

A Coordinated Marketplace to Improve Access to Capital for Rural Businesses



Capital for Communities—
Opportunities for People®

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1 Introduction

The Great Recession of 2008 resulted in an outsized and persistent period of unemployment in rural communities when compared to their urban peers. On top of this, rural communities continue to experience a slow pace of economic recovery as a result of continued population loss, persistent high rates of poverty, and lower levels of educational attainment.¹ As a primary driver of net new employment and job creation, small businesses play an enormous role in economic recovery both in urban and rural settings. The general tightening of credit since 2008 has stifled growth among small businesses generally, but in a rural context, this is made worse by community bank failures and consolidations – a trend that far predates the Great Recession.² For rural businesses, already limited and decreasing *physical* access to mainstream financial service companies has significantly impacted the availability of credit. Oftentimes operating in “financial deserts”, rural business owners are unsure where to turn for financing needs without the local banking relationships which they relied upon historically.

Meanwhile, a national network of Community Development Financial Institutions (CDFIs) with flexible credit policies and a history of serving businesses left behind by the banks has demonstrated a longstanding mission of service to rural America. Even for the most highly motivated lenders, though, the rural marketplace presents unique challenges that interrupt the efficient flow of capital to businesses that have the ability to grow and create jobs and wealth in poverty-stricken communities. Specifically, high search costs, nominal brand awareness, and product/liquidity limitations have stifled the ability of CDFIs to reach and serve rural customers. On the flip side, rural businesses are often unaware of the existence of CDFIs, much less the products and services that they offer. This is primarily a problem of information asymmetry and a ripe setting for a technology solution that reduces friction between rural lenders and borrowers.

Over the past year, Community Reinvestment Fund, USA (CRF) has piloted an online solution known as Connect2Capital (www.connect2capital.com), which helps underbanked small businesses find responsible sources of capital and advisory services, while reducing customer acquisition costs for mission-driven lenders and service providers. The solution is modeled after the simple, user-friendly pre-qualification process that has been widely adopted by online lenders. Since piloting the platform beginning in September 2015 in our home market of Minneapolis-St. Paul, MN, Connect2Capital has sourced inquiries from nearly 300 businesses requesting over \$80 million in financing. Active Connect2Capital opportunities represent more than 10% of CRF’s total SBA 7(a) loan pipeline. This early success prompted us to consider how this tool could become a resource for other CDFIs operating in different markets across the country.

In its nature, CRF is a “supporting organization”. That is, we derive our charitable status by serving the needs of other mission-driven organizations. Over our 29 year history we have focused on developing services and solutions that grow the capacity and capabilities of our network of more than 170 community partners. We believe Connect2Capital can become a valuable resource for CDFIs operating in the rural marketplace by helping them coordinate their product offerings, respond to financing requests quickly and efficiently, and develop referral relationships that allow for scale. We envision a separately branded Connect2Capital offering, specific to a set of CDFIs focused on rural communities, which would be supported by a targeted direct-to-borrower marketing plan as well as a robust referral partner network. Referral partners, including community economic development organizations, local chambers of commerce, Small Business Development Centers, and bank and non-bank lenders, would be provided a mission-aligned resource for their rural business customers. Further, assuming an increase in loan volume among our lending partners, CRF would provide consulting services to help them securitize and sell loans in order to increase available liquidity. We believe this comprehensive approach would improve the ability of CDFIs serving rural communities to adopt a networked delivery

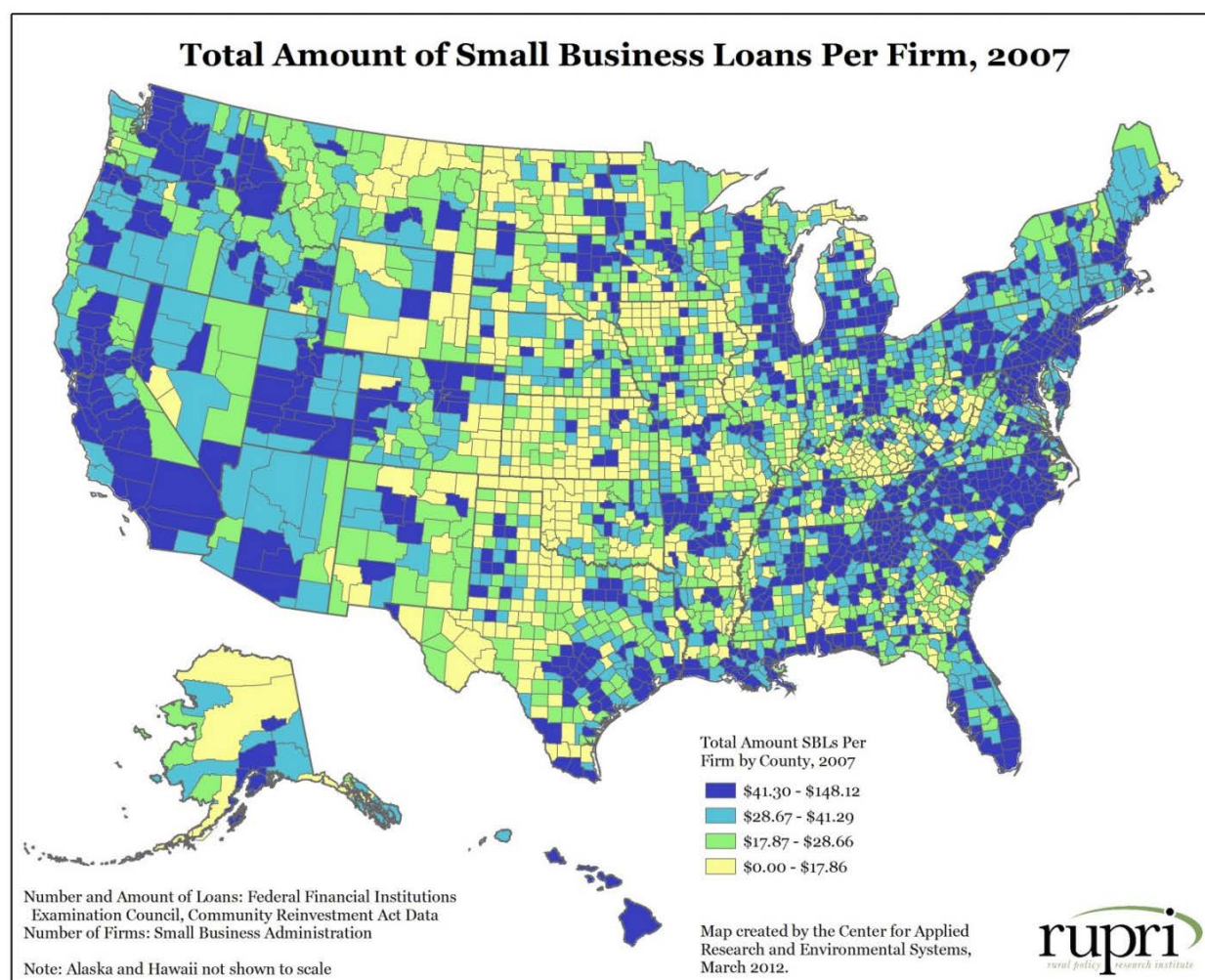
¹ *Rural America at a Glance: 2015 Edition*, United States Department of Agriculture, 2015

² *Restructuring of the Financial Industry: The Disappearance of Locally Owned Traditional Financial Services in Rural America*, Journal of Rural Sociology, 2014.

model, ultimately enabling them to access new resources, more easily find their customers, and leverage referral partnerships at an unprecedented scale.

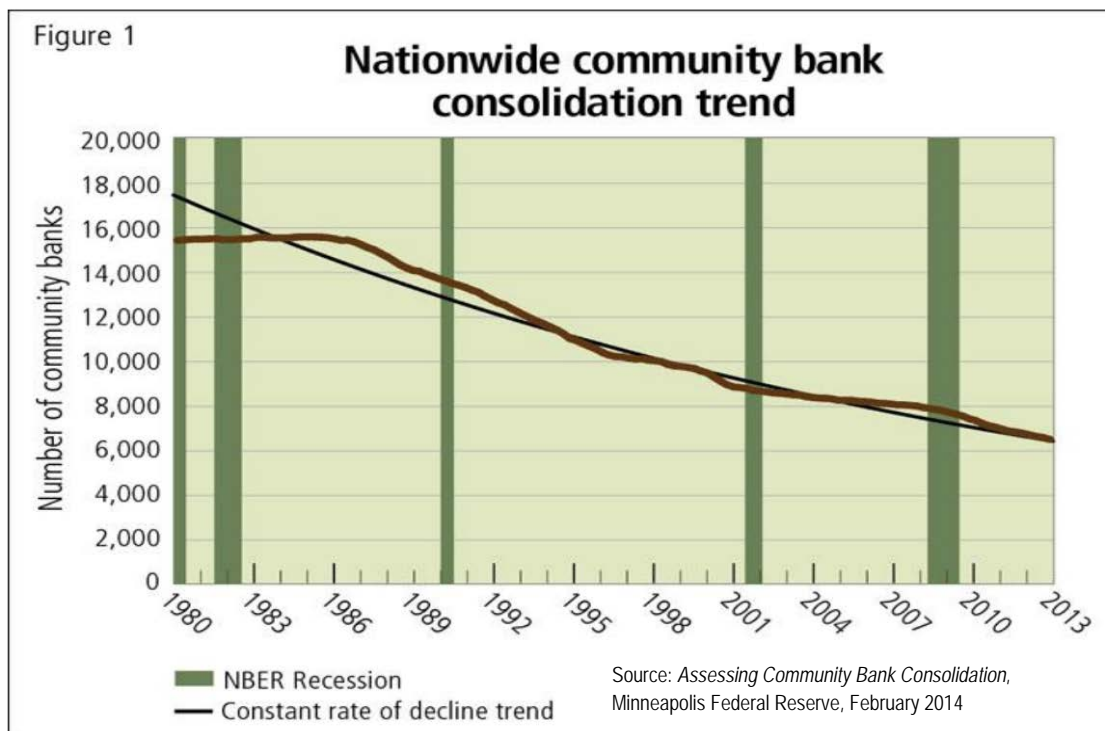
2 Problem

As referenced above, small businesses in rural communities face many challenges when compared to their urban peers. Population loss, consistently high poverty rates, and lower educational attainment are all significant factors that contribute to difficult operating environments for rural businesses. Even prior to the Great Recession, as evidenced below, rural counties in the Midwest and South represented a significantly smaller proportion of overall small business lending volume among traditional financial institutions when controlling for number of firms.



There is undoubtedly a clear linkage between consistently high unemployment and a systemic lack of capital access for rural businesses, hindering their growth and ability to create new jobs. In addition, the well-documented trend of community bank consolidation has shifted the lending paradigm in a rural context from one that was primarily *relational* to

one that has become increasingly *transactional*.³ According to research from the Rural Policy Research Institute (RUPRI), 71% of rural businesses identified their primary financial institution as a local bank.⁴ However, in rural



communities across the country, a Baylor University study observes that bank branches are “headquartered in distant urban areas – and in some cases, financial ‘deserts’ exist in towns with few or no traditional financial institutions such as banks or credit unions.”⁵

Either unable or unwilling to seek financing from a distant bank, rural business owners turn to friends and family or home equity lines of credit in order to support their businesses. An Appalachian Regional Commission (ARC) review states that “owners of the smallest businesses in Appalachia were much more likely to transfer their savings and use personal credit cards to fund their business than their counterparts in the nation.”⁶ Ultimately, lack of access to a healthy capital markets ecosystem starves rural businesses of the potential for growth.

Over this period of decline in the number of traditional financial institutions in rural communities, there has been an increase in the number of non-bank financial intermediaries providing access to credit and business advisory services. In its *Insights from the Field and Policy Recommendations* publication, RUPRI notes the importance of developing a coordinated model for these alternative lenders:

³ *Restructuring of the Financial Industry: The Disappearance of Locally Owned Traditional Financial Services in Rural America*, Journal of Rural Sociology, 2014.

⁴ *Access to Capital in Rural America Supporting Business Startup, Growth and Job Creation in the Wake of the Great Recession Interim Briefing for USDA*, Rural Policy Research Institute, April 2012.

⁵ *Small Businesses in Rural Area Must Hustle for Loans from Far-Off Banks*, Baylor University, February 2014.

⁶ *Access to Capital and Credit in Appalachia and the Impact of the Financial Crisis and Recession on Commercial Lending and Finance in the Region*, Josh Silver and Archana Pradhan, National Community Reinvestment Coalition; and Spencer M. Cowan, Woodstock Institute, July 2013.

Most assessments of capital markets, rural and urban, focus on the supply side of the market – on the amount and type of capital available to businesses. With the proliferation of non-bank financial intermediaries, including microenterprise organizations and CDFIs, there has been greater attention paid to building effective demand for capital – identifying and developing deals and building the skills of entrepreneurs and business owners to put capital to work in their businesses. What is often overlooked is the connective tissue between the two sides of the capital market. One of the key insights from our fieldwork is the important role that intermediaries play in connecting supply and demand in the capital market ecosystem. While the role is central, the specific kind of organization that fills this intermediary role varies across states and across regions within states. In some cases, this role is assumed by a non-profit organization; in others, public sector economic development groups lead. Intermediaries often serve a particular and limited geography, such as a county or multi-county economic development group, while in other cases the organization has a statewide footprint.⁷

Especially in a rural context where resources are constrained and physical access is limited, technology can be a great equalizer by creating greater transparency, access, and an efficient and coordinated delivery system of capital and business advisory services for firms that are unable to secure traditional financing.

3 Proposed Solution

Our proposed solution, a separately branded version of Connect2Capital suited to a rural context, will help rural small businesses more easily find transparent, responsible lenders who offer products and services that are designed to help them grow and thrive. This solution addresses information asymmetry that often results in small businesses in underserved markets being unable to secure financing to grow their business, or in some cases, resorting to borrowing from predatory lenders who may charge effective interest rates greater than 200%.

Time comes at a premium for small business owners. Rather than expecting them to commit hours and hours to research and make sense of the mission-driven lender landscape, Connect2Capital will do the hard work for them. Connect2Capital will leverage a single, uniform web prequalification form, which a small business owner can complete in about two minutes. Once the form is submitted, our algorithm will efficiently route the borrower to the lender, product, or service that matches their request.

There are a growing number of mission-driven lenders around the country, most of which have small marketing budgets and lack brand awareness, making it hard to find businesses that are ideal candidates for their advisory services and capital solutions. According to CDFI Fund data for 2014, the total number of businesses financed by CDFIs was 12,300.⁸ Meanwhile, census research estimates that there are nearly 5 million “main street” employer businesses through the United States and the Federal Reserve’s 2013 Small Business Credit Survey indicates that 37% of small businesses sought financing in the prior year, and of those that sought financing, it is estimated that 43% were not successful or did not acquire the full requested amount.⁹ Recognizing that defining the national small business credit gap is imprecise, this rough calculation yields nearly 800,000 underbanked small businesses. When compared to the total reported financings

⁷ *Access to Capital in Rural America Supporting Business Startup, Growth and Job Creation in the Wake of the Great Recession*, Rural Policy Research Institute, October 2012.

⁸ *A Year of Engagement and Action for the Future, 2015 Year in Review*, CDFI Fund, 2015 (available at https://www.cdfifund.gov/Documents/FY2015%20Year%20in%20Review_web.pdf)

⁹ *The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game*, Karen Gordon Mills and Brayden McCarthy, Harvard Business School, July 2014.

among CDFIs in 2014 of 12,300 businesses, it is clear there is a significant gap and opportunity for CDFIs to grow to meet the needs of underbanked small businesses, particularly those in rural communities.

Connect2Capital will provide the “connective tissue” to unify rural small business ecosystems by allowing mission-driven lenders to login, build profiles, and configure a set of eligibility parameters by product type and geographical footprint. A small business owner who fills out the prequalification form will immediately be “matched” to a set of products and services that are available to them based on the eligibility criteria of our network of lending partners. The business owner will be able to immediately submit a request to its “matched” lender, who will be notified of the lead in real time.

3.1 *Referral Partner Network*

The Connect2Capital platform will be built such that it can be adaptable and customized to several different types of partnership scenarios. For example, the tool could be used to address borrowers that are declined by banks because they don’t meet strict credit standards. Citing the RURPI research we know that many rural small businesses still approach banks where possible as the first potential source of financing. Banks would clearly benefit from having a second look option for declined borrowers, but they have little incentive to invest the time in building out a program with any one single mission-driven lender due to geographic or deployment limitations.

However, a coordinated network of mission-driven lenders presents an entirely different value proposition. These lenders do not compete for bank customers’ depository relationships, they have a commitment to providing responsible and transparent pricing, and ultimately their goal is to improve the credit quality of borrowers such that they can be returned to the bank for a lending relationship in future years. To provide an important incentive for bank referral partners, the rural version of Connect2Capital would support CRA Assessment Area reporting so the banks could track successful referrals for CRA credit purposes. CRF is currently exploring the development of second look programs with three large national banks and two regional banks that have significant exposure to rural communities.

In addition to facilitating referral partnerships with banks, the Connect2Capital solution could also be customized to serve a similar role with other rural small business support service organizations including community economic development agencies, chambers of commerce, Small Business Development Centers, and others who could host the prequalification form on their websites as an add on service. The power of the Connect2Capital solution is its potential to be distributed by multiple partner organizations, while maintaining data in a structured and aggregated manner that allows for quick decisioning and match-making.

3.2 *Direct-to-Borrower Targeted Marketing*

In addition to developing a referral partner network that would drive rural small businesses to our lending partners, we envision building upon the experience we’ve gained over the past year managing a direct-to-borrower marketing campaign for the pilot implementation of Connect2Capital. As noted above, the pilot campaign has generated inquiries from nearly 300 businesses totaling \$80 million in loan requests. Interestingly, though we intended to limit the geographic scope of this campaign to our home market of Minneapolis-St. Paul, MN, we received inquiries from more than 30 states across the country. We referenced these requests against the Rural Area and Persistent Poverty Lookup Tables provided by the CDFI Fund and found that more than \$10 million originated from small businesses in rural areas (nearly 14% of the total) and more than \$3.4 million originated from Persistent Poverty Areas (over 4% of the total). These figures jumped out considering we had no strategic focus on rural markets for the pilot, and the duration of the pilot was only about eight months.

We would apply what we've learned from the pilot and adapt our marketing strategies – including site development, search engine optimization, targeted paid advertising, email and content marketing, and social media marketing – to supplement the creation of a robust referral partner network that will drive rural small businesses to Connect2Capital as a resource hub.

In proposing this strategy, we recognize the existence of the “digital divide” – the historical trend of rural and other demographic groups having proportionally less access to the internet than urban peers – but, we believe this trend is eroding over time. The latest Pew Research Center data shows that the percentage of rural American adults who use the internet has climbed to 78% as of the year 2015, compared to 85% of urban and suburban demographics.¹⁰ Due to the distributed nature of rural communities, and the accelerating rate at which they are gaining access to broadband, we believe online strategies will be critically important to the delivery of capital and services for rural business owners.

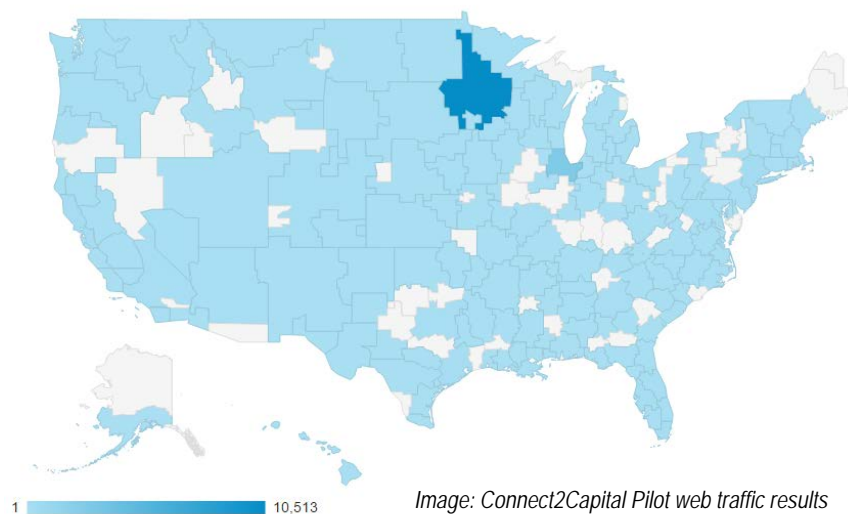


Image: Connect2Capital Pilot web traffic results

3.3 Evaluation of Proposed Solution

We would periodically evaluate the effectiveness of our program with a clear set of metrics in the following categories that will help us to refine our approach in an ongoing manner.

- **Percentage of loan requests originating from Rural Areas and Persistent Poverty Areas as defined by the CDFI Fund lookup tables.** Tracking this will help us to retarget our marketing activity to ensure we are reaching the intended geographies
- **Success rate for matched small businesses.** We will track the status of referred loan requests by status (open, contacted, funded, disqualified) over time to ensure referred borrowers have a reasonable expectation of the likelihood of receiving financing.
- **Overall volume and number of loans deployed by our lending partner network.** We'd like to see an increasing percentage of loans deployed in target communities on a year-over-year basis. This will help us understand if we are achieving our goal of reducing friction between rural borrowers and lenders.
- **Jobs created and maintained as a result of new lending activity.** This will help us determine the overall impact of our program in targeted rural communities.
- **Customer satisfaction.** We will periodically survey small businesses, referral partners, and lending partners to develop a baseline customer satisfaction metric and work to demonstrate improvement, targeting >90% overall customer satisfaction.

¹⁰ *Americans' Internet Access*, Pew Research Center for Internet, Science, and Technology, June 2015.

4 Targeted Rural Areas

The scope of our solution is national in nature – we intend to leverage our existing network of more than 170 community partners and recruit additional partners to fill in any gaps to support a national rural footprint. Currently, we have gone through an initial exercise to map the product offerings of a group of seven high performing CDFI business lenders. Together, this group of lenders includes products that range from \$500 to \$5 million and operates in geographies including Alabama, Arkansas, California, Florida, Georgia, Kentucky, Louisiana, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, North Carolina, Oklahoma, Oregon, Pennsylvania, South Carolina, Texas, Tennessee, and Washington.

When referenced against the Rural Area and Persistent Poverty Lookup Tables provided by the CDFI Fund, these states include 1,073 Rural Counties, 320 Non-Native Persistent Poverty Counties, and 119 Native Persistent Poverty Areas. While this group of lenders does not specifically target businesses in all of the counties listed in the Rural Area and Persistent Poverty Lookup Tables, our program is designed to help them increase their exposure to rural counties by reducing search costs and more effectively connecting them to rural small businesses who are seeking financing.

4.1 *Intended Short Term Outcomes (One Year)*

Within the first year, we expect to develop and implement the infrastructure – including technical functionality, marketing strategy, and a legal operating framework – required to launch and grow this program. We have a head start on each of these items and we expect to enter the market with an initial version in October/November 2016. Our targeted year one goals and outcomes will include:

- Develop customized rural instance of Connect2Capital
- Go-live with initial group of seven CDFI business lending partners
- Secure one large national or regional bank referral partnership with a rural footprint
- Source at least \$25 million in loan requests for our lending partners
- Succeed in funding \$10 million of the \$25 million requested
- Create 400 new jobs in Rural Areas and Persistent Poverty Areas as defined by the CDFI Fund
- Secure five additional referral partners and 10 additional lending and/or business advisory service partners with geographic footprints aligned to Rural Areas and Persistent Poverty Areas as defined by the CDFI Fund
- Secure an additional \$1 million from other philanthropic institutions focused on rural communities to support this program

4.2 *Intended Long Term Outcomes (Five Years)*

Within five years, we would expect to experience a significant growth rate following a successful year one implementation. If we are able to demonstrate traction with our initial set of referral partners and lending partners, we will have a robust set of data to help us recruit new partners. Additionally, we'd expect to begin to be able to model the broader financing gap in rural communities, as well as the aggregate credit quality and performance of rural borrowers in our network. Our targeted five years goals include:

- Grow lending and business advisory services partner network to at least 30 organizations
- Secure referral partnerships with 10 banks serving a rural footprint
- Source \$350 million in loan requests for our lending partners
- Succeed in funding \$175 million of the \$350 million requested

- Create more than 6,000 jobs in Rural Areas and Persistent Poverty Areas as defined by the CDFI Fund
- Define and develop new capital products and services that meet the unmet needs of underserved rural small businesses
- Develop and launch a fund to serve the growing liquidity needs of our lending partners

5 Partnership Model

In addition to the initial group of seven CDFI business lenders referenced above, we would pursue targeted partnerships with other lenders that have a specific focus on serving rural communities, many of whom we have worked with in the past. CRF has a robust community partner network of more than 170 organizations which includes lenders, business advisory service organizations, and community economic development groups. We have partnered with these organizations in a variety of different ways including through our process optimization consulting program (JumpStart), as a technology service provider with our proprietary loan originations platform (Spark), as a liquidity provider by purchasing and securitizing loans, and as both a recipient and provider of referrals.

We believe we have a unique set of solutions aimed at building the capacity of our partner organizations to grow and develop new, efficient, technology-enabled strategies to serve their stakeholders. We recognize the unique value that CDFIs provide in their home communities, and we believe Connect2Capital is an important tool that will allow our partners to maintain their independence, but operate in a networked model that creates new opportunities and access to resources.

If we are successful in winning the CDFI Fund Prize Competition, we will develop a partner recruitment plan that prioritizes both bank referral partners and CDFI lending and advisory service partners in the rural Midwest, working outwardly from there. Given our existing community partner network, which is concentrated in the Midwest, we believe we could ramp up quickly to meet a growing volume of loan requests originating from bank referrals and our direct-to-borrower marketing campaign. New partners would be referred to our customer success team for initial product configuration and onboarding, and we'd measure loan requests, success rates, and customer satisfaction over time to ensure overall program efficacy.

6 Scalability

Part of the power of the Connect2Capital concept is its ability to be scaled up or scaled down to meet the requirements of several different partnership scenarios. Initially, we expect to create customized instances of Connect2Capital to support second look programs with national bank partners that can select the specific subgroup of CDFIs that they want to include in their program. As we create several of these partnerships, adding additional lenders and business advisory service providers to our platform, the overall value of Connect2Capital increases exponentially. Ultimately, we envision a single borrower-facing instance of Connect2Capital, which includes product and service offerings of our entire network of partners. In this scenario, a rural business owner in Texas could potentially be matched to a CDFI lender in New York who has a suitable product for the small business. These kinds of connections aren't happening today in the current environment for CDFI lenders and the borrowers they serve.

Additionally, to support the scale of the program, we recognize we will need to develop a flexible funding mechanism that can support the liquidity needs of our partners as they experience increased deal flow. This could take shape in the form of an investment marketplace or as a single, continuously-issued fund that several underlying lenders could draw upon to fulfill their loan origination activity. With our 20+ year history as a leader in the securitization market for community development organizations, we are well positioned to develop a funding mechanism that meets the needs of investors and

mission-based lenders. The envisioned fund or marketplace would create transactional efficiencies for all parties and address growing demand among impact investors who, for the most part, remain on the sidelines due to the often small and private nature of existing investment opportunities.

Finally, from an organizational capacity standpoint, CRF has the know-how to manage the growth of a program like Connect2Capital. We are unique among CDFIs in that we've made significant internal investments in technology – both people and platforms – over the past 10 plus years. We have a world class team of developers and we've built the internal infrastructure to host and maintain the Connect2Capital solution without having to rely on outside resources. We also have a uniquely qualified digital marketing and inside sales team, as evidenced by our early success with the Connect2Capital pilot. We believe we have a demonstrated track record of innovation and successful execution that makes us a strong candidate to expand this program into rural communities, build capacity among our CDFI partners, and increase access to capital among rural business owners who are making vital contributions to their local economies.

7 Conclusion

Bringing Connect2Capital to rural communities is well aligned with our strategic plan and organizational vision to lead the industry in deploying innovative financial solutions that level the economic playing field for *everyone*. While it may not be widely known, CRF has a longstanding history of serving rural markets. Cumulatively between our direct lending program and our securitization program, we have invested **over \$215 million in rural communities and more than \$50 million in rural persistent poverty areas** (as defined by the CDFI Fund Lookup Tables). These investments have created more than 9,000 jobs. We believe this is only the start.

We know the true power and potential of CRF and our CDFI partners lies in our ability to grow *together*. In today's fast-moving environment, with the emergence of cash-rich online lenders, we have no choice but to collaborate in order to compete. Fortunately for us, we are bound together by a common sense of mission and commitment to serving our small business customers responsibly, helping them to grow and thrive and become engines of economic progress in their communities. Connect2Capital is a solution that acknowledges and respects the unique value of each CDFI, but affords us a framework to operate in partnership and scale our impact together.