Policy Brief

A PATHWAY TO A FINANCIALLY INCLUSIVE AND SUSTAINABLE TACOMA, WA.

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Why should we care about entrepreneurship?

Making loans work for entrepreneurs

Lack of hand-me-down wealth

Equity investments

Sustainability wins with entrepreneurship

Entrepreneurship is taking centre stage across the US with 419, 518 business applications made in the month of February 2022 alone.[1] The Covid 19 pandemic has given rise to remote work which in turns gives people more flexibility to start businesses while holding full or part time jobs.

Like good soil is essential for plants to grow well, so also is an efficient ecosystem necessary for entrepreneurs to thrive. What makes an efficient ecosystem? Finance, business support, government policy.[2] Business support is on the rise at local, state, and federal level, which is evidenced by increased availability of accelerator and incubator led programs.

These programs have stimulated entrepreneurial activity at all levels; however, we must look beyond venture creation and towards venture sustainability which undoubtedly hinges on availability of entrepreneurial finance. How does entrepreneurial finance differ from conventional business finance – **RISK** *is the answer with the former seeking to foster innovation by financing risky early-stage innovation and the later funding established incremental innovation*.[3]

Risk appetite differs from entrepreneur to entrepreneur with those from historically underfinanced background taking on less risk than their non-barrier facing counterparts. This may mean ventures created by these entrepreneurs are less innovative due to economic and social barriers. These barriers manifest in the form of limited financial networks, lack of prior credit rating and unconscious bias.[4] How we can create a more financially inclusive society where entrepreneurs are assessed based on their economic contributions rather than bogus social norms.

Setting the Scene

Source: TownmapsUSA.com

The policy brief was informed by research conducted with the William Factory Small Business Incubator which is one of the longest serving incubators in America. It is based in Tacoma, Washington and caters to the needs of early and growth stage entrepreneurs.

A total of twenty-one interviews were conducted via Zoom with entrepreneurs from historically underfinanced backgrounds. A break down is provided in table 1. For purposes of this study, entrepreneurs from historically underfinanced backgrounds are described as those who have either been excluded or face more difficulty when accessing financial resources. Examples are people of colour, women, recent immigrant, low to mid income earners.

Table 1: Break down of study participants

Background	Male	Female
Mid- low-income neighbourhood	2	4
Black	2	7
Latino	0	1
Asian	2	0
Recent immigrant	2	1

Source: Author

Overcoming barriers

To overcome barriers to finance, entrepreneurs seek to form industry networks to gain bootstrap revenues, make meaningful connections with financial providers for affordable loans, substitute grants for lack of lineage wealth, and sometimes raise investment funds via venture capital.[5]

Grants

Does "no payback venture funds" have a place in entrepreneurial finance? There are arguments in favour and against it. The success of NACCE's everyday venture funds [6], proves it works alongside grant beneficiaries; however, some investors might argue that free money is loosely regarded. Below, we try to make a case for it and highlight pain points faced by entrepreneurs when applying for grants.

Source: Bedford Independent

Lack of "hand me down wealth"

Across America, house prices are rising leading more young adults to stay with parents longer than planned. A one bed condo in Seattle is going for almost a million dollars with median income just above $100,000 annually.[7] So, what does this mean for entrepreneurs from historically under-financed backgrounds unable to afford their own houses due to financial reasons? Debt finance is usually secured against collateral and when "lack of generational wealth" as highlighted by participant 1 is coupled with rising house prices, the access to finance gap is widened. This is further supported by findings from the Office of the Advocate for Small Business Capital Formation annual report stating that 41% of borrowers are discouraged by lack of collateral.[8]

Burdensome Requirements

Early-stage entrepreneurs are usually in inundated with numerous daily tasks which means time is a scarce resource. A large percentage of these businesses are also micro sized with a maximum of 3 – 5 employees, thus limiting personnel for "paperwork" tasks. The level of business knowledge required in filling out grant applications can be quite intense for early-stage entrepreneurs with participant 2 stating "it's challenging for me to understand the verbiage of grant proposals, and I've gotten like a master's degree and grown-up speaking English all my life".

This level of knowledge as indicated above means already time constrained entrepreneurs spend a reasonable amount of it on applications without any guarantee of yielding grant money. Participant 5 highlights "I find applying for grants a time-consuming process".

Fragmented Information

Numerous grants are provided by several institutions in Tacoma; however, the lack of a central resource or database for entrepreneurs makes the process of seeking and applying a difficult one. Participant 13 highlights "I wish there was central location where I could see all the grants available to me". Grants are favoured by entrepreneurs that bootstrap their business for growth without debt. Grant making bodies do their best to allocate finances equitably; however, findings suggests that rectifying pain points mentioned above can go a long way towards improving access to finance for more entrepreneurs.

Debt finance

As businesses scale their operations, founders from historically under-financed backgrounds with limited access to family or personal wealth begin seeking external finance with debt being the usual next alternative. Debt finance is negatively perceived by many entrepreneurs due to its history of foreclosures, high cost and collateral requirements. Having said that; bankers argue that some form of guarantee is required to ensure borrowed money is paid back. But the question remains, can we find a common ground where banks are able to provide some form of risk capital through reformed policies which widen access to debt finance?

Source: UNCTAD

Low credit rating

Research conducted by the LISC, and Next City suggests that low credit rating deters historically underfinanced entrepreneurs from obtaining debt finance.[9] Participant 13 shares their experience "Do you want to tell me the reason why the bank did not approve? The only reason was because I have a low credit score".

Reasons for low credit rating stem from poor financial backgrounds, lack of financial literacy, personal zip codes and structural barriers faced by people of colour. Widening access to debt finance means providing alternatives for these group of entrepreneurs who are significantly disadvantaged by credit ratings.

Lack of intellectual diversity

Loan officers usually comprise of junior to mid-senior members of staff who haven't been exposed to entrepreneurial settings. As identified by participant 21 "A lot of times the people at the finance table have no entrepreneurial background". This may impact their loan assessment abilities where things are viewed from a single dimension without room for flexibility. Perhaps if loans officers or teams could have diverse intellectual backgrounds, this will enable them to approach loan applications from a practical angle rather than purely technical.

What are Loan Officers Looking for?

Entrepreneurs from historically underfinanced background are unclear as to what loan officers require from them.[10] Women in particular feel intimidated by the process; long list of requirements; and cold approval processes as indicated participant 14 "I'm not being taken seriously as a young female".

Furthermore, lack of transparency leads entrepreneurs from this group to feel marginalised by the system due to their race, gender, or socio- economic status. Participant 21 provides context for these arguments by saying "being a woman, being a minority, coming from a marginalised background, the bar is going to change, the problem that I have now is that we're starting to question how many bars and for how long" these will be barriers.

Equity

The Office of the Advocate for Small Business Capital Formation under the US Securities and Exchange Commission in its 2021 annual report highlights that equity investments represent 6% of entrepreneurial finance in the US.[11] Several reasons pertain to this small portion, some of which are discussed below:

Source: TechEU

Lack of networks

The nature of equity investments mirrors the "who you know" paradigm which involves a lot of networking and dedication. Entrepreneurs lacking strong networks from which equity finance can be raised tend to struggle in this setting. This leads entrepreneurs from historically underfinanced backgrounds having to work twice harder to gain legitimacy within networks due to lack of exposure arising from their socio-economic setting. Participant 5 buttresses the point by saying "It requires the founder or the innovator to focus full time. And that doesn't happen unless you have a network willing to support you".

Does Gender have a role to play?

Questions posed by investors to female entrepreneurs tend to be preventive in nature while those posed to men tend to promote them.[12] Promotion questions come in the form of "How long will it take you to break even?" versus preventive questions "How do you plan to monetize this idea?" Promotion-based questions imply success and winning while those of a prevention nature suggest defensiveness and safety. By asking female entrepreneurs prevention questions, they are forced to reduce their risk appetite while male entrepreneurs are encouraged to increase theirs. In a capitalist economy that favours risk taking, female entrepreneurs in this setting are disadvantaged.

Risk Capital

The search for the next unicorn is a never ending one with investors willing to gamble huge sums of money for a piece of the next "Amazon". The reality however remains that a large percentage of entrepreneurial ventures will never be unicorns. Therefore, to sustain economic growth and progress, funding must be made available for likely successful but non-unicorn enterprises.[13] This may entail reducing average returns and accepting differing levels of risks but which in turn creates a more resilient pool of start-ups.

The way forward

Making entrepreneurial finance more inclusive entails putting historically underfinanced entrepreneurs at the heart of finance distribution mechanisms. This can be achieved by the following: access to grants, access to affordable debt arrangements, and access to venture investments.

Source: istock

Philanthropic Capital

To overcome wealth distortions, entrepreneurs without a family lineage of "hand me down" money will need philanthropic capital for certain initial investments. For instance, the founder of a delivery business will face a barrier in securing sunk cost funds to obtain a sufficient fleet of vehicles unencumbered by debt and lease fees. If instead, a philanthropic fund provides no-payback investments for this purpose (after a thorough review of how the fleet can reach additional customers), the founder can focus on marketing, personnel, and related company operations.

Consolidating Grant Resources

A directory of grants available by key institutions serving the Tacoma area would reduce time spent searching and applying for grants. The directory can be structured in such a way that clear information on eligibility, response time, point of contact amongst others is readily available to applicants.

Revenue Based Financing

Debt finance as earlier discussed is unattractive to entrepreneurs from historically underfinanced backgrounds. A revenue-based loan with low fixed interest may seem more attractive as repayments are based on a fixed percentage of revenue. This means that when cash is low, repayments are low and when cash is high repayments increase up to a predetermined amount.[14] Such loans should be designed with financial inclusion in mind where entrepreneurs are not gravely penalised for missed payments if cash strapped. A convertible based approach could also be adopted for this type of loan where providers have the option to convert to equity.

Low-Cost Lines-of-Credit

Another important element is access to a low-cost line of credit related to accounts receivables. This ensures the founder can continue growing revenues without expending precious early-stage funds on finance charges. In the delivery business example, as the additional fleet and personnel are deployed to gain revenues, additional operating costs can be absorbed through short-term credit until customer revenues are received. The financing provider will likely analyse cash flow to provide assurance that increased revenues will support the amount of credit, yet not harm operating profit margins necessary for continued growth of the enterprise.

Deferred Royalty Agreements

Deferred royalty agreements relate to a scenario in which an investor receives a percentage of profits following a certain number of years. During this "waiting" period, positive operating margins are reinvested back into the enterprise. Again, in the delivery business model, an investor may infuse the firm with finance to incorporate viable marketing and logistic technologies that increase revenue.

Transparent Loan Application Processes

Debt providers can widen access to entrepreneurial finance by ensuring loan application criteria are clearly laid out and reasons for rejection stated. This provides assurance to entrepreneurs from historically underfinanced backgrounds that "intentional marginalisation" is not the motive. Early financial literacy classes could also be provided to high school/college students thereby enabling them to understand the importance of credit score and how they can be managed.[15] This would in turn create a pool of early-stage entrepreneurs fit for debt finance.

Equity Investment

Equity investments need to be re-designed for financial inclusion. This can be achieved by creating pre-seed and venture funds with a patient time horizon of 5–10 years. With traditional VC's lacking focus on the historically underfinanced population, new investment vehicles with specific inclusion strategies must be created and supported. With the delivery service model equity investments can

replace or be an addition to royalty agreements, which scale a proven operation to larger markets and generate wealth capital through the issuance of stock in the company.

Mentorship at the heart of Equity investment

Entrepreneurs from historically underfinanced backgrounds lack exposure to network with wealthy individuals. Long term and consistent mentoring can be a bridge between these two worlds where entrepreneurs are matched with mentors who can expose them to such networks via events and introductions.[16] This form of mentoring would also mirror a "hand-holding" relationship where entrepreneurs have a stable guide while navigating their complex early-stage journey.

Sustainability Wins with Entrepreneurship

A green economy is the aspiration of most modern societies today; one where a sustainable environment is not sacrificed for economic progress. Given that entrepreneurs represent over 80% of businesses in the private sector, it's of paramount importance that sustainable practices are encouraged within these businesses.[17] As more entrepreneurs embed sustainability into product and service design, a multiplier effect is created, one that champions eco-friendly practices. This multiplier effect can also be increased by providing more training on sustainable practices and creating more awareness on green tax reliefs.

As entrepreneurial ventures adopt greener processes by incorporating technology, they must find ways to leverage upon their business analytics. Value derived from business analytics can serve a road map to building resilient business processes and supply chains for the future.[18]

Conclusion

We have made a case on behalf of historically excluded entrepreneurs by clearly identifying barriers they face when accessing entrepreneurial finance to achieve a more financially inclusive and sustainable Tacoma, WA. Financial inclusion is a tool for achieving progressive economic prosperity. Where large groups of the population feel marginalised by economic and social structures, dissatisfaction arise which can be a breeding ground for divisive rhetoric that only take economic development and civilisations backward. By integrating financial inclusion mechanisms at the heart of financial systems, everyone wins even though not equally. A sense of hope is provided and sometimes in the darkest of times, hope is all we need.

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