Small Business and Entrepreneurship during an Economic Recovery

Presented by the Federal Reserve Board of Governors,
the Federal Reserve Bank of Atlanta, and
the Ewing Marion Kauffman Foundation

November 9-10, 2011
Washington, D.C.

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KAUFFMAN
The Foundation of Entrepreneurship

Strengthening Entrepreneurship Opportunities in Urban and Rural Communities

Moderator: Jeremiah Boyle, Federal Reserve Bank of Chicago

Capital Availability in Inner Cities: What Role for Federal Policy?

Teresa Lynch, Initiative for a Competitive Inner City

Determinants of Rural Self-Employment: Insights from County-Level Data

Stephan J. Goetz, Northeast Regional Center for Rural Development and Pennsylvania State University

Discussant: Timothy Bates, Wayne State University

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Capital Availability in Inner Cities: What Role for Federal Policy?

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What is an Inner City?

Definition of Inner City

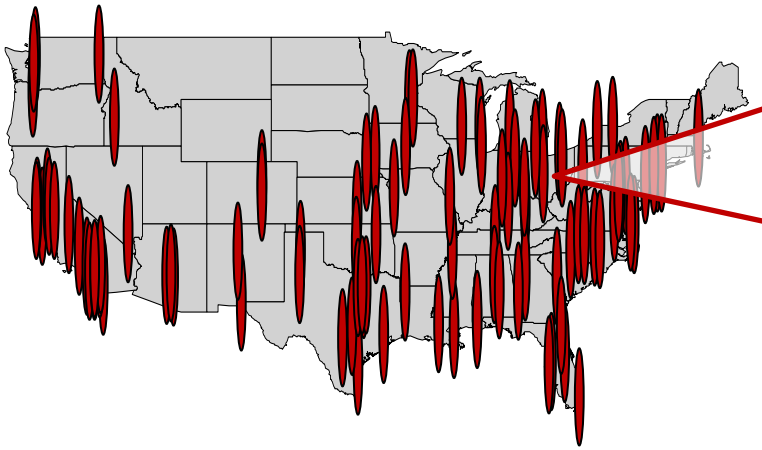
Contiguous census tracts in central cities that are economically distressed, as defined by having:

Poverty rate 20% or higher ***or*** ***Two of three other criteria:***

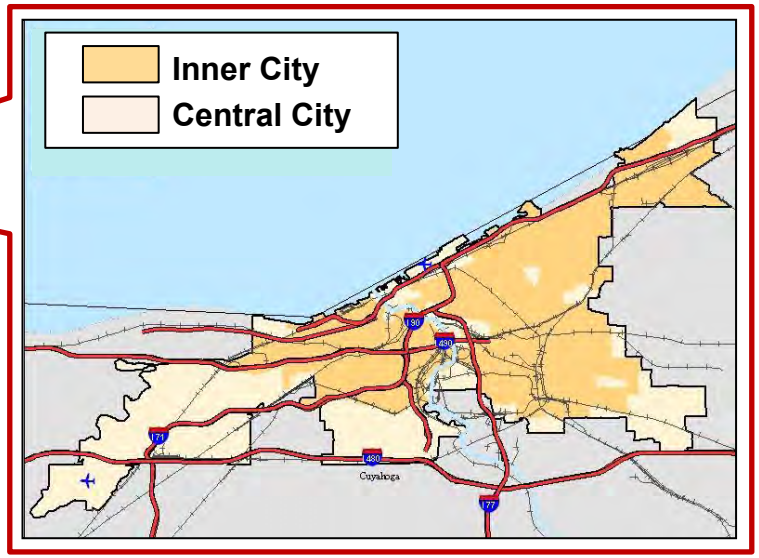
- Poverty rate 1.5 times or more than the MSA
- Median household income 50% or less than the MSA
- Unemployment rate 1.5 times or more than the MSA

ICIC has tracked the performance of inner cities in 100 of the largest U.S. Cities

100 Largest U.S. Cities



Example: Cleveland, OH



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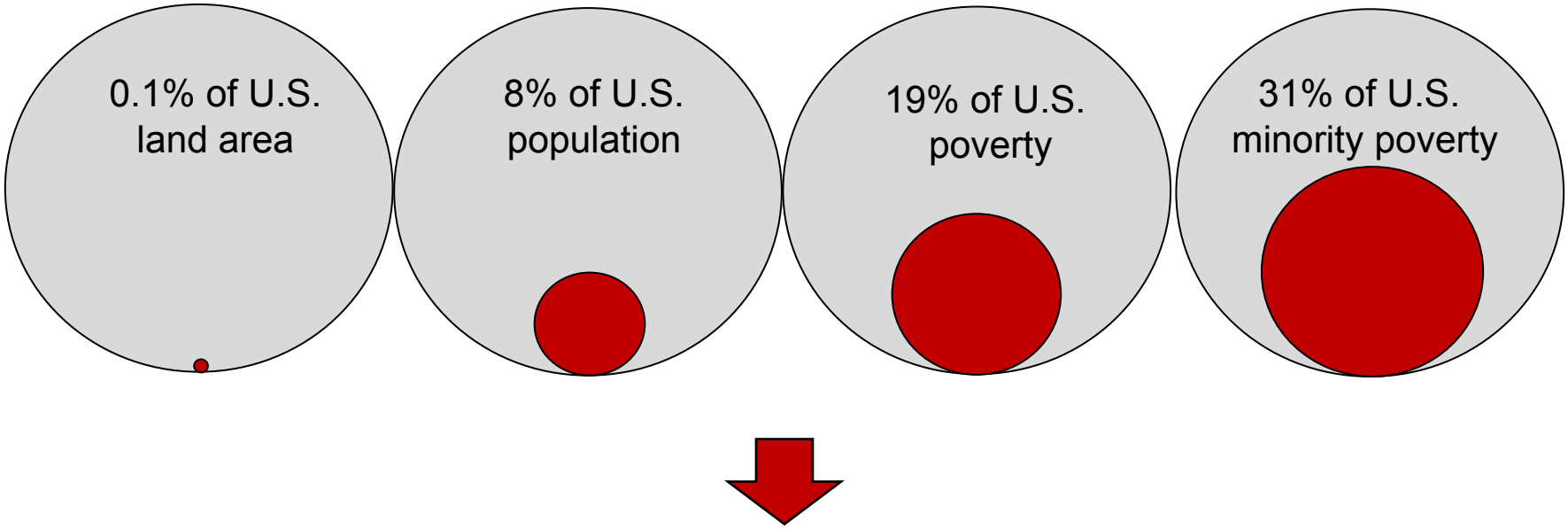
Source: State of the Inner City Economy Database (SICE) Database 2000, ICIC analysis

Inner Cities and Poverty



- Poverty, especially minority poverty is concentrated in Inner cities
- Targeting poverty in inner cities allows wholesale rather than retail approach to poverty reduction

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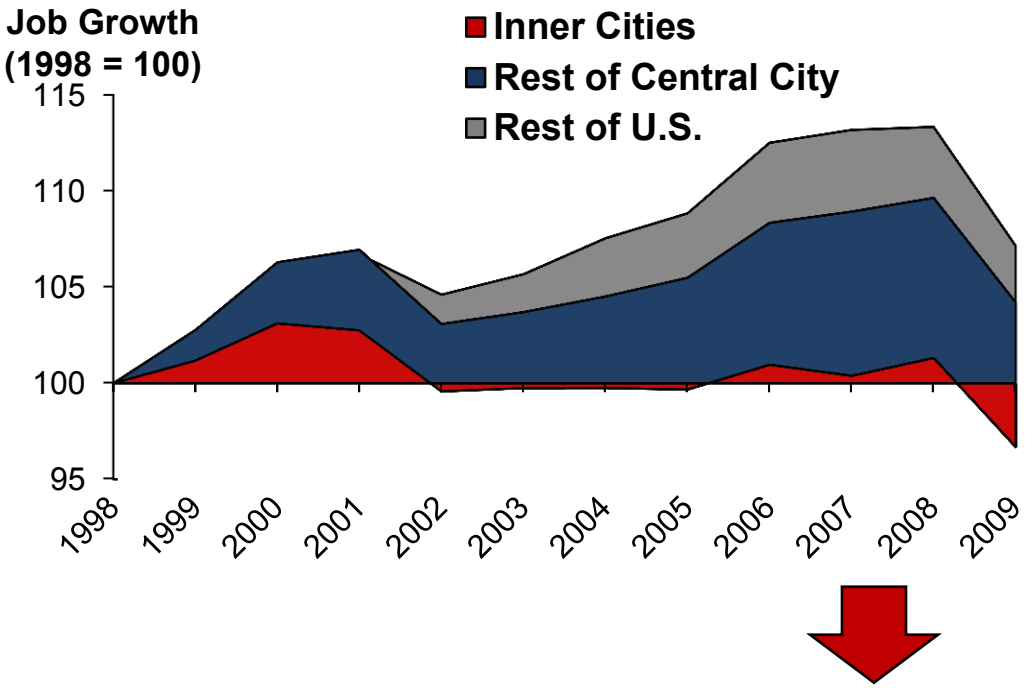
Source: U.S. Census 2000, ICIC analysis

Inner Cities: Employment Growth

100 Largest Inner Cities vs. Rest of U.S. (1998-2009)



Net Job Growth 1998-2009			
	Number	Percentage	CAGR
Rest of U.S.	+5,900,000	7.2%	0.6%
Rest of Central City	+700,000	4.2%	0.4%
Inner City	-300,000	-3.3%	-0.3%

- Inner cities have experienced a net job loss over the past decade

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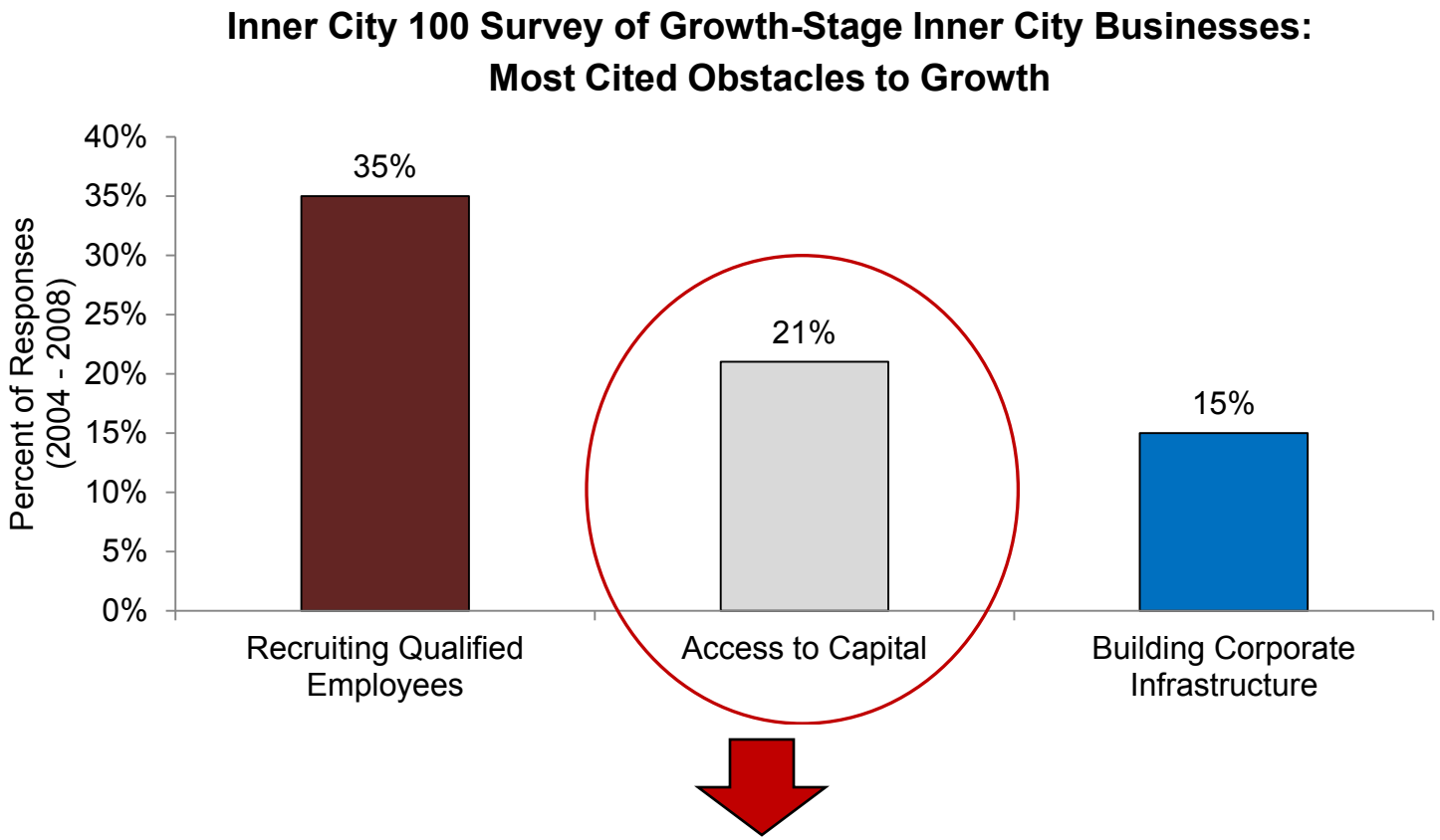
Source: State of the Inner City Economy Database (SICE) Database 2000, ICIC analysis

Motivation for Study



- A key driver of business success is access to financial capital but one in five fast-growing inner city businesses faces barriers to accessing capital.

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Source: IC100 Survey, ICIC analysis

Methods for Examining the Capital Gap in Inner Cities?

- Aggregate Measures of Capital Supply and Demand
  - Supply: loan to firm rations; bank establishment counts
  - Demand: number and size of firms, capital intensity of activities

- Firm-level data from Kauffman Firm Survey (KFS), which provide:
  - Proxies for capital supply/utilization: capital levels
  - Proxies for capital demand: average capital levels of all firms in the industry, i.e., average competitor (a proxy for).

- The KFS data are used to:
  - Estimate overall capital gap in inner cities
  - Capture the distribution of the capital gap across inner city firms
  - Tease out the influence of “race” and “place” on capital flows

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Loan Activity in Low-Income Census Tracts

Key Observations and Measures of Capital Flows to Inner Cities

Inner City 100 Survey of Growth-Stage Inner City Businesses:

- **One in five of the fastest growing inner city businesses cite facing barriers to accessing capital.** Based on 2004 – 2008 surveys of the fastest growing inner city businesses with a minimum of $1M in revenues and posting double-digit 5-year growth, access to capital was the second most cited obstacle to growth.

CRA Business Loan Data:

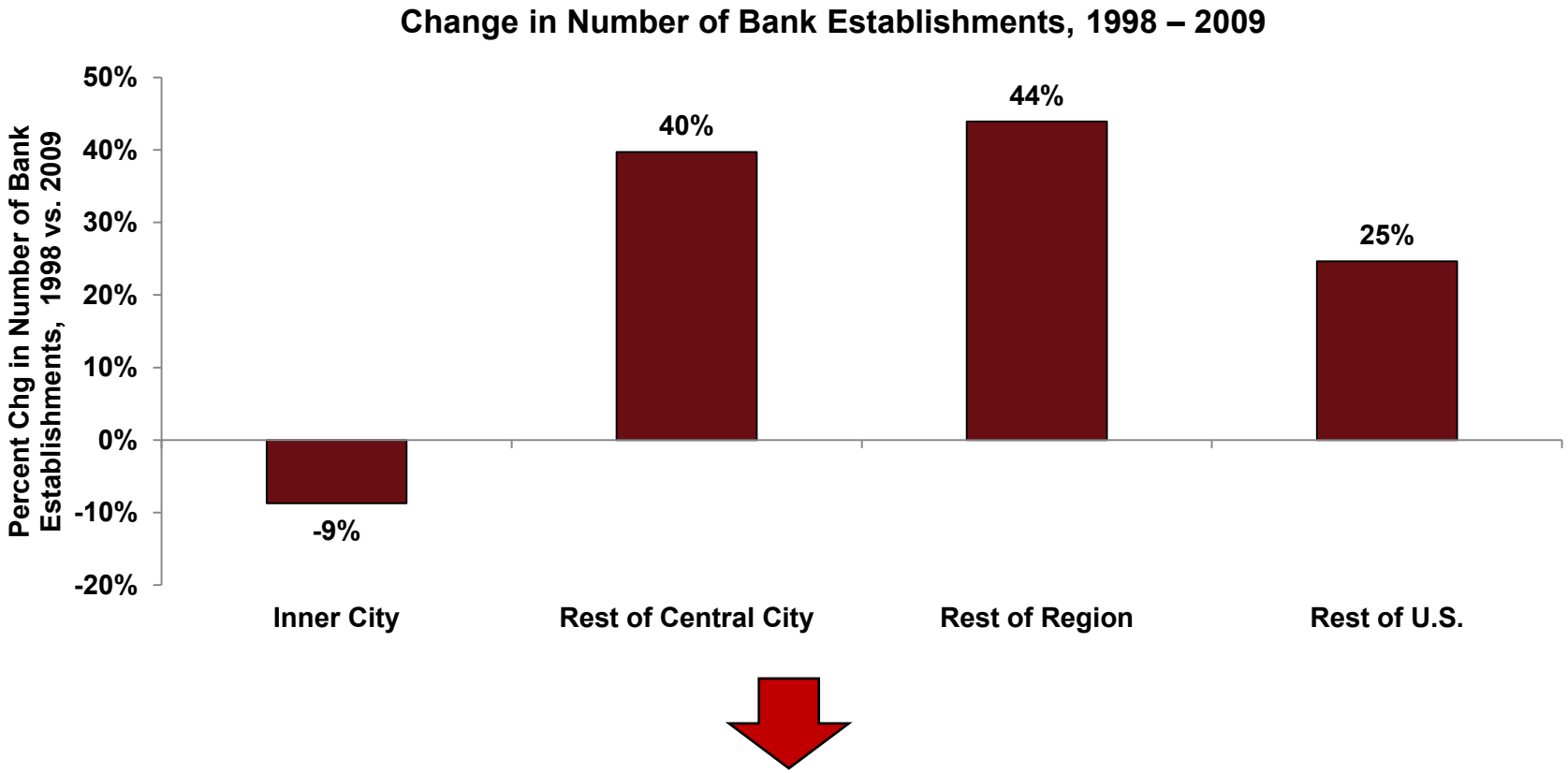
- **By loan volume, LMI firms are significantly underserved vs. other firms.** These firms received 21% fewer loans than would be expected based on the number of firms in these census tracts.
- **By loan amount, LMI firms' performance is relatively strong by national standards (loan amount-to firm share 103%). However, within the urban areas, LMI firms significantly underperform vs. firms in upper income areas.**

CRA Loan Share to Firm Share by Income Levels of Census Tracts, 1998-2007 Average

	Low	Moderate	Middle	Upper
Share of Loan Volume to Firm Share	79%	89%	101%	117%
Share of Loan Amount to Firm Share	103%	100%	105%	126%

Source: Federal Financial Institutions Examination Council (FFIEC), "Findings from Analysis of Nationwide Summary Statistics for Community Reinvestment Act Data," various years; ICIC analysis

Bank Presence in Inner City Areas



- By 2008, the number of bank branches per business establishment was 7% lower in the rest of the United States; bank branches per employee was over 35% lower.

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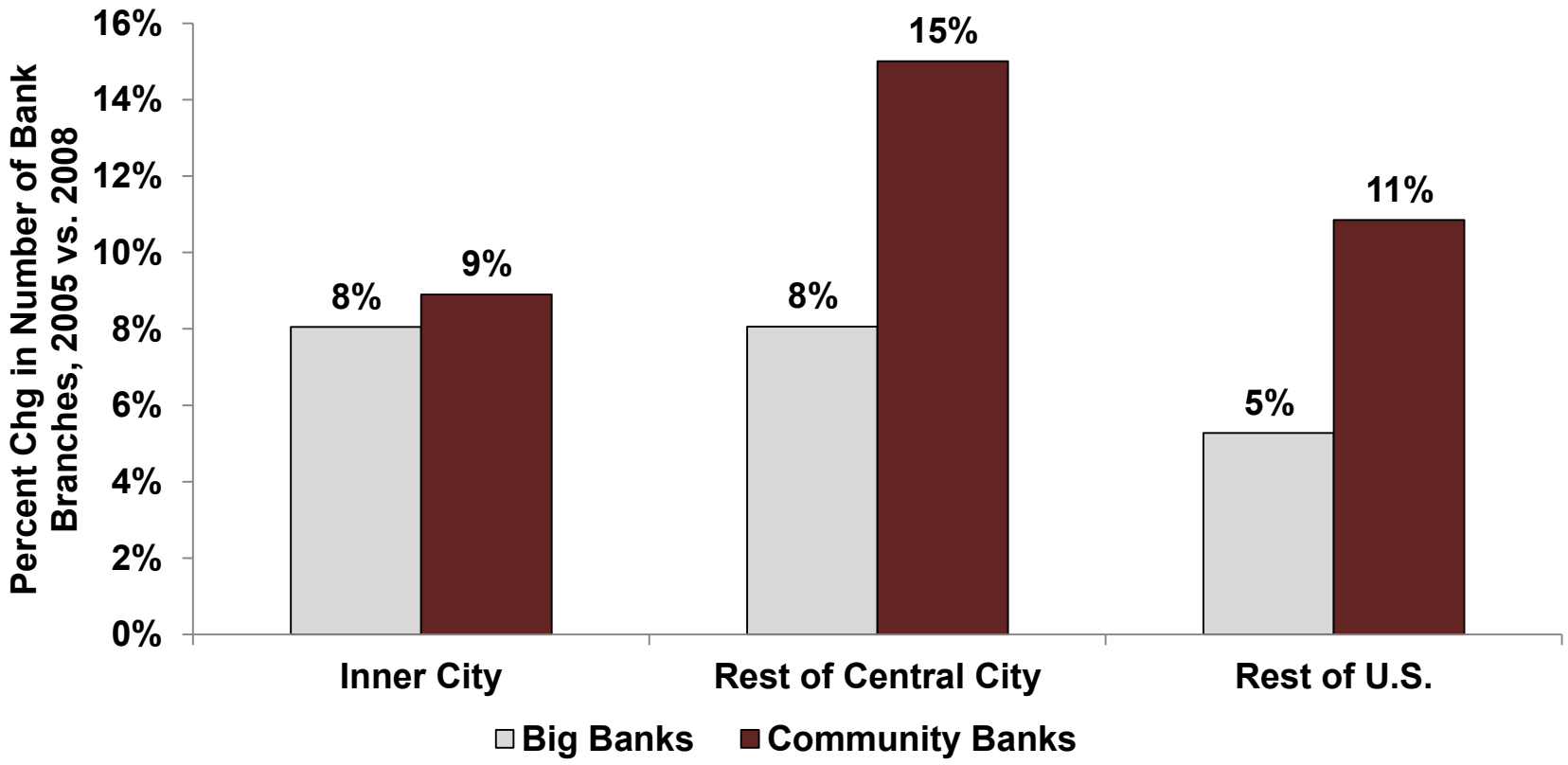
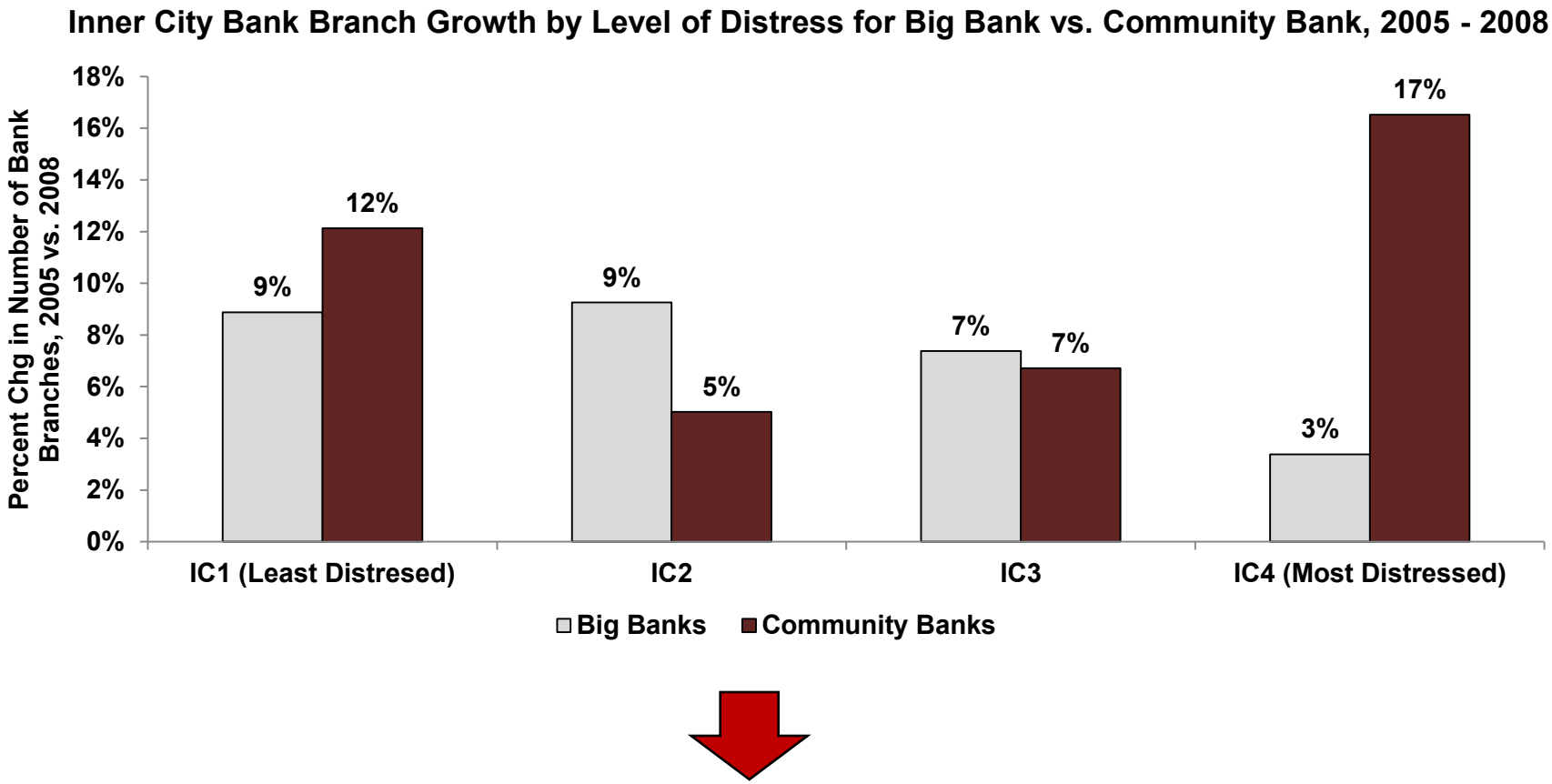
Source: SICE, 1998 - 2009

Change in Number of Bank Branches by Type, 2005-2008



Source: FDIC

Change in Number of Branches by Level of Distress, 2005-2008



- Community bank branches saw the strongest growth of 17% in the most distressed portions of inner cities, while big bank branches saw the lowest growth of 3%.

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Source: FDIC

Summary of the Evidence on Capital Supply in Inner Cities

- Loan-to-firm ratios are lower in LMIs than in higher-income urban or suburban census tracts. Loan dollar-to-firm ratios in LMIs are close to the national average but much lower than in higher-income urban tracts.

- Inner cities have slightly fewer bank branches per establishment than the rest of the U.S. However, a large inner city gap appears if we examine bank branches per employee.

- More recent data show that big bank branches have grown faster in inner city zip codes than in the rest of the U.S. However, rates of big bank branch growth decline dramatically as economic distress increases.

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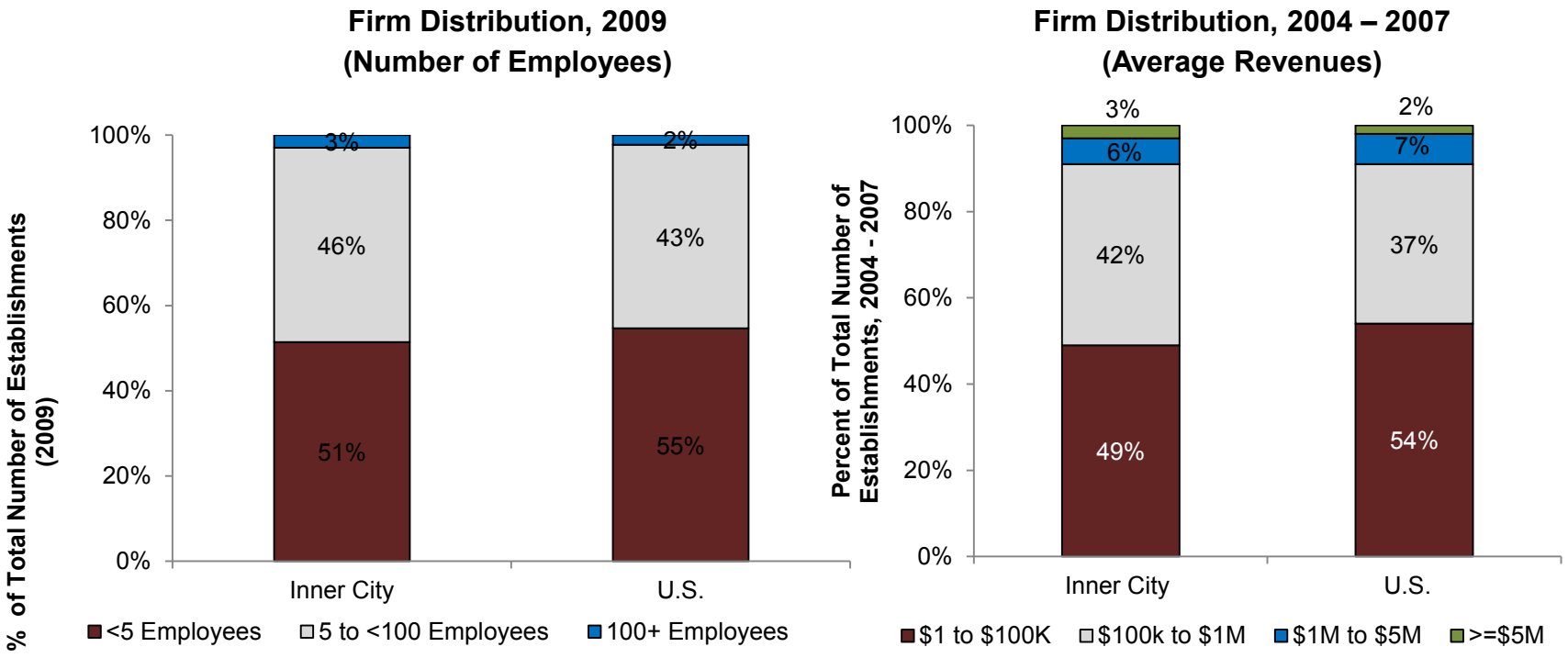
Firm Size Distribution, Inner Cities and the U.S., 2009



- Data on employment and revenue size of inner city firms do not support the hypothesis that inner city firms require less capital than other US firms.

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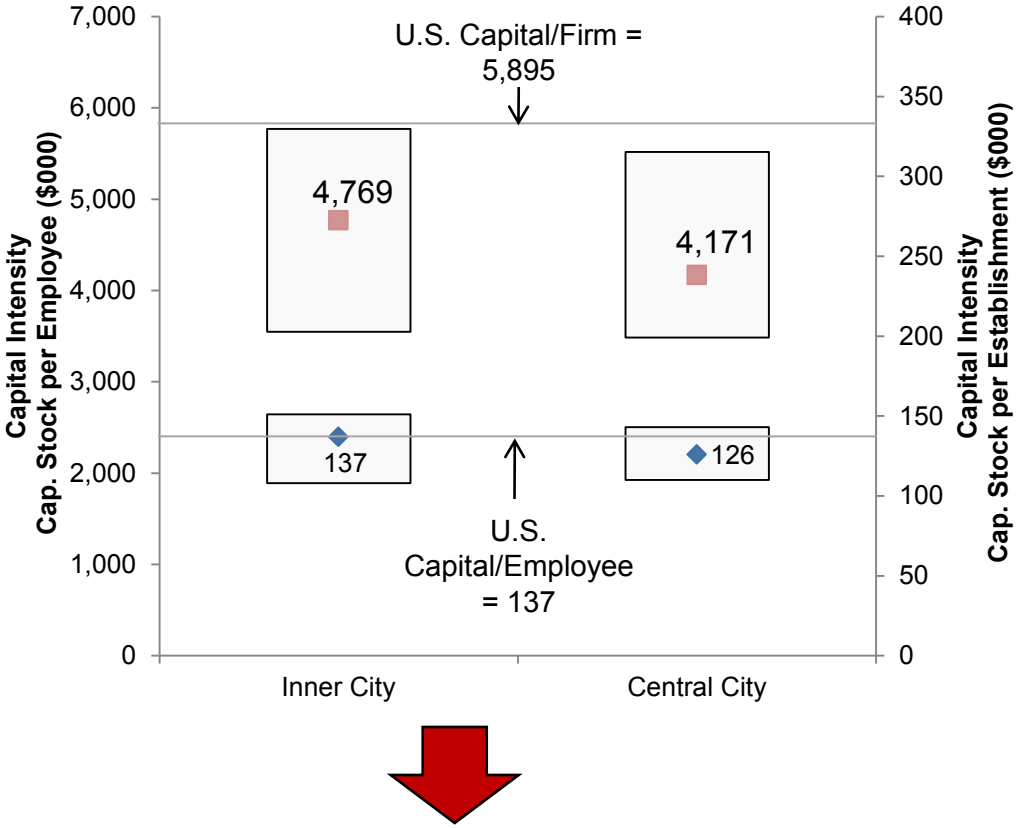
Source: State of the Inner City Economy (SICE) database, ICIC analysis
Source: Kauffman Firm Survey data, ICIC analysis

Capital Intensity of Manufacturing, 1999-2005

Average Capital Intensity of Manufacturing, Inner Cities and U.S., 1999-2005



Inner city firms' have similar capital spending per employee but because of smaller average firm size, lower spending per firm.

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Source: NBER, 1999 – 2005; ICIC analysis
Note: The boxed areas denote the 25th-75th percentiles; the weighted averages are labeled for each.

Capital Intensity of Manufacturing by City Density

Average Capital Intensity of Manufacturing by Density, 1999-2005

Inner City	Population Density	Capital Intensity
Manhattan - Bronx	62,853	108
Brooklyn - Queens	54,087	118
San Francisco	22,576	70
Long Beach	21,228	107
Jersey City	17,177	190
Santa Ana	16,911	116
Philadelphia	16,745	135
Los Angeles	16,213	110
Chicago	15,642	119
Boston	15,347	141
Average, 10 Densest		*115*
Average, Other 90		*142*

Inner cities with high population density have measurably lower capital intensity in manufacturing.

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Source: NBER, 1999 – 2005; ICIC analysis
Note: The boxed areas denote the 25th-75th percentiles; the weighted averages are labeled for each.

Summary of the Evidence on Capital Demand in Inner Cities

- Inner cities are not over-represented by “mom and pop” stores with low demand for capital. Inner city firms, of average, are slightly larger than in other parts of the U.S.

- The evidence on capital intensity of inner city economic activities is limited and mixed. In manufacturing, inner cities firms are in slightly more capital intensive portions of the sector. On average, manufacturing firm size is smaller in inner cities.

- The evidence is mixed regarding capital availability in manufacturing: inner cities have had robust growth in capital-intensive parts of the sector but the dominant manufacturing industries are in highly concentrated industries that are unlikely to utilize local capital providers.

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Average Total Capital, Inner City vs. Non-Inner City Firms

Total Capital, Inner City and Other U.S. Firms, 2004 - 2007

	Total Universe			Excluding $10M+ Total K		
(U.S. $)	Inner City	Non-Inner City	Total US	Inner City	Non-Inner City	Total US
Total Debt	301,000	420,000	409,000	260,000	140,000	151,000
Total External Equity	153,000	124,000	127,000	55,000	40,000	41,000
Total Owner Equity	71,000	127,000	122,000	70,000	69,000	69,000
Total Capital	**525,000**	**671,000**	**658,000**	**385,000**	**249,000**	**261,000**
Debt-to-Equity	1.3	1.7	1.6	2.1	1.3	1.4
Total # of Firms	234	2,282	2,516	232	2,263	2,495

Source: Kauffman Firm Survey (KFS), ICIC analysis

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Distribution of Inner City Firms by Average Capitalization

Inner City Firm Distribution by Average Capitalization, 2004 - 2007

	Overcapitalized IC Firms vs. US Avg (29% of IC Firms)	Undercapitalized IC Firms vs. US Avg (71% of IC Firms)
# of IC Firms	61	150
Avg Capitalization	$1,085,000	$75,000
US Avg Capital Requirement	$283,000	$273,000
% of MBE Firms (vs. Non-IC Avg)	28% (16%)	42% (15%)
% of Economic Distress at Zip Code Level	34%	46%

Source: Kauffman Firm Survey (KFS), ICIC analysis
Note: Excludes $10M+; Excludes 21 inner city firms that compete in industries that have no non-inner city firm representation.
* The Figure represents the average total capital of all non-inner city firms that compete in the same two industries in which the most highly capitalized inner city firms compete. The average total capital of non-inner city firms that have greater than $10M in total capital and compete in these two industries is $89M.

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Capital Structure of Inner City and Non-Inner City Firms

Capital Structure of Inner City and Non-Inner City Firms, Excluding Firms with $10M+, 2004 - 2007

	Debt	External Equity	Owner Equity	Average Total Capital	Debt-to-Equity	Number of Firms
Inner City Firms	240,000	58,000	69,000	367,000	1.9	211
% of Total Capital	65%	16%	19%			
Undercapitalized vs. Industry Avg	44,000	3,000	28,000	75,000	1.4	150
% of Total Capital	59%	4%	37%			
Well-capitalized vs. Industry Avg	720,000	195,000	170,000	1,085,000	2.0	61
% of Total Capital	66%	18%	16%			
Non-Inner City Firms	140,000	40,000	69,000	249,000	1.3	2,263
% of Total Capital	56%	16%	28%			

Source: Kauffman Firm Survey (KFS), ICIC analysis

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Capital Structure of MBEs and Other U.S. Firms

Average Total Capital, MBE and non-MBE firms, 2004 - 2007

(U.S. $)	Excluding $10M+ Total K				[1]	[2]	[3]	[4]	[5]
	MBEs	Non-MBEs	Delta	Total US	MBEs	MBEs, U.S. Capital	Delta	Non-MBEs	Rest of Non-MBEs
Debt	145,000	153,000	-5%	151,000	132,000	141,000	-6%	140,000	180,000
External Equity	22,000	42,000	-48%	38,000	19,000	24,000	-21%	26,000	74,000
Owner Equity	68,000	69,000	-1%	69,000	67,000	69,000	-3%	67,000	74,000
Total Capital	**235,000**	**264,000**	-11%	**258,000**	**218,000**	**234,000**	**-7%**	**233,000**	**328,000**
# of Firms	403	2,028		2,431	367			1,384	644

Source: Kauffman Firm Survey (KFS), ICIC analysis
Note: Excludes 64 firms that either did not report the race of the owner or had 50/50 ownership between minority and non-minority owners. One of the 64 firms had greater than $10M in total capital.

MBEs Might Be Selecting into Less Capital-Intensive Industries

Average Total Capital by Ownership and Industry Type, 2004 - 2007

(U.S. $)	[1] MBEs, Common Industries	[2] Non-MBEs, Common Industries	[3] Remaining Non-MBEs In Unique Industries	[4] Remaining MBEs In Unique Industries*
Debt	132,000	140,000	180,000	160,000
External Equity	19,000	26,000	74,000	51,000
Owner Equity	67,000	67,000	74,000	70,000
Total Capital	**218,000**	**233,000**	**328,000**	**281,000**
Debt-to-Equity	1.5	1.5	1.2	1.3
External Capital-to-Owner Equity	2.3	2.5	3.4	3.0
# of Firms	367	1,384	**644**	**35**

Source: Kauffman Firm Survey (KFS), ICIC analysis
Note: Excludes 64 firms that did not indicate the race of the owner and 20 firms with $10M+ in total capital
* Excludes one minority firm with $5M in growth capital

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Three-quarters of MBEs are Less Capitalized than Industry Peers

Capital Levels Within MBE Sample, 2004 – 2007

	Well-capitalized MBEs (26% of MBEs)	Under-capitalized MBEs (74% of MBEs)
# of MBEs	97	270
Avg MBE Capitalization	$640,000	$67,000
Avg U.S. Industry Capital Requirement	$230,000	$236,000
Avg Level of Zip Code Distress, All Firms	8%	13%
Avg Level of Zip Code Distress, IC Firms	44%	60%

Source: Kauffman Firm Survey (KFS), ICIC analysis
Note: Excludes 36 MBEs that compete in industries in which there is no non-MBE representation in the KFS.

Summary of Findings Firm-Level Analysis

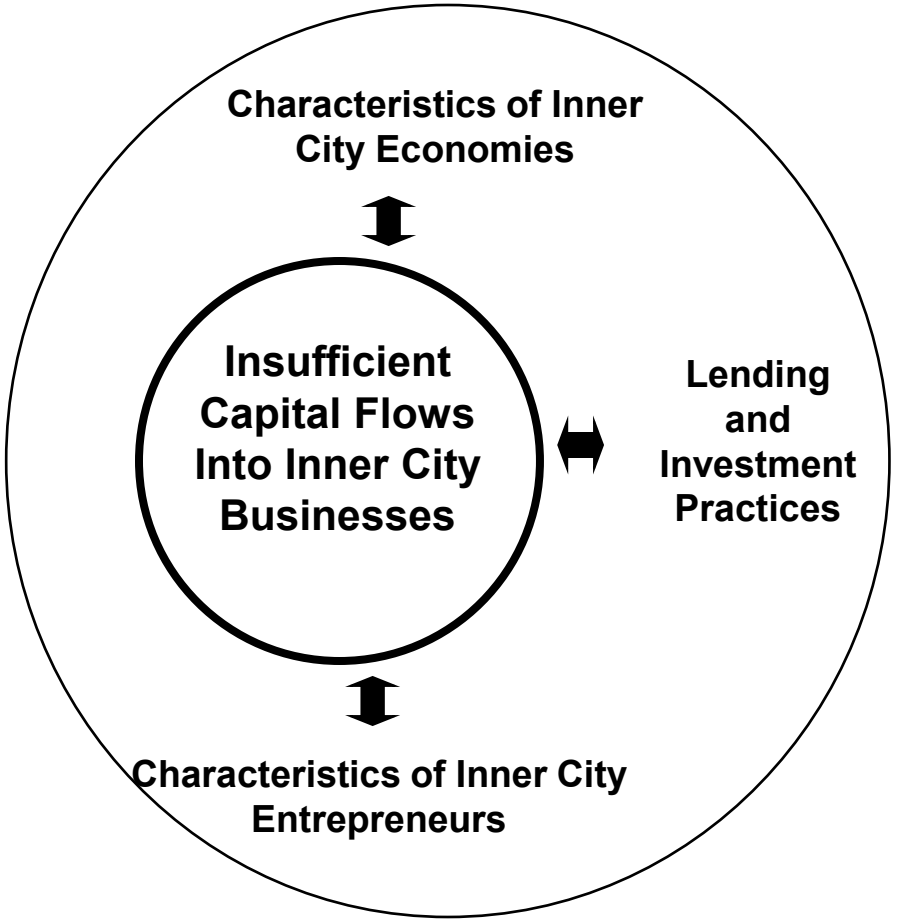
- Methodologically, to estimate the size of the capital gap, comparable measures of both capital supply and demand are needed. Because KFS data capture the industry in which each firm competes, as well as detailed data on capital acquisition, we are able to compare capital levels at individual firms (a proxy for capital utilized) relative to the average of all firms in the industry nationally (a proxy for capital demand). We then sum these across inner city firms to look for evidence of a capital gap.

- While the KFS data show a capital gap in the inner city, the more important findings relate to the distribution of capital across firms: about 70% of inner city firms are undercapitalized relative to their industry peers.

- Moreover, we examine differences in capitalization by the race of the business owner, in addition to the place-based differences, as capital challenges faced by MBEs is critical for understanding outcomes in the economies of inner cities. In the inner cities, 40-45% of businesses are minority-owned compared to 18% of all firms nationally.

- About three-quarters of MBEs are found to be less capitalized than their non-MBE industry peers. There is some evidence that minority entrepreneurs select into less capital-intensive industries, possibly due to their lack of access to capital.

Understanding Capital Challenges in Inner City Areas



I. Empirics: What is the relative importance of each of these possible causes?

II. Trajectory: What expected changes in the market will address some of these causes?

III. What are the appropriate targets of federal response?

IV. Existing policy evaluation

V. Development of new policy areas

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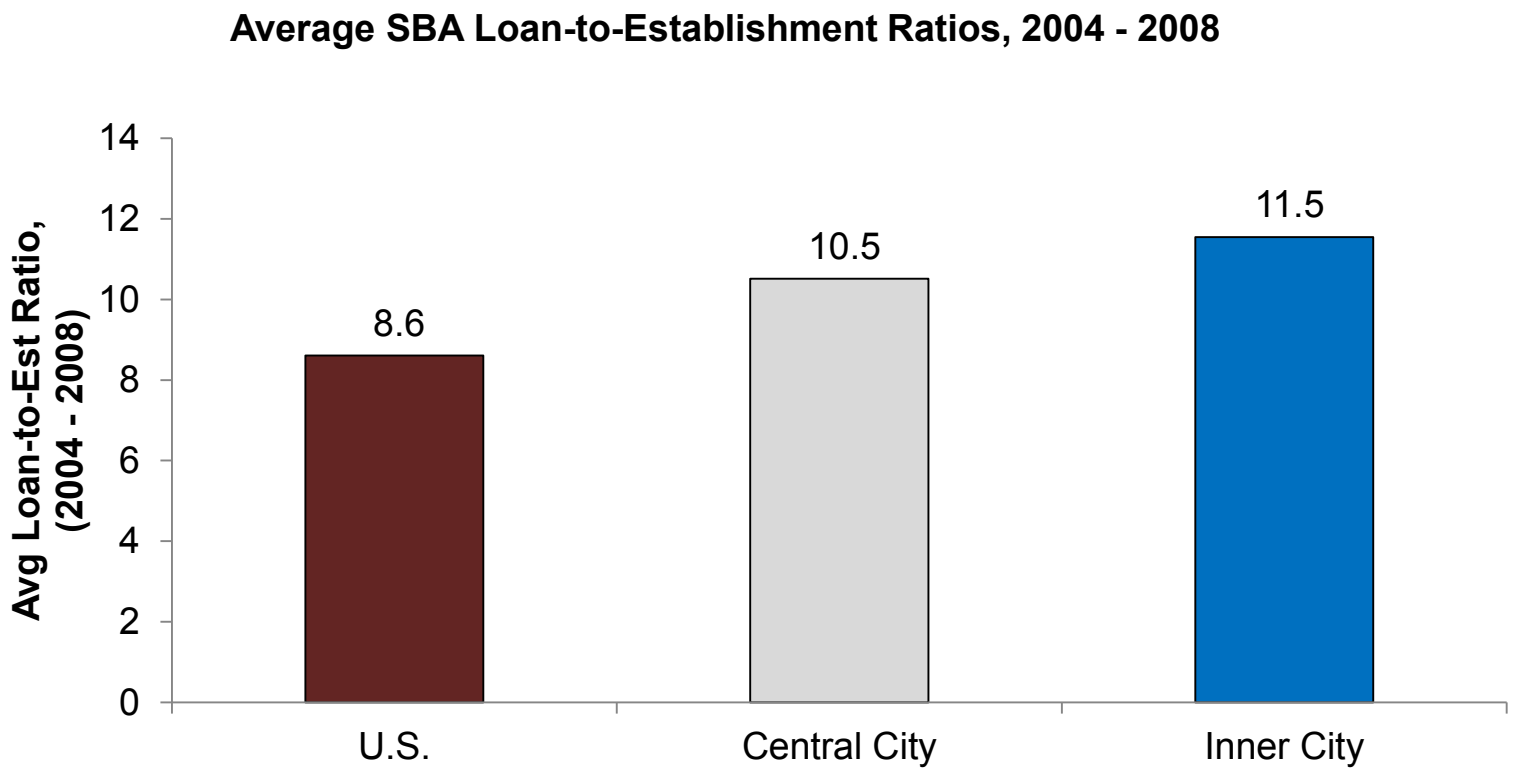
Federal Programs and Inner City Capital Flows - SBA



Source: Small Business Administration 7A and 504 Loan data, 2004 – 2008, SICE, 2004 - 2008, ICIC analysis

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Federal Programs and Inner City Capital Flows – SBA Loans

SBA Loans as Percent of Total Small Business Loans, 2006 - 2008

(U.S. Millions $)	2006	2007	2008
Total Small Business Loans	305,590	329,220	295,560
Total SBA Loans	9,060	8,900	6,690
Percent of Total	**3.0%**	**2.7%**	**2.3%**
Estimated Total Small Business Loans in the Inner City	22,710	24,460	21,960
Total SBA Loans in the Inner City	800	800	560
Percent of Total	**3.5%**	**3.3%**	**2.6%**

- SBA loans make up only about 3% of all outstanding small business loans.

Source: Small Business Administration 7A and 504 Loan data, 2004 – 2007; FFIEC CRA National Aggregate Reports, 2006 – 2008

Notes: (1) Small business loans are defined as those whose original amounts are $1 million or less and were reported as either loans secured by nonfarm or nonresidential real estate or commercial and industrial loans. (2) The total inner city small business loan amounts were estimated by taking the 2006 % of inner city employees/total U.S. employees, which is 7.4%, and applying it to the total U.S. small business loan amount. (3) All SBA small business loans in this table are loans of $1 million or less.

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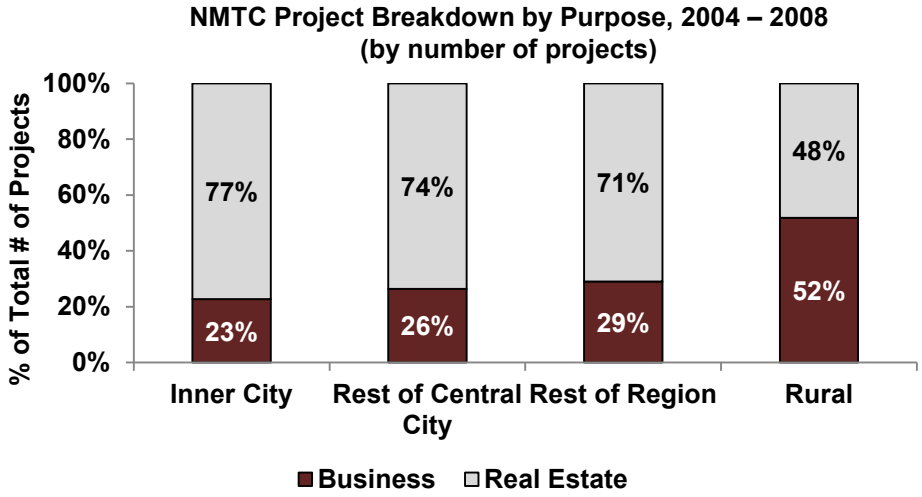
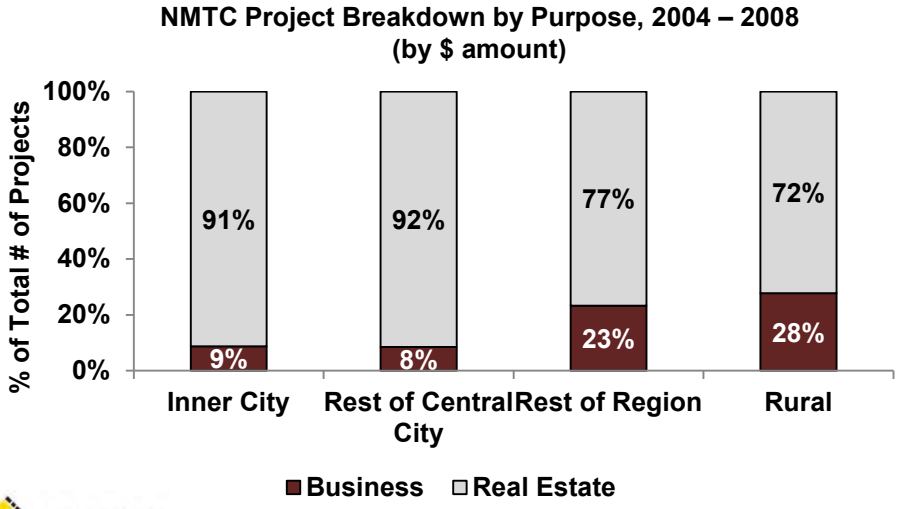
Federal Programs and Inner City Capital Flows - NMTC





Since inception of the program to year-end 2008, half of NMTC investments have taken place in the inner city. In dollar amounts, about half of all NMTC investment dollars have been directed to the inner city.

Inner cities have not successfully attracted business-purpose NMTC investments. Less than a quarter of NMTC projects in the inner city is for "business-purpose". In dollar amounts, they make up only 9%. Despite concerns that NMTC transactions may not be best suited for business transactions, in the rural areas (areas outside of the metropolitan region), "business-purpose" projects make up 52% of all projects.

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Source: Community Development Financial Institutions Transaction Level Report data; ICIC analysis

Multiple Roles for Federal Policy

- Information: Increase data collection, standardized measurements and data on capital demand for businesses in distressed urban areas:

- Capital: To reduce real or perceived risk associated with capital provision in LMI areas
  - Act as guarantors
  - Provide patient capital
  - Provide near-equity loans

- Research: Better understanding of the relationship between concentrations of under-capitalized firms and economic volatility

- Framing the issues

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