding.

- *There is some evidence of inefficiencies in the distribution of development finance resources.* While some ARC-funded revolving loan funds cannot meet the demand for financing, others have not drawn on all of their available funds. Other federally-funded programs that make large grant or low-interest loan commitments that are then drawn down as needed by local development finance organizations are likely to experience similar inefficiencies.

- *There is widespread recognition in the region's development finance community of the need to expand non-financial business assistance and better coordinate it with financial assistance.*

Chapter Six: Key Findings and Recommendations

6.1 Summary of Key Findings

1. *The economy of the Appalachian region, while performing well in some respects, continues to lag the rest of the nation in key measures of economic health, including unemployment, new enterprise formation, and participation by non-traditional entrepreneurs.* This is particularly true in the more rural parts of the region. Greater capital availability alone can not address these problems, but can play an important role as one tool in the economic development "toolbox."

2. *The present and evolving structure of the Appalachian economy has important implications for capital needs.* The region remains more heavily dependent on its manufacturing base than the nation as a whole. Manufacturing firms that have the potential to remain competitive will need to modernize, boost productivity, and develop new products and markets. Financial products tailored to the needs of manufacturers, along with other forms of business assistance, will be required to address these needs. At the same time, certain industries are playing an expanding role in the region's economy, such as tourism and other service industries, small suppliers to large manufacturing facilities (e.g., new automobile assembly plants), and technology-based industry. Traditional financing sources will have to modify or develop new financing products to address the particular needs of these industries.

3. *While there is no evidence of widespread, systemic gaps in the availability of private sector business financing in Appalachia, the region has lower levels of financial resources and offers business fewer financing options.* Personal financial resources, the most important source of risk financing for startup and early-stage firms, are at a low level in the region. Beyond the entrepreneur's own financial resources and those of family, friends, and business associates, Appalachian businesses are heavily dependent on the banking industry for financing. Financing sources that are active outside the Appalachian region, including non-bank SBA lenders, commercial finance and leasing companies, SBICs, and venture capital firms, provide very little financing to Appalachian businesses. This is particularly true in the more rural and economically distressed parts of the region.

4. *Despite this relative scarcity of financial resources, the availability of financing does not appear to be a strong concern to a large majority of Appalachian businesses.* Insufficient financing appears to have a serious impact on the investment decisions of about one in five established companies. (It is also unlikely that all of these investments would be financially justifiable even if financing were available.) At the same time, Appalachian firms appear quite conservative in their use of financing, particularly firms in rural areas. Business attitudes about the use of financing may pose a further constraint to business investment and growth.

5. ***The region's banking industry is fairly well equipped to meet the demand for most secured debt financing.*** Banks in the Appalachian region are as financially healthy and have used their deposit base as aggressively to make loans as their peers in the rest of the U.S. However, levels of bank deposits in the region are relatively low, and are particularly low in economically distressed areas. This could potentially be constraining the level of bank lending, although banks experiencing strong credit demand do have access to funds in addition to local deposits. In addition bank financing is supplemented on a modest scale by other secured debt sources, such as equipment dealers and suppliers.

6. ***While risk capital is needed by a relatively small subset of firms, it is scarce for those who do need it.*** Entrepreneurs and businesses in the Appalachian region remain heavily reliant for risk capital financing on their personal savings, retained business earnings, and support from family members, friends, and business colleagues. This is particularly true of very small businesses and businesses in rural areas. Informal local investors, or "business angels," are a much less important source of risk financing, and primarily target larger and higher-growth businesses. Formal risk capital sources, including venture capital firms and small business investment companies, make very few investments in the region. Because of generally low levels of personal wealth in the region, this reliance on informal investment from local sources indicates that risk financing is relatively scarce.

7. ***Demand for business financing in the region has increased in recent years as a result of a number of factors.*** These include the region's participation in the sustained national economic expansion, in-migration, growth in business startups by downsized professionals, and increased outsourcing and job shops.

8. ***The availability of business financing does not, on balance, appear to have changed greatly in recent years, either for better or worse.*** The most significant change has been brought on by banking industry consolidation. While this trend has increased the presence of larger statewide and regional banks in the region, and has reduced the number of locally-owned banks, the number of banks competing in local markets remains relatively high in proportion to population. While larger banks have introduced different lending practices and have sometimes targeted different markets, these changes appear to have had differing impacts, some positive and some negative, in different parts of the region and for different types of businesses. It is probably too early to judge the full effects of these changes. Another trend that has affected other parts of the U.S., the entry of nonbank lenders into the business credit market, has not yet had a notable impact in the Appalachian region.

9. ***Evidence does not suggest that the cost of financing is a constraint to business investment in the Appalachian region.*** Real interest rates in the U.S. have been relatively low and stable throughout the 1990s. In addition, recent studies of rural financial markets have shown that capital costs for rural businesses are comparable to those for urban businesses and that rural businesses do not consider cost of financing to be as important in their banking relationships as such factors as their bankers' accessibility and knowledge of their businesses, and the reliability of access to

financing. (Rural businesses also tend to be more satisfied with their banking relationships than urban businesses.) Development finance professionals interviewed for this study did not identify capital costs as a serious constraint to business investment in the Appalachian region.

10. *A number of factors affecting the more rural parts of the Appalachian region indicates a need to target development finance resources and build additional development finance capacity in rural areas, particularly those suffering from high levels of economic distress.* These factors include less robust economic performance, lower levels of personal financial resources, less activity by private sources of business financing, higher unmet financing needs among businesses, and greater reluctance among businesses to use any financing.

11. *Very small firms -- those with fewer than 10 employees -- generally face a less favorable financing environment than larger firms, indicating the need for more intensive targeting of development finance resources to these firms.* While these firms have similar financing needs as larger firms, they appear less likely to seek and obtain external financing. They report higher levels of unmet financing needs, are less likely to anticipate future business investment, and are more likely to anticipate future financing problems. These smaller firms also appear to have difficulty obtaining very small bank loans, non-bank credit, and risk financing outside of their own resources and those of family members and friends.

12. *The slow pace of development of non-traditional industries and entrepreneurs in the region may also indicate a need for targeting of development finance resources.* The role of non-traditional industries and entrepreneurs in the region's economy remains relatively undeveloped. These include seasonal businesses, particularly in tourism, firms commercializing technology, firms in emerging industries that are unfamiliar to local bankers and private investors, and women-owned firms. There is some evidence that these firms have greater difficulty obtaining financing than more traditional firms.

13. *Development finance programs are a moderately important supplement to the private financial market for Appalachian businesses.* Businesses in the more rural parts of the region consider these programs particularly important, although they do not appear to use them at a higher rate than urban businesses.

14. *On balance, bank participation in development finance programs seems to be on a par with that in other parts of the country.* Bankers in the region have also exhibited a greater willingness to participate in such programs than in the past. However, banks in more rural parts of the region appear less inclined to participate in some of these programs than their urban counterparts.

15. *There is a mismatch between the region's unmet business financing needs and the financing tools emphasized by the region's development finance organizations.* While the most difficult types of financing to obtain include risk financing, working capital financing, and financing of less than $50,000, development finance sources place a stronger emphasis on providing secured debt financing, particularly for fixed

assets, and on participating in financings of greater than $50,000, and, more typically, greater than $100,000. State development finance programs are particularly poorly matched to needs in the region. In addition, development finance resources in some areas are insufficient to meet demand, in part because of inefficiencies in the allocation of these resources.

16. *Finally, there is strong need for expanded non-financial business assistance and better coordination between non-financial and financial assistance.* Beyond additional resources, this requires the application of more sophisticated tools to support coordination.

6.2 Strategy Recommendations

6.2.1 Strategic Focus

The findings from the study suggest four critical needs that should be addressed by ARC development finance initiatives:

1. *Develop flexible mechanisms to channel capital in a timely manner to existing ARC RLFs that are experiencing high levels of demand for financing that cannot be accommodated with existing RLF resources.* This is particularly important to maintaining economic momentum in areas where key manufacturing or other industries are expanding rapidly.
2. *Increase capital resources to support small entrepreneurship, particularly in economically lagging parts of the region and for non-traditional entrepreneurs.*
3. *Support capacity development among regional development finance organizations to increase their ability to access financial resources, engage in more sophisticated forms of financing, and more effectively manage the development lending process within their regions.*
4. *Increase the availability of non-financial business assistance and improve its coordination with development finance activities.*

6.2.2 Recommended Initiatives

1. Expand Capital Availability to Existing RLFs

Revolving loan funds remain an important development finance tool in the Appalachian region. They can play a particularly important role in financing the expansion of small- and medium-sized manufacturers and other "traded sector" firms. Many ARC-funded revolving loan funds have been able to meet loan demand with ARC capital grants, and some have substantial liquid capital to meet future loan demand. However, others are finding that demand for loans exceeds their existing financial capacity. Given the limited amount of funding available from ARC and other sources of RLF grant capital, as well as the procedural constraints placed on ARC's ability to reprogram unused RLF grant capital, it is probably unrealistic to assume that this demand can be fully met through additional capital grants. In addition, the use of grant capital alone to meet financing demand is not necessarily an efficient use of grant funding, particularly for RLFs with solid lending track records that have the ability to leverage their core capital. Many nonprofit loan funds have been able to leverage capital grants with additional debt financing to expand the total amount of funds available for loans. Others have sold loans in secondary markets to increase their available capital.

ARC could help its RLFs to obtain additional loan capital in a number of ways. Some of these could be relatively low-cost information or brokering initiatives. Others might involve providing direct financing or credit enhancements. The following options are recommended for consideration.

➢ *Directly Provide or Guarantee Capital Loans to RLFs*

ARC could provide capital loans to RLFs experiencing high loan demand. These loans would not replace capital grants but would be offered as an additional level of financing for RLFs that could not accommodate loan demand with grant capital. Such loans should be structured to enable RLFs to meet near-term loan demand, not as permanent additions to RLF capital. Interest rates should reflect the cost of funds for federal agencies and terms should be for no more than five years. A loan could be renewed if the RLF demonstrates that loan demand continues to require additional capital. It should be noted that an amendment to ARC's authorizing legislation would be required to enable it to lend funds.

As an alternative to direct loans, ARC could guarantee loans to RLFs from banks or other non-government financing sources. Such loans could be obtained from a number of sources, including banks, foundation program-related investments, development intermediaries, or socially-responsible mutual funds. Guarantees could be structured such that ARC and the RLF share the risk and returns on the business loans underlying the guarantees. For example, ARC could require the RLF to establish a reserve to back the guarantee and could charge an annual guarantee fee. The terms of the guarantee should be tied to the RLF's historical portfolio track record, i.e., larger reserves or higher fees might be required of RLFs with weaker track records.

➢ *Develop Mechanisms to Support the Sale of RLF Loans to Secondary Market Investors*

Secondary market transactions involve the sale by loan originators to other investors of loans or financial instruments secured by loans in exchange for a negotiated cash value based on loan asset quality and revenue streams. Such transactions generally involve the pooling of individual loans and the sale of these pools or of securities backed by the pools. Intermediaries often play a role in assembling pools and negotiating transactions.

The sale of secondary market securities, first in the residential mortgage market, and later in commercial mortgage and business loan markets, has been going on for several years. In recent years, a number of efforts have been undertaken to increase the sale to secondary market investors of loans made for community development purposes. These include the establishment of nonprofit secondary market intermediaries, such as the Minneapolis-based Community Reinvestment Fund, and initiatives by state development finance agencies in South Carolina, New Jersey, New Hampshire, and other states to sell secondary market securities backed by business loans. Private loan brokers have also become involved in arranging secondary market sales, both of individual loans and loan pools. Federal agencies, notably EDA and HUD, have funded studies and pilot programs to promote secondary market sales of loans made with their funding, although these efforts have, to date, not been very successful. One of the major barriers to such efforts is the unwillingness of local and regional development finance organizations to sell below-market loans at the discount required to provide the return demanded by secondary market investors.

While efforts to establish secondary markets for small business loans have met with mixed success, the concept of selling loans for cash to make additional loans is a sound one for development lenders who would not otherwise have the resources to meet loan demand. While loans originated at below-market interest rates are likely to be purchased at a discount, this may be an acceptable trade-off for an RLF with no other means to finance a potentially viable local business. Moreover, the discount does not actually represent a loss of funds to the RLF, but rather the current value of the revenue losses from below-market interest rates that the RLF would otherwise incur in the future. RLFs considering selling loans in the secondary market would have to more carefully consider borrowers' subsidy needs when pricing their loans. While subsidizing interest costs, like reducing other business costs, may make certain businesses more viable, this does not mean that interest subsidies are always necessary or even desirable.

ARC should consider a number of options to develop mechanisms to facilitate secondary market sales by ARC RLFs. These include the following:

- ***educate RLFs about existing opportunities to sell loans in the secondary market and about the requirements of secondary market investors;***
- ***provide technical assistance to individual RLFs in negotiating and packaging secondary market sales to local banks.*** Local banks may be willing to purchase seasoned loans made to current or prospective bank customers;
- ***solicit interest in purchasing RLF loans from national development intermediaries or from social investors (e.g., foundations, religious pension funds) with a particular interest in the Appalachian region or rural areas in general.*** This might include retaining a broker to solicit interest among potential purchasers and to broker loan sales;
- ***provide standby letters of credit for loan sales by individual RLFs.*** While the RLF reserves would remain the first recourse for secondary market investors, ARC could provide an additional layer of security to reduce investor risk and, therefore, increase the yields to RLFs from the loan sales;

- *pool loans from several RLFs and package them for sale as secondary market securities.* ARC could either sell loan packages directly or warehouse the loans and issue notes backed by loan repayments. It could provide credit enhancement either through full or partial guarantee of the securities, and/or by creating two "tranches," senior and subordinated, and either holding the subordinated portion or selling it to higher-risk investors; and
- *work with other federal agencies, including EDA, HUD, and USDA, to establish a multi-agency loan pooling and packaging mechanism.*

To be sure, there are certain inherent tensions between engaging in lending with a developmental function and meeting standards established by secondary market investors. Initiatives to support increased use of the secondary market by ARC RLFs must be sensitive to the need to maintain this developmental function.

➢ *More Rigorously Enforce Time Limits on Draw-Downs of Initial Capital Grants by RLFs*

ARC RLFs are currently given three years to draw down their capital grants. Funds not initially disbursed during this time period can be deobligated and returned to state allocations for use in other projects. ARC and individual Appalachian states should rigorously enforce this time limit to encourage RLFs to use their capital aggressively. Changes in ARC regulations should also be considered that would facilitate reprogramming these funds directly into grants or loans to capital-short RLFs.

2. *Provide Capital to Support Small Entrepreneurship*

The results of this study confirm long-running concerns about the low level of entrepreneurship in the Appalachian region and the lack of financial resources to support new entrepreneurs and early-stage microbusinesses. The need to support small, home-grown entrepreneurship is particularly great in the poorer, more remote portions of the region that have not benefited as much from the economic recovery and that are unlikely to attract larger firms. This need is also particularly great with respect to non-traditional entrepreneurs, including women and minorities, who face heightened barriers to entrepreneurship. ARC has recognized the importance of supporting entrepreneurship, as reflected in its current *Appalachian Entrepreneurship Initiative* and past initiatives.

ARC should consider the following options for increasing the amount of capital available to support new and small entrepreneurship.

➢ *Invest in Small Enterprise Funds*

ARC should expand the use of capital grants for small enterprise funds. As noted in Chapter Five, ARC RLFs infrequently participate in financings of $50,000 or less even though this is the amount of financing most frequently needed by startups and even existing firms in the region. While microenterprise funds typically provide financing of $10,000 or less or, in the case of SBA-funded funds, $25,000 or less, few development finance organizations focus on the $10,000 to $50,000 financing niche. ARC should establish a funding window targeted to development finance organizations that seek to address this gap.

ARC has already made a number of grants for microenterprise funds through its state partners. Such funds can also be provided through the new Appalachian Entrepreneurship Initiative. States should be encouraged to consider financing mechanisms that provide a step up from microenterprise financing as part of the strategies they develop for the Initiative.

ARC should also consider establishing a set-aside for direct grants to local economic development organizations to be used as a match for other funding sources. These grants would be made through a competitive application process. The grants would be small -- no more than $250,000 dollars, and would be targeted toward organizations in more rural parts of the region. Additional funding should be made available for the provision of entrepreneurial training and technical assistance. Organizations receiving such grants would be required to submit a detailed business plan tying small and microenterprise development to a broader economic development strategy and demonstrating the capacity to provide related training and business assistance.

In addition to direct investment, ARC should draw in the resources of other funding sources and intermediaries supporting microenterprise development. It could identify and seek co-investors from among other national or regional co-investors, including private and corporate foundations and bank community investment units. It should also seek to draw in the financial and technical resources of organizations such as ACCION International or Working Capital, which support local organizations in implementing their microlending models.

➢ ***Invest in Socially-Oriented Venture Funds***

Our study has shown that conventional venture capital funds and even SBICs have very little presence in most parts of the Appalachian region. At the same time, a few organizations in the region, including Kentucky Highlands Investment Corporation and the Self-Help Ventures Fund in North Carolina, have demonstrated that, with the right types of investment capital, sufficient scale, and strong staffing and technical capacity, socially-oriented venture investing can be successful. However, these organizations only cover a small part of the region.

ARC should establish a fund to make direct seed investments in a limited number of socially-oriented venture funds. It should establish rigorous criteria for investing in such funds based on experience from successful models. These criteria include minimum capitalization, sufficient operating revenues, and a management team with strong investment and technical assistance skills. In order to ensure that these funds reach an economically-efficient scale, attract sufficient funding, and achieve sufficient portfolio diversity, ARC should require that they serve substantially larger areas than do its RLFs. It should also require a non-governmental match component of at least 1:1.

3. *Support Capacity Development Among Regional Development Finance Organizations*

In order to effectively utilize the above initiatives and, more generally, to enhance their capacity to provide development finance services to businesses in the region, development finance organizations will need to further develop their professional skills and adopt more sophisticated management tools. The field of development finance has advanced greatly in the last several years, and development finance organizations in the Appalachian region are no exception to this trend. Yet, particularly in light of the economic development challenges facing the region, the region's development finance organizations should be supported to stay on the cutting edge of the field. ARC should consider the following options for strengthening development finance capacity in the region.

➢ ***Establish a Professional Development Institute for Development Finance***

ARC could supplement existing development finance training programs and offer a more systematic approach to professional development by establishing a Professional Development Institute for Development Finance. The institute would not be a physical structure, but rather could offer a series of meetings and training programs in different parts of the region, along with publications. The institute would draw on the capacity of existing training providers where possible, and would develop additional offerings as necessary either directly or by contracting with other organizations. Program offerings and activities of the institute could include the following:

- briefings on national and regional economic trends;
- briefings on developments in the financial market (e.g., banking consolidation, growth of nonbank lenders) and their implications for business lending;
- training in market analysis and strategic planning;
- presentations on best practices in organizational development and program design and management, and demonstrations of management tools and systems;
- training in non-traditional and complex lending and investment techniques (e.g., informal investment brokering, equity financing, working capital loans, export financing);
- training in providing financing to particular industries;
- information on funding sources and mechanisms (e.g., national intermediaries, secondary markets);
- informal networking and information exchange opportunities among development finance professionals; and
- one-on-one technical assistance in program design and the adoption of new management systems.

➢ ***Develop Shared Lending and Management Support Mechanisms***

Whatever their level of capacity, the many small development finance organizations populating the Appalachian region are too small to undertake certain infrequent or costly development finance transactions. These may include large financings, financings involving complex forms of collateral, or secondary market transactions. ARC should work with development finance organizations to develop new tools or organizational mechanisms that would assist organizations wishing to undertake such transactions. These could include the following:

- *developing communications systems to enable development finance organizations to identify and share information with potential local and non-local financing partners, both private and public, and with business technical assistance sources;*
- *establishing and providing startup capital for a service corporation that would handle large or complex financings and structure secondary market transactions.* The service corporation could invest in specialized staffing and management tools, and develop relationships with national financial institutions and funding sources that would be beyond the reach of individual development finance organizations. RLF representatives would participate in the design and management of this organization to ensure that it remains responsive to local RLF needs.

4. Increase the Availability of Non-Financial Business Assistance and Improve its Coordination With Development Finance

While this study did not directly address the demand for and supply of non-financial business assistance, it is clear that the availability and quality of non-financial assistance is an important factor in efforts to build and sustain a healthy business base throughout the Appalachian region. Development finance professionals throughout the region have expressed concerns that, without greater support for the provision of non-financial assistance and stronger efforts to coordinate non-financial and financial assistance, the impacts of additional commitments to development finance programs will be diminished. While we do not offer detailed recommendations in this area, we recommend that ARC take the following steps to improve the availability and quality of non-financial assistance in conjunction with ARC's development finance initiatives:

- recognize that non-financial assistance is essentially an educational function that cannot be fully supported through the normal operations of development finance programs and, therefore, requires ongoing funding;
- ensure that recipients of ARC development finance funding have developed a comprehensive non-financial business assistance plan that is appropriate to the needs of targeted businesses, draws to the extent possible on existing public- and private-sector service providers, and is adequately funded;

- support, through funding and information dissemination, the application of tools and mechanisms that link development finance organizations with private financing sources and technical assistance providers ; and
- use the Professional Development Institute to train development finance professionals in both the direct provision and effective utilization of non-financial business assistance.

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Appendix A: Business Survey Methodology and Characteristics of Respondents

A telephone survey was conducted of businesses in the Appalachian region during June 1997. A sample of 800 businesses with five or more employees was drawn from Business ConnX, a database of over 650,000 businesses in the region compiled by TRW Credit Services. A random sample was drawn, stratified by state to ensure proportional representation of businesses in each ARC state. The survey was conducted by Atlantic Marketing Research of Boston, a professional survey research firm. The number of surveys completed was 206, translating to a response rate of 25.75 percent. Data was entered into a database, with standard quality control procedures used to ensure that responses were complete, legible, and consistent, and that data was coded and keyed accurately. The data was analyzed using Systat, a PC-based statistical analysis package .

The data in the following tables provide a profile of survey respondents.

Table A.1
Profile of Survey Respondents
Employment (%)

	Total Employment	
	At Surveyed Facility	Overall
5 to 9 employees	48	42.6
10 to 24 employees	31.7	27.7
25 to 49 employees	6.9	9.2
50 to 99 employees	4.5	5.6
100 to 249 employees	4.5	4.1
250 to 499 employees	3	2.1
500 or more employees	1.5	8.7

Source: Mt. Auburn Business Survey

Table A.2
Profile of Survey Respondents
Gross Sales for Most Recent Fiscal Year

	Number of Respondents	Percentage of Respondents
Less than $50,000	19	9.2
$50,000 to $250,000	39	18.9
$250,001 to $1 million	46	22.3
$ 1,000,001 to $5 million	36	17.5
$5,000,001 to $25 million	17	8.3
More than $25 million	16	7.8
Don't know or N/A	33	16
Total	206	100

Source: Mt. Auburn Business Survey

Table A.3
Profile of Survey Respondents
Industry Sector

	Number of Respondents	Percentage of Respondents
Retail	58	28.3
Wholesale	21	10.2
Manufacturing	36	17.6
Services	84	41
Construction	19	9.3
Transportation/Utilities	7	3.4
Other	8	3.9
Don't know or N/A	0	0

Note: Total number of respondents = 205.

Total adds up to more than 100% as some respondents may have checked more than one category.

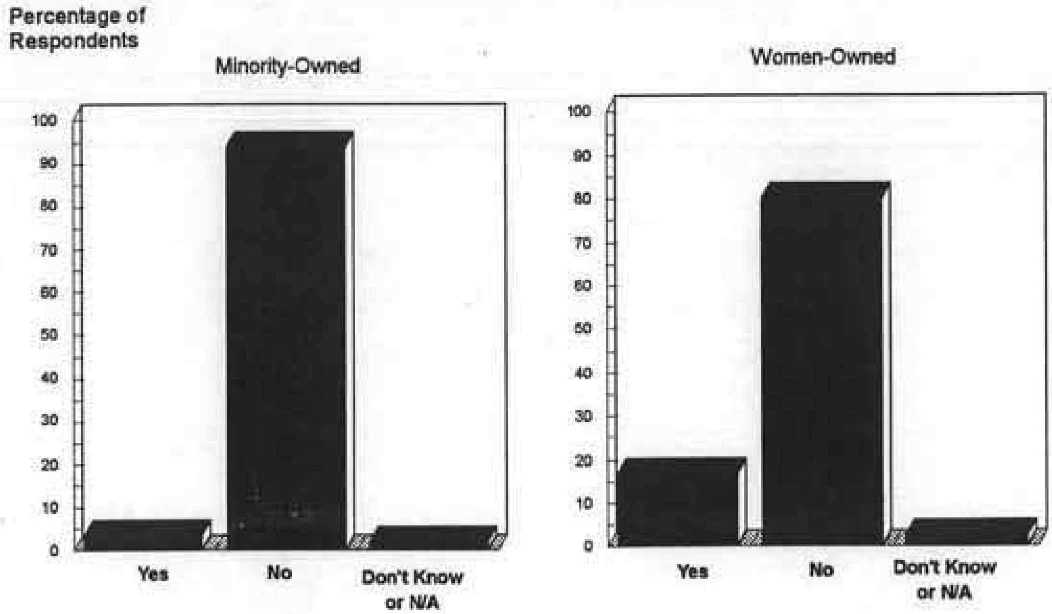
Source: Mt. Auburn Business Survey

Table A.4
Profile of Survey Respondents
Current Financial Situation

	Number of Respondents	Percentage of Respondents
Established firm with healthy profits	98	47.6
Established firm experiencing just breaking even or experiencing mix of profitable and unprofitable years	80	38.8
Start-up firm (operating for two years or less)	12	5.8
Established firm experiencing operating losses	6	2.9
Don't know or N/A	10	4.8
Total	205	100

Source: Mt. Auburn Business Survey

Graph A.1
Profile of Survey Respondents
Company Ownership (%)



Note: A minority-owned firm is defined as being at least 51% owned by one or more members of the following ethnic groups: African-American; Hispanic; Asian American; or Native American. A woman-owned firm is defined as being at lest 51% owned by one or more women.
Source: Mt. Auburn Business Survey

Table A.5
Profile of Survey Respondents
Geographical Distribution

State	Number of Respondents	Percentage of Respondents
Alabama	17	8.3
Georgia	17	8.3
Kentucky	8	3.9
Maryland	2	1
Mississippi	8	3.9
North Carolina	17	8.3
New York	10	4.9
Ohio	18	8.7
Pennsylvania	50	24.3
South Carolina	15	7.3
Tennessee	26	12.6
Virginia	2	1
South Virginia	14	6.8
Total	206	100

Appendix B: Cumberland Valley Area Development District (CVADD) Region

Regional Economic Conditions

The region served by the Cumberland Valley Area Development District covers eight counties in southeast Kentucky -- Bell, Clay, Harlan, Jackson, Knox, Laurel, Rockcastle, and Whitley. The region had a population of 232,344 in 1995. The region is heavily rural -- its largest cities are Middlesboro (population 11,328), Corbin (7,419), and London (5,757).

The economy of the region was centered around the coal mining industry from the early 1900s through the mid-1980s. Recent automation in the industry has greatly reduced manpower requirements, leading to widespread unemployment in coal producing counties. Unemployment in the region was 8.1 percent in 1995, compared to the state average of 5.4 percent and the national average of 5.6 percent. The region also suffers from low levels of personal income and high rates of poverty. Per capita income in 1995 was $13,341, compared to $18,847 statewide and $24,426 nationally. The poverty rate in 1990 was 33 percent, compared to 19 percent statewide and 13.1 percent nationally. Seven of the eight counties are designated as "distressed" by the Appalachian Regional Commission.

Although distressed, the region has experienced moderate employment growth in recent years. Between 1993 and 1995, employment increased by 4 percent. This compares favorably to the statewide average of 2.5 percent but is about equal to the national average of 3.9 percent.

Economic conditions in the region vary somewhat by county. Harlan County, which traditionally has been heavily dependent on the coal industry, is the most distressed of the eight counties. Unemployment in Harlan County was 16.2 percent in 1995 and total employment in the county declined by 4.9 percent between 1993 and 1995. Per capita income is lowest in Jackson County ($11,386), one of the region's most rural counties. In contrast, the three counties sitting along Interstate 75 between Lexington and Knoxville -- Laurel, Rockcastle, and Whitley, have the strongest economies. Laurel County, with the lowest 1995 unemployment rate in the region (6.3 percent) and the highest per capita income ($15,176), is also the only county not designated by the ARC as distressed. Rockcastle had the highest 1993 to 1995 employment growth rate in region (9.2 percent), and Whitley outperformed the region as a whole in both 1993 to 1995 employment growth (4.6 percent) and 1995 unemployment (6.4 percent).

The Demand for Financing: The Region's Business Base

With declining employment in the region's coal mining industry, the region's business and employment bases have been shifting. Manufacturing has been increasing in importance in the region, although it still lags behind mining as a source of employment. In 1995, manufacturing employment in the region comprised 12.4 percent of total employment, still below the state average of 15.3 percent and the national average of 12.9 percent. Almost 80 percent of the manufacturing jobs were concentrated in four of the eight counties (Knox, Laurel, Rockcastle, and Whitley). The tourism industry has also grown in importance, fueled by the region's state and national parks and other scenic and recreational attractions. In an effort to accelerate this trend, the region's economic development efforts have focused on recruitment of small- and mid-sized manufacturing firms (e.g., plastic components for the automotive and appliance industries), development of resource-based manufacturing (secondary wood products, agricultural processing), and tourism development.

In recent years, the region has had some success in attracting new firms and supporting the expansion of existing firms. Firms in its recently established Empowerment Zone have created 600 new jobs; other firms have made commitments to create an additional 1,900 jobs. These are primarily expansions, but some are newly recruited firms. The low rate of new enterprise formation remains a concern to regional economic development officials. According to national data, the rate of new enterprise formation is about one-third below the national rate. Economic developers note that entrepreneurially-oriented individuals tend to leave the region for more hospitable entrepreneurial environments. They also note that individuals who do try to start businesses in the region often lack the financial resources and management skills to be successful.

Other economic challenges faced by the region include:

- *the scarce supply of land suitable for large-scale industrial development, particularly as a result of the region's mountainous terrain;*
- *lack of tourism infrastructure (e.g., accommodations, developed historical and recreational sites, tourism development organizations);*
- *low educational and skill levels -- less than one-half of adult residents have graduated from high school;* and
- *the potential impact of welfare reform on the region's economy -- local officials estimate that one-third of the region's population will be affected.*

The Supply of Financing: The Regional Financial Market

Private Debt and Equity Markets

Secured Debt Financing

There are 20 commercial banks and savings institutions operating in the region. Despite the pace of banking industry consolidation nationwide, most of the banks in the region remain locally-owned community banks. Only one large, non-local bank, Louisville-based National

City Bank of Kentucky, has a significant presence in the region. It has offices in five of the eight counties and holds about 12 percent of the region's total deposits.

The region has a relatively low level of banking resources. Total deposits per capita in commercial and savings banks were 25 percent below the state average and 29 percent below the national average. When commercial bank resources alone are considered (commercial banks have traditionally been more active business lenders than savings banks), the disparity is about the same -- 28 percent below both the state and national averages.

While banking resources are somewhat low, the region's banking environment appears to be highly competitive. No bank holds more than 15 percent of the region's total bank deposits and the three largest banks hold just under 40 percent. The level of competition does vary by county, however. While five counties -- Bell, Harlan, Knox, Laurel, and Whitley -- have between five and six banks, the other three counties -- Clay, Jackson, and Rockcastle, only have one or two banks. (These three counties also have the smallest populations.)

In measures of availability of banking services, the region also does reasonably well. It has more banks in relation to population than the national average but about the same as the state average. Its ratio of savings and commercial banks to population is over twice the national average while its ratio of commercial banks to population is almost twice the national average. In both of these measures, the region is roughly the same as state averages. In measures of banking offices to population, the region is somewhat below state averages although it is still higher than national averages. The ratio of both combined commercial and savings bank offices and commercial bank offices alone to population is about 10 percent below state averages. These ratios are about 25 percent above national averages in both categories. The region's less favorable standing with respect to this second set of measures reflects the smaller than average size and less extensive branch networks of the region's banks.

The region's banks, while viewed by development finance professionals and bankers themselves as conservative, are also viewed as generally responsive to the needs of local businesses, within the market and regulatory constraints placed on the banking industry. Banks are seen as doing a good job of meeting the demand for secured debt financing. Non-bank lenders are not considered a significant source of business financing in the region.

While the region's banking environment has been affected by banking consolidation and other changes within the industry occurring nationally, this is not seen as having a major impact on business financing in the region, at least to date. Some observers do detect a somewhat more competitive environment for small business lending resulting from a combination of factors, including acquisitions of local banks by non-local banking organizations, the entry of some savings banks into the commercial lending market, and the improving economy. It is also noted that the few large banks active in the region tend to focus on high-volume loan products, are introducing credit scoring systems for business loans, and are reducing the discretion given to local branch personnel in lending decisions. This is seen as beneficial to businesses that fit these banks' standard lending criteria, but as harmful to businesses that may be creditworthy but may not have all the information required by the bank or may not meet certain financial performance ratios.

Banks in the region are not very active users of SBA loan products. In 1996, the number of SBA 7(a) guaranteed loans made in the region was less than one-third the national average. One small business assistance professional notes that, in addition to the traditional reluctance of small, rural banks in the region to use SBA programs, the local SBA office is also somewhat conservative.

Risk Financing

Bankers and development finance and business assistance professionals all agree that there is very limited private risk capital activity, either formal or informal, in the region. While there is some private wealth in the region, there is not a strong tradition among wealthy individuals of investing in small, entrepreneurial enterprises in the region. Because of generally low income and asset levels in the region, would-be entrepreneurs have very limited personal or family resources from which to draw. These problems are particularly severe in the poorer, more remote parts of the region.

It is also generally noted that, while risk capital is in limited supply, it is not the sole or even the primary barrier to new enterprise development. Many would-be entrepreneurs lack management skills and have not developed good business plans. For these individuals, the need for technical assistance is greater than the need for capital. Entrepreneurs are also reluctant to cede any ownership in their ventures to outside investors.

SOURCES OF DEVELOPMENT FINANCE

Local and Regional Organizations

Private sources of credit and capital within the region are supplemented by four well-established development finance organizations, some with substantial financial resources:

Cumberland Valley Area Development District (CVADD): CVADD is nonprofit organization designated by the state and federal governments as a regional development district. It is governed by a board of directors comprised of public officials and citizens from the eight-county Cumberland Valley region. In addition to development finance, it is involved in a range of planning, development, and social service activities in the region.

CVADD has two revolving loan funds, one capitalized by ARC, the other by the Economic Development Administration. The combined capitalization of these funds is almost $1.5 million. As of May 31, 1997, they had a combined portfolio of 21 outstanding loans with a total principal balance of $882,118. Characteristics of the portfolio included the following:

- *average loan amount of about $70,000, with a range of between $10,000 and $100,000;*
- *average total financing amount of about $1.28 million, with a range of $30,000 to $5.33 million;*
- *interest rates of 5 to 6 percent;*

- *terms of five to ten years (usually no more than seven years);*
- *primarily fixed-asset financing;* and
- *most of the borrowers were in the manufacturing sector, but the tourism-related businesses are also targeted.*

CVADD typically provides financing in participation with banks, often on a subordinated basis. It also works with borrowers to approach other financing sources and to structure deals. While CVADD advises prospective borrowers on the development of their business plans, it does not provide extensive technical assistance. Rather, it refers borrowers to other technical assistance sources such as the Small Business Development Center.

Kentucky Highlands Investment Corporation (KHIC): KHIC is a nonprofit community-based development organization focusing on small business investment and venture development. It currently has a staff of 15 and almost $30 million in assets. Its business financing activities include:

- *an SBA-funded microloan fund that makes loans of $500 to $25,000 in a 12-county region. The fund is currently capitalized at $545,000 and made six loans in 1996;*
- *a revolving loan fund capitalized by the U.S. Department of Agriculture's Intermediary Relending Program (IRP);*
- *real estate financing;*
- *revolving credit lines;* and
- a Development Venture Fund that makes venture capital investments in the $50,000 to $1.5 million range. As of June 1, 1997, it had 12 investments with an outstanding value of $2.3 million. The average KHIC investment per deal was $417,000 and the average total investment per deal was $3.1 million.

In addition to its financing activities, KHIC also provides extensive entrepreneurial training and technical assistance. It takes a very active management role in companies in its venture portfolio, much like traditional venture capital firms. It is also willing to hold an investment much longer than a traditional venture capitalist if necessary to produce economic benefits for the region.

Eastern Kentucky Corporation: Eastern Kentucky Corporation serves 43 of the 49 Kentucky counties in the ARC region. It is funded by utilities, coal-related companies, and banks. It has a privately capitalized $1 million revolving loan fund that provides subordinated financing of $10,000 to $50,000, primarily to small manufacturers. It had 13 outstanding loans and three loan commitments as of May 31, 1997, two of which were in the CVADD region. The organization is also involved in industrial recruitment.

Mountain Association for Community Economic Development (MACED). MACED, a community-based development organization based in Berea, just north of the CVADD region, serves the entire 49-county ARC region in Kentucky. MACED has a small ARC revolving loan fund, capitalized at $262,000 in 1995. The fund has made four loans since its inception. Since it is very small and serves such a large region, it is not a significant resource for the CVADD region.

In addition to these organizations, five banks are in the process of establishing a multi-bank CDC covering a three-county area in the region. The banks have committed $125,000 of initial funding and will provide loans in the $1,000 to $15,000 range. The founding banks hope to bring five other banks into the CDC and to increase its capital base.

State Programs

The state of Kentucky operates a number of development finance programs available to businesses in the state:

- *the Kentucky Economic Development Financing Authority (KEDFA) provides low-interest fixed-asset loans in the $25,000 to $500,000 range, primarily targeted to manufacturing firms. According to a state economic development official, these loans are rarely for less than $200,000;*
- *KEDFA also has a loan guarantee program for craft businesses, which guarantees loans of between $2,000 and $20,000;*
- *the Commonwealth Small Business Development Corporation provides SBA 504 certified development company loans.* These are subordinated loans for fixed assets in participation with a private lender. The 504 loan is 40 percent of the total financing, with a minimum of $25,000 and a maximum of $750,000;
- *the Kentucky Agricultural Finance Corporation provides tax-exempt industrial revenue bond financing;* and
- *a state venture capital network that seeks to match private investors to companies needing risk financing.*

In general, state programs are viewed within the region as primarily serving medium-sized and large established firms, primarily in the manufacturing sectors. Very few firms in the region have received state financing.

Assessment of Capital and Credit Needs and Gaps

There is general agreement among development finance and business assistance professionals and bankers in the region that among the most difficult types of business financing to obtain from private sector financing sources are: 1) small amounts of working capital; 2) financing for startup and early-stage firms; and 3) financing for small service and retail businesses, particularly in the tourism sector.

There is a range of viewpoints on how effectively development finance programs address these gaps and what additional steps should be taken:

- *State financing programs are generally not seen as useful to small firms, non-manufacturing firms, startup firms, and firms needing working capital.* Some local development finance professionals also complain that the state has made little effort to foster tourism enterprises, an increasingly important component of the region's economy.
- *Some development finance professionals believe that the shortage of good technical assistance is a more serious problem than the shortage of development finance resources.* While this is particularly true for startups, they note that even most established firms still do not have business plans. Still, most appear to believe that, with increased technical assistance capacity, the region could absorb more development finance resources than are currently available.
- *While KHIC is viewed as a highly competent organization that is addressing part of the risk capital gap through its Development Venture Fund, some observers believe there is still a gap for risk capital financings in amounts smaller than deals in which KHIC typically participates.*
- *There is mixed opinion about the need for additional microenterprise financing.* Some development finance professionals believe microenterprise development is overemphasized and does not hold the potential to significantly affect the region's problems of poverty and unemployment. Even among those who are more supportive of microenterprise development, the concern is more about increasing entrepreneurial training and technical assistance than the availability of financing.
- *The various development finance and technical assistance organization are seen as having made progress in coordinating their activities.* However, small business assistance professionals indicate that small businesses and new entrepreneurs still have difficulty identifying resources and determining where to go for assistance.
- *Some firms remain reluctant to use development finance programs because of fear of red tape and taking on additional debt.*

Summary

The Cumberland Valley ADD region faces a number of economic development challenges and still lags well behind national averages in measures of economic well-being. Yet, the region is also experiencing positive, if uneven, economic trends. The region's private capital markets have turned in a mixed performance in supporting economic development. The banking industry, despite a limited deposit base, appears to be reasonably competitive and to offer a level of service to businesses comparable to other parts of the country. However, like many poor, rural regions, the region lacks access to other sources of capital, particularly formal and informal risk capital. At the same time, the region benefits from a number of well-established, highly-regarded development finance organizations that fill gaps left by the private financial market. While the region could benefit from additional development finance resources, particularly working capital, financing for early-stage businesses, and financing for firms in emerging industries such as tourism and secondary wood processing, these would have to be combined with other additional resources and capacity-building, particularly in the areas of general education, entrepreneurial training, intensive business technical assistance, infrastructure development, and institutional development.

Appendix C: North Central Pennsylvania Regional Planning and Development Commission (NCPRPDC) Region

Regional Economic Conditions

The region served by the North Central Pennsylvania Regional Planning and Development Commission (NCPRPDC) covers six counties -- Cameron, Clearfield, Elk, Jefferson, McKean, and Potter. The region had a population of 232,769 in 1995. The region is heavily rural, but has a number of small towns, the largest of which are Bradford (population 9,965), Dubois (8,286), and Punxsutawney (6,782).

The region has long been heavily dependent on the manufacturing sector. Over the last few decades, the character of the manufacturing sector has changed, as traditional industries have declined and new ones have emerged. In addition, the total size of the manufacturing sector has declined, and other sectors such as services and retail have increased in importance. These structural changes have resulted in dislocations for large segments of the workforce and have changed the nature of employment opportunities for new workforce entrants.

The region generally underperforms the state and the nation as a whole in indicators of employment and income. Unemployment in the region was 7.3 percent in 1995, compared to the state average of 5.9 percent and the national average of 5.6 percent. The region also has lower-than-average levels of personal income and higher-than-average rates of poverty, although these disparities are relatively modest. Per capita income in 1995 was about $18,869, compared to $23,588 statewide and $24,426 nationally. The poverty rate in 1990 was 13.1 percent, higher than the statewide average of 10.8 percent but equal to the national average. None of the six counties are designated as "distressed" by the Appalachian Regional Commission. Five are characterized as "transitional" and one as "competitive."

The region has experienced moderate employment growth in recent years. Between 1993 and 1995, employment increased by 3.9 percent. This was more rapid than the statewide growth rate of only .3 percent but about equal to the national rate.

Economic conditions in the region vary by county, although not drastically. Elk County has experienced the most robust recent economic performance. It experienced employment growth of 8.6 percent between 1993 and 1995 and had an unemployment rate of 5.7 percent in 1995. Jefferson and McKean counties experienced the lowest rates of 1993 to 1995 employment growth, 3 percent each. Clearfield County, the most populous county in the region, had the highest 1995 unemployment rate, 8.6 percent, and a 1993 to 1995 employment growth rate of 3.5 percent.

THE DEMAND FOR FINANCING: THE REGION'S BUSINESS BASE

The manufacturing industry remains a relatively important component of the region's economic basic. Manufacturing employment in 1995 comprised almost 25 percent of total regional employment, compared to 15 percent statewide and under 13 percent nationally. Important manufacturing sectors include powdered metals and metal fabricating, forest products, and specialized electronics. Other industries that contributed to the region's traded sector include warehousing and distribution, and tourism.

The powder metallurgy industry has become a particular success story in the region in recent years. The powder metallurgy process involves placing metal powders in dies and forming metal parts using a combination of heat and pressure. Powder metal parts are used primarily in the automotive industry, but are also used in other products including household appliances, tools and hardware, and industrial motors.

The local powder metallurgy (PM) industry has its roots in the carbon factories established in the region in the late 1800s. The first powder metallurgy firm was started in the region soon after World War II. Over time, employees of established PM firms left to found their own companies. Today there are over 40 PM houses operating in the region. The market for powder metallurgy products has been expanding in recent years because of the strong performance of the automotive industry and the industry's increasing use of relatively inexpensive PM parts. The industry is said to be highly profitable at the present time and is thought to have considerable expansion potential.

The capital costs involved in starting a PM house have been relatively modest in the past, but this is changing with the introduction of more advanced technologies. Today, the equipment costs for a startup PM house are typically at least $1 million. This, in turn, has made it more difficult for new entrepreneurs in the industry to attract startup capital as they have had to reach beyond their own resources and those of friends and family members.

While far less important than the PM industry, other growth industries include secondary wood products (e.g., cabinetmaking) and tourism. The region has substantial hardwood forest resources suitable for the manufacture of secondary hardwood products. It also has a number of rivers and scenic areas, including the Allegheny National Forest and three state forests, suitable for a variety of outdoor recreational activities. Another trend noted by bankers and economic development professionals has been the growth in the number of home-based businesses operated by professionals who are attracted to the area by its rural character.

The Supply of Financing: The Regional Financial Market

Private Debt and Equity Markets

Secured Debt Financing

There are 20 commercial banks and savings institutions operating in the region. The region's banking market has a mix of large non-local banks and smaller community-owned banks, but remains largely dominated by smaller banks headquartered in or near the region. The two largest banking organizations with offices in the region are National City Bank of Pennsylvania, based in Pittsburgh and a subsidiary of an Ohio-based holding company, and PNC Bank, also based in Pittsburgh. Both of these banks have offices in five of the region's six counties. Together, they controlled a little over one-quarter of the region's banking desposits in 1996.

The region has a relatively low level of banking resources overall. Total deposits per capita in commercial and savings banks were 39 percent below the state average and 29 percent below the national average. Approximately the same disparities exist for commercial bank resources alone (commercial banks have traditionally been more active business lenders than savings banks).

While banking resources are somewhat low, the region's banking environment appears to be highly competitive. No bank holds more than 18.5 percent of the region's total bank deposits and the three largest banks hold just under 46 percent. The level of competition does vary by county, however. While four counties -- Clearfield, Elk, Jefferson, and McKean -- have between six and 11 banks, the other two counties -- Cameron and Potter, only have two or three banks. (These two counties also have, by far, the smallest populations.)

In another sign of relatively robust competition, the region also has more banks and banking offices in relation to population than national averages. Its ratio of savings and commercial banks to population is about three times the state average and over twice the national average while its ratio of commercial banks to population is about five times the state average and almost twice the national average. Its ratio of banking offices to population compares somewhat less favorably to national and state averages, although it is still higher -- by over 15 percent over the state average and almost 60 percent over the national average for savings and commercial bank offices combined and by almost 25 percent above the state average and 50 percent above the national average for commercial bank offices alone. This smaller gap reflects the smaller than average size and less extensive branch networks of the region's banks.

Bankers and development finance professionals agree that the market for small business lending in the region is highly competitive. This is attributed to a number of factors, including the improving economy, the entry of savings banks into the small business lending market, and the acquisition of local banks by non-local banks, who then try to expand market share by aggressively pursuing new customers. One banker in Dubois noted that, whereas two banks used to control the local market, at least five banks are actively competing today. Development finance professionals see this competitive environment demonstrated in the large number of bankers willing to serve on their loan committees and the high level of interest in joint financings. A number of banks are also SBA Preferred or Certified Lenders, indicating that they actively use the SBA 7(a) Loan Guarantee Program. However, use of the program in the region is only about two-thirds of the national average, as measured by the number of loans-to-enterprises. One small banker indicates that his bank steers away from the program because of the extra expense and reduced flexibility for the borrower.

The region has been affected to some degree by banking industry consolidation, with the entry into the region of large banks such as National City and PNC. A number of small community banks have also been acquired by mid-sized banking organizations. The impact of this trend on the availability of business financing in the region is seen as mixed. A development finance professional in the region sees both positive and negative impacts. On the positive side, banks are reaching into new territories, resulting in more competition and a stronger bargaining position for borrowers. On the negative side, non-local banks strip local lenders of some of their lending authority and make lending decisions at more distant locations, reducing flexibility and the role of subjective factors, such as the borrower's background and character, in the lending decision.

At this point, the region is seen as having a good mix of large, medium-sized, and small banks. While banks acquired by large banking organizations have become less hospitable to smaller businesses that do not meet standard lending criteria, smaller banks have been eager to attract these customers. At the same time, there is uncertainty about future trends in the region's banking structure, and concerns that additional consolidations may lead to a deterioration in the lending climate for small firms.

Aside from banks, leasing companies are reported to be fairly active in the region. However, a development finance professional reports that they tend to be less flexible than banks on collateral positions. Non-bank SBA lenders are not known to be active in the region.

Risk Financing

Bankers and development finance professionals report that there is very little formal venture capital financing activity in the region, even though Pittsburgh, the home of several venture capital firms, is less than a three-hour drive. There is, however, an active informal investment market, centering primarily around the powder metallurgy industry. Informal investors include successful entrepreneurs from the industry and wealthy professionals. Some of these investors participate in investment groups. In addition, some established PM houses, believing that growth in the number of PM houses will benefit the entire industry in the region, help startups by subcontracting small jobs to them and paying receivables quickly. Outside of the PM industry, startup entrepreneurs are primarily dependent on their own resources or those of friends and family members.

Sources of Development Finance

Local and Regional Organizations

North Central Pennsylvania Regional Planning and Development Commission (NCPRPDC). NCPRPDC is the primary source of development finance resources within the region. NCPRPDC is a nonprofit organization also organized as a Regional Planning Commission acting through the Pennsylvania Department of Community Affairs. It is governed by a 25-member board composed of county and municipal elected officials and local civic leaders. Its membership is appointed by the region's six county commissioners and the mayors of each of the region's cities.

NCPRPDC has three revolving loan funds.

- *a U.S. Department of Agriculture Intermediary Relending Program (IRP) with current capitalization of about $2 million;*
- *an ARC RLF with current capitalization of about $1.6 million;* and
- *an Economic Development Administration RLF with current capitalization of almost $1.2 million.*

NCPRPDC loans are provided on the following terms:

- *loan amounts in the $10,000 to $100,000 range for fixed assets and in the $10,000 to $50,000 range for working capital;*
- *maturities range from three to ten years;*
- *interest rates ranging from 4 percent to four points below prime and fixed at closing;* and
- *a minimum of 50 percent of the deal in private financing.*

About two-thirds of the loans are to startups and about 60 percent to PM houses. Most of the loans are for fixed assets because borrowers prefer to use low-interest loans for longer-term assets.

NCPRPDC has experienced strong demand for its RLF loans and has aggressively lent out its funds. As of May 31, 1997, it had a total of almost $4.6 million in loans and commitments outstanding and only $215,000 available to lend. It had a total of about 200 loans outstanding. NCPRPDC staff report that they receive about 10 applications for every loan approved.

Many of the banks in the region are eager to participate in financings with NCPRPDC, and also have representatives on the organization's loan committee. Banks report a number of reasons for their interest. First, the low-interest rates are attractive to their clients and improve cash flows. Second, smaller banks sometimes cannot lend the full amount needed by borrowers because of bank lending limits. Third, some of the deals are weak in some respects (e.g., collateral, equity participating -- NCPRPDC's participation can reduce the bank's risk and this makes it more comfortable with the deal. NCPRPDC staff believe that these advantages translate into accelerated business development and more jobs for the region.

NCPRPDC is viewed by bankers and other development finance organizations in the region as the lead organization in development finance. Bankers interested in partnering with a local, regional, or state development organization typically contact the NCPRPDC lending staff to inquire about appropriate options. If other organizations need to be contacted or joint financing packages developed, NCPRPDC typically plays a coordinating role.

NCPRPDC's RLFs are part of its Enterprise Development Program, a comprehensive one-stop center for business. It provides assistance with financing, market development (including exporting), product development, and application of advanced technologies, and also offers operating space for small startups. In addition to its Enterprise Development Program, NCPRPDC's activities include: infrastructure development, social services, workforce development, transportation, and planning and development assistance to communities. Three of NCPRPDC's staff are involved in operating the loan programs -- the Deputy Director for Enterprise Development, the Loan Program Director, and the Loan Program Assistant.

Other local and regional loan programs. The region does not have a 504 certified development company to make SBA 504 loans. These are subordinated below-market fixed-rate loans for fixed assets, in partnership with private lenders. NCPRPDC refers borrowers interested in obtaining these loans to a certified development company operated by another of the state's regional development organizations, SEDA-COG, which serves a region just to the east of the NCPRPDC region. NCPRPDC lending staff report that the program has been used infrequently and that they do not consider the terms of the financing attractive to the borrowers they typically serve.

The region also has at least three small RLFs operated by local governments and development organizations. Some of the banks in the region are also considering forming a bank consortium to make higher-risk loans.

State Programs

The Commonwealth of Pennsylvania operates a number of development finance programs available to businesses in the state:

- *the Pennsylvania Economic Development Finance Authority (PEDFA) provides tax-exempt industrial revenue bond financing;*
- *PEDFA also operates a Machinery and Equipment Loan Fund providing loans up to $500,000 targeted to manufacturing firms;*
- *the Department of Community and Economic Services operates the Small Business First Program, an $18 million fund that provides fixed asset and working capital*

loans up to $200,000 for firms with less than 100 employees. The program made about 100 loans in 1996;

- *the Pennsylvania Industrial Development Authority (PIDA) provides fixed asset financing of up to $2 million targeted to small manufacturing and technology firms;* and
- *the Ben Franklin Partnership provides research seed grants of up to $750,000 for new product development to firms with fewer than 250 employees. It funded approximately 150 firms in 1996.*

While these programs have been used by only a small number of businesses in the region, bankers and development finance professionals generally view them as targeted more to urban areas and firms that are larger than most of those located in the region. Yet, NCPRPDC staff maintain a good relationship with state agencies, and believe that if the fit between the borrower and the program is good, they can secure state participation.

Assessment of Capital and Credit Needs and Gaps

In some respects, the region's financial markets are performing reasonably well in meeting the demand for business financing:

- *Between the region's banks and development finance organizations, the supply of secured debt financing appears to be largely adequate, particularly for manufacturing firms.* NCPRPDC staff believe that the organization could make additional loans if it had additional capital, and, in fact, the organization has lent out virtually all of the capital it has available. While staff speculate that many of the firms they are unable to finance are able to obtain conventional financing, they believe that the more favorable terms that NCPRPDC offers enable firms to obtain financing earlier in their development cycle and to expand more quickly, thus stimulating more rapid job creation.
- *While there is little formal venture capital investment in the region, informal risk financing appears to be available for firms favored by local informal investors, particularly firms in the powder metals industry.*
- *Coordination among development finance organizations, and between development finance organizations and banks, spearheaded by NCPRPDC, is seen as generally effective.*

At the same time, development finance professionals and bankers identify a number of significant financing gaps. These include:

- *startup financing for firms not favored by local banks and informal investors, including firms in less established manufacturing industries than powder metals,* *such as secondary wood processing, and firms in the retail and service industries, including those related to tourism;*

- *working capital for early-stage firms that have not reached profitability;*
- *small loans (especially under $25,000) for home-based and other microenterprises, a growing presence in the region's economy.* Banks will not typically make these loans, particularly to individuals with limited personal assets, and there are no SBA-funded or other microloan programs serving this market; and
- *loans for firms that do not fit traditional financing practices of conventional lenders or the targeting criteria of development finance programs.* One banker notes that, despite the growing importance of the region's retail economy, banks continue to resist financing retail firms. Development finance programs tend to target manufacturing firms.

Aside from the issue of financing, development finance professionals express concern about the limited availability of management and technical assistance to the region's small firms. NCPRPDC's Enterprise Development Program offers specific forms of technical assistance but does not provide one-on-one assistance in such areas as business plan development and financial management. The major source of that type of assistance is a small business development center that is located just outside the region and is not easily accessible for many businesses. The SBDC has not been aggressive in its outreach or in trying to make its services more easily accessible. NCPRPDC would like to bring a staff person on board to work with businesses on business plan development, but is concerned about potential conflicts of interest of interest with its lending function.

Summary

The economy of the North Central Pennsylvania region, while lagging in some respects, has weathered recent economic transitions reasonably well and is showing strength in its important manufacturing sector, particularly through the healthy growth of its powder metallurgy industry. The region is experiencing other positive trends, including the development of secondary wood processing, tourism, and home-based professional businesses.

The performance of the region's capital market in responding to the resulting demands for business financing has been good in some respects but has fallen short in others. The region has a highly competitive banking industry and a fairly active informal investment market. Firms in the powder metallurgy industry have largely been able to meet their needs for both risk capital and secured debt financing. However, firms in industries that are not as well established have had greater difficulty. Development finance organizations have played an important and effective role as partners with banks and private investors, but are limited by a narrow range of financing tools that does not include flexible risk financing and financing for small-scale enterprises. The region also lacks sufficient capacity to provide small business management assistance to fully capitalize on the region's entrepreneurial potential.

Appendix D: Northeast Mississippi Planning and Development District (NMPDD) Region

Regional Economic Conditions

The region served by the Northeast Mississippi Planning and Development District (NMPDD) spans six counties in northeastern Mississippi -- Alcorn, Benton, Marshall, Prentiss, Tippah, and Tishomingo. The region had a population in 1995 of 135,552. Over one-fifth of the population are minorities, primarily African-American, who are clustered in Marshall and Benton counties in the western part of the region. Previously stable, the population has grown 3 percent since 1990, primarily in the western counties. About 75 percent of the residents live in areas classified as rural. The region averages 46 people per square mile, compared to 70.3 nationally. The largest urban centers are Corinth (population 11,820), Booneville (7,995), Holley Springs (7,261), and Ripley (5,371).

The topography of northeast Mississippi is generally hilly, mostly forested, with a limited amount of good farmland. Three U.S. highways and seven state highways provide the basic transportation network. Most towns have rail service, and the Tenn-Tom Waterway passes through the eastern end of the region. Tennessee Valley Authority electric power and gas pipelines serve much of the region.

The region has a rich history, as exhibited by its many attractive artifacts. Handsome homes and commercial buildings cluster around towns and villages. Civil War sites are commemorated and celebrated. The Natchez Trace Trail, an ancient Indian path along which a parkway with historic sites now extends, traverses the District. Also, three state parks, a national forest, and Army Corps of Engineers recreation areas offer outdoor recreation opportunities.

The region suffers from higher rates of unemployment and lower incomes than the state and nation as a whole. Average annual regional unemployment in 1995 was 7.8 percent compared to 6.1 percent statewide and 5.6 percent nationally. While unemployment has fallen in recent months, this pattern has continued. In April 1997, the regionwide unemployment rate was 5.5 percent, compared to the state average of 4.7 percent and the national average of 4.8 percent.

NMPDD is a relatively poor area. Per capita income in 1995 was $14,985, compared to $16,709 statewide and $24,426 nationally. The percentage of residents living below the poverty level in 1990 was 23.4 percent, slightly lower than the statewide rate of 24.5 percent, but far higher than the national rate of 13.1 percent. Households receiving Food Stamps exceed 20 percent. Over 48 percent of adults older than 25 lack a high school diploma. The NMPDD reports that the low earnings of manufacturing workers -- less than $10.00 per hour -- reduces the per capita income and constrains the level of non-basic jobs that the economy can support. The NMPDD also reports that employers are experiencing increasing difficulty in recruiting and retaining quality workers

The region has experienced flat employment growth in recent years. Between 1993 and 1995, employment increased by only 0.4 percent. This compares with 4.1 percent at the state level and 3.9 percent nationally.

Economic conditions in the region vary by county. Benton and Marshall counties have the lowest incomes and the highest unemployment. These counties also have the greatest concentration of minority populations and, along with Tishomingo County, are the most rural. Prentiss and Tippah counties have the strongest recent employment growth and the lowest unemployment. Alcorn and Tishomingo have the highest income levels.

The Demand for Financing: The Region's Business Base

The primary industry in the region is manufacturing. Manufacturing grew vigorously from 1950 to 1980, but has declined modestly since then. Between 1980 and 1990, agriculture, government, and transportation/communications/utilities shed 32 percent of their jobs. Although northeast Mississippi remains rural, its agricultural sector has especially declined, losing 89 percent of its jobs from 1960 to 1990. Furniture manufacturing, employing approximately 7 percent of the labor force, is the most important industry, recently replacing the garment industry, which has suffered due to NAFTA. More than 30 furniture firms employ some 4,400 workers. Retail trade is the second industry. With the growth of metropolitan Memphis, located about 100 miles northwest of Booneville, businesses, especially warehousing firms, have begun locating in the western areas of the District. Tourism is growing in some localities and is increasingly promoted.

The region is far more reliant on manufacturing jobs than the state or the nation. Manufacturing employment in 1995 comprised almost 35 percent of total regional employment compared to a little over 19 percent statewide and under 13 percent nationally. In 1990, manufacturing firms comprised over 11 percent of all startups in the region, compared to 6.7 percent statewide. The NMPDD maintains that low startup costs continue to facilitate the growth of the furniture industry. Availability of quality workers, however, is limiting this growth.

Public expenditures have resulted in varying impact on the business base. On the one hand, public work projects such as the Tenn-Tom Waterway created temporary jobs and vital infrastructure. On the other hand, the demise of a NASA aerospace project displaced hundreds of workers.

The Supply of Financing: The Regional Financial Market

Private Debt and Equity Markets

Secured Debt Financing

The six-county region is served by 14 commercial banks and savings institutions. These include both small locally-based community banks with less than $250 million in assets and large statewide or multi-state institutions exceeding $1 billion in assets. However, most of the banks are small and locally-based. Ten have home offices in the region and another two have home offices located just outside the region. Only three of the banks with a significant presence in the region are large banks with assets exceeding $1 billion and with statewide or multi-state operations. One of these, BancorpSouth (formerly Bank of Mississippi), is based in nearby Tupelo.

The banks with the strongest presence in the region are BancorpSouth; People's Bank, a community bank with headquarters in Ripley; Deposit Guaranty National Bank, a statewide bank based in Jackson; and People's Bank and Trust, a community bank based in nearby Tupelo.

The region has a relatively high level of banking resources for a rural area. Total deposits per capita in commercial and savings banks (as of June 30, 1996) were about 5 percent above the state average, but still 19 percent below the national average. When commercial bank resources alone are considered (commercial banks have traditionally been more active business lenders than savings banks), the region's position is even stronger. Commercial bank deposits per capita are 9 percent above the state average and only 7 percent below the national average.

The region's banking environment appears to be reasonably competitive. No bank holds more than 16 percent of the region's total bank deposits and the three largest banks hold about 43 percent of the total. In another sign of relatively robust competition, the region also has more banks and banking offices in relation to population than state and national averages. Its ratios of both savings and commercial banks combined and commercial banks alone to population are about two-and-one-half times the state average and almost three times the national average. Its ratio of banking offices to population compares somewhat less favorably to state and national averages, although it is still higher -- by 9 percent over the state average and 60 percent over the national average for savings and commercial bank offices combined, and by 15 percent above the state average and 70 percent above the national average for commercial bank offices alone. This smaller gap reflects the smaller than average size and less extensive branch networks of the region's banks.

Development finance professionals, economic developers, and banks offer varying assessments of competition among banks. Bankers suggest competition is active. Others report that competition is active for small loans in the $25,000 to $250,000 range, but limited for larger loans, and languid for microloans. Community relationships often prevail in opening access to these smaller loans from local banks. Many interviewees suggest these banks have very conservative lending practices, thus constraining available financing. In some cases, banks either lack competition or are very aggressive in satisfying the market. One bank reported that it enjoyed a 72 percent market share in its rural county, and that it loaned almost 64 percent of its deposits.

The level of banking resources and the banking market environment vary significantly within the region. The two counties with the lowest income levels and highest minority populations -- Marshall and Benton -- also have the smallest deposit base, with per capita deposits of less than half the regional average, and about one-third the level of the two most deposit-rich counties, Tippah and Tishomingo. Marshall County also has the lowest ratio of banks and bank offices to population, while Benton County has the lowest absolute level of banking operations, with only two banks. Tishomingo County has the highest ratio of banks and bank offices to population while Alcorn, the most populous county, has the highest level of bank operations, with six banks.

Area banks reportedly use development finance resources in varying levels. Banks in the six-county region use some SBA programs heavily and other others less so. Across all six counties, banks use the 7(a) loan guarantee program at a rate exceeding 115 percent of the U.S. average, as reflected in the number of 7(a) loans outstanding per 1,000 enterprises in 1996. In contrast, banks' use of the 504 program, which provides secondary co-financing for 40 percent of the total financing, is below 85 percent of the U.S. average. Some public officials believe that some banks lack information needed to effectively use development finance programs. Others report that banks do not need these programs to conduct a profitable lending division.

The region has been affected to some degree by the national trend toward banking consolidation. Within the past year alone, two small, local banks were acquired by large banks. However, as noted, most of the banks in the region remain locally-owned. Opinion is mixed on the local impact of banking consolidation. Many economic development officials and some bankers believe that the reduction in the roster of local banks has resulted in a less responsive banking system, less familiar with community needs. On the other hand, most agree that banks now offer more diverse, sometimes more sophisticated loan products.

Non-bank sources of financing are limited. Leasing companies are active, but other non-bank sources seldom finance businesses in the area.

Risk Financing

Formal sources of risk capital are virtually nonexistent in the region. According to knowledgeable business people, a limited amount of informal investment activity occurs in the region, but informal investors are not organized into any sort of network, and are thus difficult to approach. Consequently, entrepreneurs in the region are left to rely heavily on their own resources, and those of friends and family members, for investment capital. However, low per capita income levels in the region suggest that these resource are limited.

Sources of Development Finance

Local and Regional Organizations

Northeast Mississippi Planning and Development District (NMPDD). NMPDD is the lead economic development organization in the region. It has revolving loan funds funded by three federal agencies, ARC, the Economic Development Administration, and the U.S. Department of Agriculture. The total capitalization of these funds in mid-1997 was approximately $11.75 million. NMPDD also offers small and minority business financing through state of Mississippi programs.

NMPDD provides RLF loans on the following terms:

- *fixed-asset and working capital financing;*
- *senior lien required for most loans;*
- *7 percent fixed interest rate;*
- *maximum 10-year term;*
- *leverage of 2:1 on EDA and ARC RLFs; 1:1 on USDA RLF;* and
- *maximum amount of $200,000 on EDA and ARC RLFs, $150,000 on USDA RLF.*

Through October 1997, the NMPDD's RLFs have made 183 loans totaling $17.9 million.[1] It made 20 loans in 1996 and currently has 107 active loans. Its loans have assisted in creating or retaining over 4,000 jobs and leveraged $2.25 in private investment for each RLF dollar. It has written off only 3.4 percent of its loans. It is seen as coordinating well with state and local public financiers and sources of business assistance and in "fulfilling a real need" for non-conventional financing.

NMPDD focuses heavily on providing fixed asset financing for manufacturing firms. Over 90 percent of the funds have been used to acquire or improve fixed assets. Over 58 percent of the loans and 41 percent of the loan volume has been invested in the manufacturing sector. NMPDD has financed both expansions and startups -- over half of its loan volume supports business expansion, while almost 40 percent assists startups.

NMPDD has experienced strong demand for its financing and has aggressively lent out its funds. Of the $2.17 million in RLF funds it currently has available to lend, it has $2.16 million in outstanding loan commitments. Since certain projects can only be financed by particular RLFs (because of differing financing criteria), some RLFs have available funds while others do not have sufficient funds to meet current commitments. In the cases of the ARC and EDA sources, commitments exceed available funds by $208,000 and $223,000, respectively.

[1] Letter report of 13 November 1997 from Pat Falkner of NMPDD provided all data describing the RLF lending and portfolio.

NMPDD is involved in a number of activities in addition to business financing. These include planning and obtaining funding for regional transportation projects, water and sewer facilities, and community facilities, and expanding industrial parks.

State Programs

The state of Mississippi operates a number of development finance programs available to businesses in the state. Two state entities, the Mississippi Business Finance Corporation and the Department of Economic and Community Development provide business financing. Among the major financing programs of these entities are the following:

Mississippi Business Finance Corporation

- *Through the Small Enterprise Development Program, MBFC provides fixed-asset senior secured loans of $300,000 to $2 million at fixed rates (currently 7.25 percent) . It made 15 such loans in 1996.*
- *Through its Small Business Loan Guaranty Program, MBFC guarantees loans in the $25,000 to $500,000 range for fixed assets and working capital. It made seven such guarantees in 1996.*
- *Through the Minority Business Enterprise Loan Program, MBFC provides fixed-rate low-interest subordinated loans of $2,000 to $250,000 for fixed assets and working capital to minority-owned businesses. It made 26 loans in 1996. MBFC also has a Minority Surety Bond Guaranty Program.*
- *MBFC provides tax-exempt industrial revenue bond financing.*

Mississippi Department of Economic and Community Development

- *Through the Agribusiness Enterprise Loan Program, DECD provides fixed-asset subordinated loans of $10,000 to $200,000 at market rates to agribusiness enterprises. It made 239 such loans in 1996.*
- *Under the Mississippi Business Investment Program, DECD provides senior secured real estate loans of $500,000 or more at a fixed, 3 percent rate, The program is aimed primarily at attracting large industrial facilities to the state. It made two such loans in 1996.*

The state's direct financing programs, with the exception of those that are narrowly targeted to minorities and agribusiness enterprises, are directed primarily at medium-sized and larger enterprises. Its guaranty program is the most applicable to small enterprises, but does a very small number of financings.

Assessment of Capital and Credit Needs and Gaps

Development finance professionals and bankers identify a number of significant financing gaps. These include:

- *equity financing , particularly for startups* -- both formal and informal sources are lacking, and the region lacks the personal wealth to support substantial private investment*;*
- *financing of less than $25,000;*
- *financings for businesses in struggling or mature industries;*
- *financing for working capital* -- this is influenced by heavy reliance of bankers on real estate collateral. Reliance on real estate as collateral sometimes even makes equipment financing difficult to obtain; and
- *financing for deals that vary from the standard,*

NMPDD financing, while seen as an important supplement to bank financing, is viewed by some economic development actors as sometimes too collateral-oriented to leverage bank financing for riskier deals. The fact that only seven of NMPDD's 30 most recent RLF financings were co-financed with private debt indicates that NMPDD loans may, to some degree, be supplanting rather than supplementing private financing. This impression is reinforced by the low rates and other favorable terms on which NMPDD loans are provided. NMPDD takes the position that taking junior positions on collateral compromises the objective of preserving capital and that sufficient demand for NMPDD loans exists without providing subordinated loans. Despite any reservations about NMPDD's lending practices, other economic development actors interviewed for this study almost uniformly expressed a need for more RLF funding, particularly in light of the RLF's current lack of resources to make new financing commitments.

Aside from financing gaps, other commonly reported constraints to business development include inadequate managerial expertise and poor infrastructure. Although the community college is reportedly surfacing as a training resource, few training programs are available to address weak management skills. While infrastructure is seen as having been substantially improved over the past several years, contributing to the region's development, further improvements are seen as needed.

Summary

While economic conditions in the northeast Mississippi region have improved in recent years, the region still suffers from high levels of economic distress, as evidenced by relatively low income levels and high rates of unemployment. This is particularly true in the more rural parts of the region with large numbers of African-American residents. The region's economy is highly dependent on a mature manufacturing base, some of which (i.e., the garment industry) is vulnerable to the effects of offshore competition and NAFTA. The region has seen only modest diversification into transportation-related and service industries, and recent employment growth has been flat.

The region's financial markets have turned in a mixed performance in meeting business financing needs. Banking resources in the region are relatively high and the banking market is reasonably competitive. The region has a good mix of small, locally-based and larger institutions. However, banking practices are still conservative and heavily collateral-oriented. This conservatism is echoed to some degree in the financing activities of local and state development finance organizations. In addition, low levels of personal wealth in the region and the lack of formal venture capital activity make risk financing extremely scarce. This, along with limited availability of management and technical assistance, has constrained new entrepreneurship. Financing constraints also exist for small-scale businesses and expanding businesses with limited hard collateral.

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