Approved March 23, 1992
Date

MINUTES OF THE HOUSE COMMITTEE ON ECONOMIC DEVELOPMENT.

The meeting was called to order by Representative Diane Gjerstad at
Chairperson

3:35 a.m./p.m. on Tuesday, March 18, 1992 in room 423-S of the Capitol.

All members were present except:

Representatives Baker, Bishop, Dean, Edlund, Love, Sluiter, Wagnon and Wisdom. Excused.

Committee staff present:

Lynne Holt, Legislative Research
Jim Wilson, Legislative Revisor
Betty Manning, Secretary

Conferees appearing before the committee:
Nancy LeGrande, Mid America Institute, Pittsburg State University
Marty Bloomquist, Program Manager, KDFA

Chairperson Gjerstad opened the meeting at 3:35 p.m.

The Chair announced there would be a joint meeting with House Taxation Committee on Wednesday, March 25 in the Old Supreme Court Room at 12 noon. Lunch to be provided.

Representative Chronister made a motion to approve committee minutes of February 17, 18, 24, 25, 26, 27, March 2, 3 and 5, 1992. Seconded by Representative Mead. Motion carried.

Hearings were held on **HB 3163,** authority for KDFA to establish standby loan participation program. Chairperson Gjerstad commented that Representative Teagarden was unable to appear before the committee but was very supportive of this legislation.

Jim Wilson, Legislative Revisor, gave a brief overview of the proposed legislation.

First proponent, Nancy LeGrande, Mid America Institute, Pittsburg State University, supported this measure. She stated that she felt the bill should be amended to include small manufacturers and processors. She also stated there are no other states with this type of legislation. Attachment 1.

Next proponent, Marty Bloomquist, Program Manager, KDFA, stated the proposed loan program would make up the difference between the borrower's equity and amount of the project the lender will loan with or without a quarantee (gap financing). She asked for favorable consideration of this bill. Attachment 2.

Final proponent, Harold Stones, Kansas Bankers Association, assured the committee that this legislation is worthwhile and deserves consideration.

Marty Bloomquist and Nancy LeGrande responded to questions from committee members.

Hearings were closed on **HB 3163.**

The meeting adjourned at 4:20 p.m.

I Mar 18, 1992 GUEST REGISTER

HOUSE

Committee on Economic Development

NAME	ORGANIZATION	ADDRESS
Roger Franzke	Ks Gov't Consulting	Topeka
Steve Kelly	KDOC	Topeka
Jim Maag	KBA	"
Charles Warren	Kansas Inc.	Topeka
Nancy Le Grande	Institute for Econ. Development	Pittsburg
Marty Bloomquist	KDFA	Topeka
Harold Stones	KBA	Topeka

PROPOSAL FOR REVISION

Of The

KANSAS BASIC ENTERPRISE PROGRAM

By

The Institute for Economic Development
Pittsburg State University

The Huck Boyd National Institute for Rural Development recently completed a study entitled "Rural Kansas: An Agenda For The Future". The study determined that the State of Kansas should strengthen the ability of rural communities to support those who want to live and/or work in a rural area. To accomplish this, certain key issues would need to be addressed, one of which is the need for available capital. Of particular importance is business financing for micro-businesses which are the backbone of rural Kansas communities. Most of these small operations are not eligible for state or federal financing, do not meet the criteria of local economic loan programs, and are too risky for conventional lenders.

The Problem

Most revolving loan funds are not available to the retail and service sectors. A job creation requirement is usually imposed which precludes most businesses except manufacturing. The same issue applies to most state and federal programs. Conventional lenders are not as concerned with job creation and would like to finance these micro-businesses. However, a conservative banking climate established by state and federal regulators has tightened credit standards. Thus, many bankers do not feel comfortable making a small business loan without a guarantee from the U.S. Small Business Administration.

This poses a problem for most small business owners. The SBA has established very strict debt-to-equity requirements. Brochures distributed by the SBA clearly state that equity after the loan must be one-third to one-half of total assets. Unfortunately, many small business owners do not have equity of that magnitude. This can eliminate many good business proposals as the following example illustrates:

> A business person wants to establish a new service and retail company. The business plan is complete, the management team has years of experience in all critical areas, the product and/or service has a good market, and the pro formas, although conservative, render a healthy profit margin and cash flow. The local lending institution has performed a credit check and, after a careful analysis of the business plan, has approved the loan application contingent upon an SBA loan guarantee.
>
> The total project cost is $100,000. The business person has $10,000 to invest. The seller of certain equipment has

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> taken a second mortgage for $5,000 and placed it on standby, and relatives of the business owner have also loaned $5,000 on standby. A standby loan, as defined by the SBA, is a note that pays interest only for an indefinite period of time. There is no principal reduction and the lender cannot demand repayment. The loan remains on standby until either the SBA loan is paid in full or the SBA allows the standby agreement to be rescinded. As long as the loan is on standby, the SBA views it as equity. This is because the standby has many of the characteristics of preferred stock. Yet it is important to note there is no ownership involvement.
>
> By placing those loans on standby, the equity according to SBA guidelines is $20,000. Unfortunately, the business would normally need at least $30,000 of equity in a $100,000 project to qualify for an SBA loan. This business, one which might have been very successful, will never open due to the partial lack of equity.

This scenario is frequently repeated throughout Kansas, not only in rural areas but also in cities. There is a great need for small equity injections in micro-businesses in order to leverage larger amounts of federal loan dollars. This would primarily benefit service, retail and small manufacturing concerns that do not normally qualify for venture capital funds.

Venture capital is usually directed to high-technology firms with tremendous growth potential. Additionally, venture capitalists prefer equity injections of at least $250,000 - $300,000. This is not the type of financing that most small businesses require. Usually, micro-businesses only lack small amounts of gap equity ranging from several thousand dollars to less than $50,000.

The State of Kansas has a seed capital program, but the use of monies from that program has been restricted to business plans, prototype development, and marketing studies. These businesses have developed beyond that stage. What is needed is equity financing.

There are numerous local economic development organizations throughout the state with available funds. However, those loans must normally be repaid on an amortized basis, be tied to job creation, and collateralized with fixed assets. Boards governing those agencies are in a stewardship position and cannot place those funds at risk.

The Proposal

The following proposal would address this problem. The Kansas Basic Enterprise Program (KBEP), already authorized by the Kansas legislature, would be capitalized with a minimum $1.0 million dollar appropriation from the state lottery (EDIF) fund. With the benefit of a few changes, the program could be implemented by the Kansas Development Finance Authority (KDFA). The funds would serve as quasi-equity and leverage at least $4.6 million, and most likely $6 - $7 million, of additional financing. The program would be available throughout the state and, although directed to rural areas, could benefit small urban enterprises.

The primary amendments to the existing statute would include:

1) Broadening the definition of basic enterprise to include the service and retail sectors. Possibly the name could be changed to the Kansas Business Enterprise Program.

2) Utilizing the fund, in conjunction with other governmental loan guarantee programs, to guarantee standby loans as defined by the SBA.

3) Limiting the percentage of a financing package that can be guaranteed by KBEP funds to no more than eighteen percent (18%) of the total. Presently, it is conceivable that ninety percent (90%) of a financing package can be guaranteed with KBEP funds. This severely limits the amount of additional financing that can be leveraged from private sources.

The revised KBEP would be utilized in the following manner. A loan application approved by a lending institution could be submitted to the SBA with a KDFA financing provision. If the application met all the SBA's loan approval standards with the exception of required equity, then KDFA could use KBEP funds to guarantee a separate loan made to the small business. As the loan would be guaranteed, it could be placed on standby and thus serve as equity for the SBA. The standby loan could be made by either the lending institution or a local economic development group.

Bank officials have indicated that non-amortized debt without a demand feature would be allowed by regulators if it was substantially guaranteed by state funds. Similarly, local revolving loan funds guaranteed by the KBEP program would not be at risk and would not place the board's stewardship in jeopardy.

The KBEP funds would remain under the control of a state agency. The funds would continue to earn interest as they normally would. They would simply be pledged as collateral.

The guarantees would be systematically released so the KBEP funds could support other loans. Thus, a state-wide revolving loan fund would be established. To accomplish this, each firm participating in the program would agree to escrow two percent (2%) of net sales on a quarterly basis. The escrow account, in the firm's name, would be pledged as collateral for the standby note. As the escrow account builds, a similar amount of the KBEP guarantee would be released. As an alternative, the KBEP guarantee could be released in one thousand dollar ($1,000) increments.

With the unencumbered funds, the Kansas Development Finance Authority would be able to repeat the process and provide additional equity financing for other small businesses.

The escrowed funds (held in the name of the business) would not be an expense, so the escrow would not affect the company's income statement. The escrow of cash would only serve to strengthen the balance sheet. The standby note, with no principal reduction, would not be affected by the escrow. Hence, there would be no violation of SBA policy. The company would only be encumbering money. However, the SBA would probably stipulate in its loan authorization that no funds could be escrowed during any time the company is behind on its SBA loan payment.

Neither the State of Kansas nor the Kansas Development Finance Authority would have any legal involvement or ownership in the companies. The state would merely be providing a financing vehicle for small business.

KDFA would not have to make the credit decision or administer the loan. That would be handled by the local lending institution and the SBA. Neither would KDFA have to liquidate the firm if the company failed. That would also be handled by the SBA and the local lending institution. The state's only involvement would be the pledging of collateral. However, it should be clearly stated that the Kansas EDIF funds allocated to this project would be AT RISK.

Certain rules would apply to the loan participation program as follows:

1) The KBEP funds would be utilized in conjunction with SBA loan programs on a first come, first served basis.

2) The owner(s) must contribute a minimum of ten percent (10%) of the total project as equity. No more than twenty percent (20%) of the total project can be financed through a standby note.

3) The percentage of KBEP guarantee placed on the standby loan should not exceed the percentage of SBA guarantee. If an SBA 504 loan is utilized, in which there is no SBA guarantee, the KBEP percentage should not exceed 85%.

4) No more than ninety percent (90%) of the standby note can be guaranteed with KBEP funds. This would limit KBEP involvement in the total project to no more than eighteen percent (18%). The maximum KBEP participation would be fifty thousand dollars ($50,000) and the minimum would be one thousand dollars ($1,000).

5) KBEP funds would not be allowed for loan authorizations issued by SBA Preferred Lenders, urban banks able to make credit decisions and loan guarantees in-house. Only loans authorized by the SBA District offices in Kansas City and Wichita would be eligible. Thus, SBA Preferred Lenders would not be able to participate in the KBEP unless the loans were forwarded to the respective district office for approval.

6) Certified Development Companies (CDCs), non-profit financing organizations certified by the SBA and funded by the state, would either package or review each loan application prior to its submission to the SBA. This would allow the CDC to ascertain that no other financing source is available and the KBEP request is for the minimum required amount.

7) Other governmental loan guarantee programs, such as the Farmers Home Administration's Business & Industry loan, could be utilized in lieu of the SBA if all the guidelines were met. This would pertain particularly to credit analysis and approval, loan servicing, liquidation, and the use of standby loans.

8) The standby loans issued by the local lending institutions or economic development groups would need to clearly state the terms and conditions of the note. The stated interest rate, either fixed or variable, should not exceed the New York Prime rate plus two percent (2%). This slight reduction in interest would clearly benefit the company during its start-up or expansion.

9) Interest earned on KBEP funds would be used to recapitalize the fund.

10) An initial loan collateralization fee of five percent (5%) would be assessed on the amount of KBEP funds pledged by KDFA. Additionally, an annual fee of two percent (2%) would be charged on KBEP funds still pledged at the end of each year, based on the year's ending balance. There would be a minimum loan collateralization fee of two hundred dollars ($200) and a minimum annual fee of fifty dollars ($50). The fees would be a modest amount for the business owner to pay in return for KDFA providing necessary equity financing. This is especially true when one considers the rates of return being requested by venture capital firms.

The loan collateralization fees would be used to recapitalize the fund and/or provide administrative support for the program. The Kansas Development Finance Authority would administer this program. The KDFA has been successfully administering the Kansas Beginning Farmers Program, where it works with a sizeable network of rural lenders in all areas of the state. It is suggested that similar prodedures be adopted for this program.

In the prior example of the small business lacking equity funds, the program could be utilized as follows:

Source of equity:

Owner equity injection	$ 10,000	(10% of total project)
Seller/relative standby	10,000	
Bank standby	10,000	(Guaranteed with $9,000 of KBEP funds)

Total equity:	$ 30,000	
SBA loan:	$ 70,000	(90% guarantee)

TOTAL PROJECT COST:	$100,000	

KBEP funds, representing 9% of the total project, would leverage a $91,000 private investment. The business would have to pay an initial $450 loan collateralization fee and up to $180 per year thereafter.

Conclusion

The loan participation program outlined above is an innovative financing plan which has not been implemented anywhere else in the United States. The program, if enacted, would be the first state loan program for small business. All other programs in the state are conduits using federal money, which increasingly has become more restrictive and less available. Through this program, Kansas would move to the foreground of small business economic development. One of Kansas' economic goals is to enhance the business environment in rural areas, and a program which augments the start-up or expansion of micro-businesses will help accomplish that goal.

Financial capital has been identified by Kansas, Inc. and the Institute for Public Policy and Business Research at the University of Kansas as one of the seven foundations of economic development. As such, the state has asked for strategies to target assistance to entrepreneurs and micro-businesses, and to develop and/or encourage use of loan guarantee programs through the state and agencies such as the Small Business Administration. The proposed capitalization and revision of the Kansas Basic Enterprise Program will meet that challenge and address those needs.

According to the recent study completed by the Huck Boyd Institute, more than 95 percent of all respondents of the Kansas Rural Issues Poll strongly support economic development in general. More than 87 percent support the use of local funds for economic development. Thus, it could be concluded that legislation appropriating funds to the Kansas Basic Enterprise Program would be met with acceptance by Kansans throughout the state.

Note: House Bill #3163 should be amended to include small manufacturers. Also, the $1.0 million appropriation should be confined solely to Item B, Page 6 which pertains to the above outlined loan participation program.

KANSAS

KANSAS DEVELOPMENT FINANCE AUTHORITY

Joan Finney
Governor

MEMORANDUM

DATE: March 18, 1992

TO: House Economic Development Committee

FROM: Marty Bloomquist, Program Manager
Kansas Development Finance Authority

SUBJECT: Testimony on House Bill 3163 - Concerning the Kansas Development Finance Authority - Establishing a Standby Loan Participation Program

This bill amends the "powers" section of KDFA's enabling legislation. Language has been added that expand's the authority's current ability under the Kansas Basic Enterprises Loan Program (KBEP) to include a standby loan participation program for Kansas Retail and Service businesses to be used with direct loan or loan guarantee programs be they private (ie. conventional bank loans), federal (ie. SBA) or state.

This loan program would make up the difference between the borrower's equity, which has to be at least 10% of the project, and the amount of the project that the lender will loan with or without a guarantee. This type of program is often called "GAP" financing. The Certified Development Companies (CDC's) brought this concept to KDFA, the Kansas Banker's Association, Kansas Inc. and the Department of Commerce for discussion last summer. Throughout the past few months, many of the aforementioned parties have assisted the CDC's in further development of the idea. This idea was developed as a result of the increasingly restrictive equity requirements on SBA direct loans and loan guarantees. The CDC'c around the state work with businesses and lenders to package loan and loan guarantee programs, including SBA loans and loan guarantees.

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It is anticipated that KDFA would administer this program using a "letter of credit" (LOC) approach. It is envisioned that money would not leave the standby loan fund, but instead an LOC would be placed with the lender. All credit analysis would be handled between the CDC and the lender. KDFA would have an application that would have certifications by the lender, borrower, and perhaps the CDC. The purpose of the KDFA application would be assurance that the conditions of the statute and other conditions of the authority would be met. KDFA would execute a standby loan agreement with the borrower. The borrower would contribute money to a fund set up with the lender until there was a sufficient amount to release the LOC. The LOC would not be drawn from the fund unless there was a default by the borrower.

This bill would expand KDFA's current authority in the area of business finance. KDFA already has a statewide loan program network of over 60 rural lenders as part of its Beginning Farmer Loan Program that is allowed by the Federal Tax Codes. Attached is a map showing the locations around the state where KDFA has worked with lenders to close Beginning Farmer Loans.

KDFA would need to charge a modest application fee and some sort of small administrative fee to the borrower for the use of the letter of credit. Like it's other programs and projects, KDFA has been able to hold costs down on its projects and programs by competitively selecting all finance professionals involved.

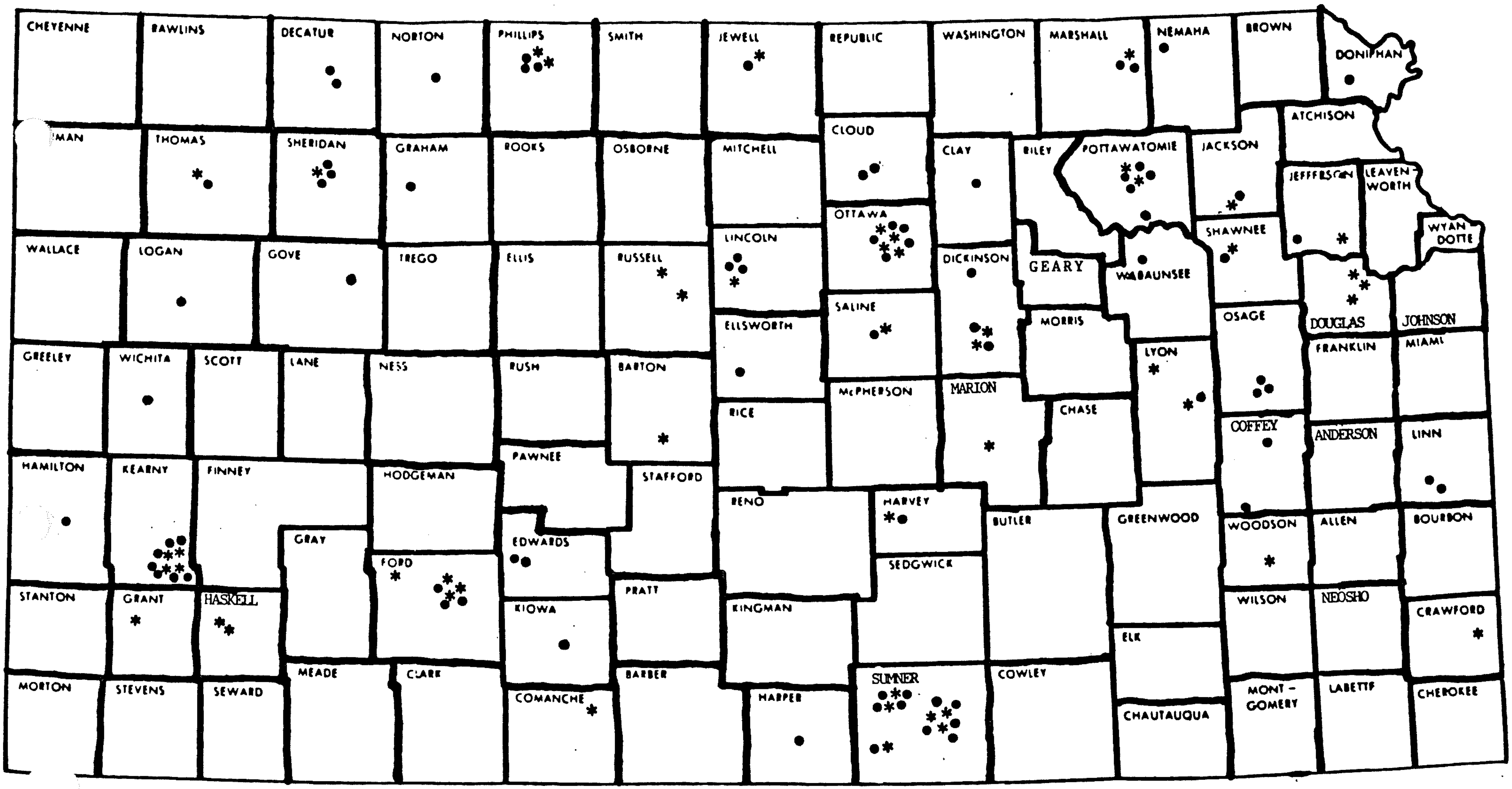
MB:bhs

cc: Wm. F. Caton
Acting President, KDFA

KANSAS DEVELOPMENT FINANCE AUTHORITY

BEGINNING FARMER LOAN PROGRAM

Location of Participants – Loans Closed June 1990 through December 1991



Loans Closed June 1990 through December 1990

Loans Closed January 1991 through December 1991