Financing the Development of Urban Minority Communities: Lessons of History

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Government intervention into financial markets seeks to alter capital availability patterns that disadvantage minorities and low-income people. The desire to increase access to credit for these traditionally underserved groups motivated President Clinton to launch the Community Development Financial Institution (CDFI) program. In fact, CDFI-like institutions proliferated in the late 1960s, and many of them still exist today. The Minority Enterprise Small Business Investment Company (MESBIC) program, started in 1969, created several hundred privately owned firms that finance inner-city situated and/or minority-owned small businesses.

This study uses U.S. Small Business Administration records to analyze the impacts of actual MESBIC investments in small businesses. Further, all MESBICs that were actively functioning in 1987 are tracked over a seven-year period, and the characteristics of those still operating are compared to the MESBICs that went out of business. Strategies used by surviving MESBICs that actively financed minority business enterprises are identified, and the traits of effective MESBICs are contrasted to those that shut down. Nearly 100 MESBICs remain active today, and the track record of the program over the past 30 years offers a wealth of insights to present-day proponents of CDFIs.

Introduction

Government policies and programs that address economic problems facing inner-city minority communities are often conceived and marketed as vehicles for achieving goals that are quite difficult to meet.

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One such program is President Clinton's Community Development Financial Institution (CDFI) initiative, which was launched in 1994. CDFIs are a diverse collection of banks, bank-owned community development corporations (CDCs), credit unions, loan funds, and so forth, that have received subsidized funding from government to serve low-income, inner-city communities. The common defining trait of CDFIs is their shared mission of filling gaps in the services provided by mainstream financial institutions.

Modern-day proponents of CDFIs typically ignore the rich history of the forerunners of today's CDCs, microenterprise loan funds, community development banks, and the like. CDFI-like institutions in fact proliferated in the late 1960s, and an understanding of their successes and failures offers rich insights for those choosing not to ignore the lessons of history. Michael Porter suggests that the urban-racial crisis of the 1960s produced social-policy fixes; lacking a firm foundation in private business development, these "fragmented and ineffective" policies offer no positive guidance to revitalizing depressed urban minority communities (1995, p. 55). Many of those first-generation CDFIs were, indeed, rooted in ineffective policies. A detailed understanding of the failures and successes of that earlier era provides society with the opportunity to replicate the successes and avoid many of the pitfalls of a previous generation of CDFIs.

President Nixon, in 1969, proposed establishing 100 minority enterprise small business investment companies (MESBICs) to alleviate the institutional gap in financial capital availability believed to be constraining minority business development nationwide. Co-sponsor of the legislation creating the program, Senator John Tower of Texas, explained its expected utility in terms virtually indistinguishable from those used by today's proponents of CDFIs (Bates, 1997a). The founders of the MESBIC program rationalized their chosen strategy in terms of remedying the deficiencies of mainstream financial institutions, particularly their uninspiring record of financing minority-owned firms. MESBICs were going to make financing more widely available to minority-owned firms, facilitating "capital formation in the minority community generally," according to Senator Tower (Hansley, 1992, pp. 2, 3).

This study of the MESBIC industry's successes and failures proceeds along three lines. First, each and every one of the 1,100 plus small-business loan and venture-capital investments actually made by MESBICs in 1993 is sorted to identify the nature of the assisted firms. Second, all 119 of the MESBICs actively operating in 1987 are tracked

over a seven-year period, and the traits of the 61 still operating at the end of 1994 are compared to the 58 MESBICs that went out of business. Third, case studies are used to illuminate the nature of MESBICs that have remained in operation by successfully financing minority-owned businesses. The track record of the MESBICs over the past 30 years offers a wealth of insights to present-day proponents of CDFIs.

The Small-Business Investments Made by MESBICs

MESBICs are privately owned small business investment companies that receive part of their funding at subsidized rates from the U.S. Small Business Administration (SBA). These funds are largely invested in immigrant and minority-owned businesses and they provide, by design, patient capital, *i.e.* equity capital as well as long-term subordinated debt. The uniqueness of MESBICs, renamed Specialized Small Business Investment Companies (SSBICs) in the 1990s, lies in their status as equity-capital providers to minority business enterprises (MBEs). Prior to the mid-1990s, no other federal government small business assistance efforts sought to encourage equity capital (popularly known as "venture" capital) investment in MBEs. What sorts of small businesses do MESBICs invest in? In practice, how did the MESBICs perform?

I obtained from the SBA a comprehensive listing of every small-business investment made by MESBICs nationwide in fiscal year 1993. Approximately 100 MESBICs were operating that year, and the SBA managed to generate data for 1,101 of the 1,140 small business investments finalized in 1993 (Bates, 1996). Amazingly, approximately half of all of these debt and equity investments in small businesses flowed to firms operating in New York City. One line of New York City small business, in turn, accounted for most of the investments made by area MESBICs. The nation's MESBIC program in the 1990s is first and foremost a program dedicated to financing the purchase of New York City taxi-cab medallions. The year 1993 was not atypical; thousands of cab medallion purchases have been financed by MESBICs over the past decade. In terms of both numbers and dollar amount of investments, New York cab-medallion financing far exceeds the total of MESBIC investments in all lines of minority businesses operating in the Midwest, the South, and the Far West. The surviving MESBICs have evolved and adopted over the decades to the circumstances of their marketplace and the constraints imposed upon them by their government sponsors. Medallion Funding, Porter's example of success, calls

itself Medallion Funding because its chosen market niche lies in financing the purchase of New York City taxi medallions. Financing medallions typifies an investment strategy known as "asset-based lending." The mechanics of asset-based lending and the reasons for its attractiveness to inner-city lenders are explored throughout this study.

Like the cab financiers in New York, most of the MESBICs nationwide that actively invest in MBEs are asset-based lenders. Indeed, most of the CDFIs that survive into the 21st century are likely to be asset-based lenders. Asset-based lending is a pragmatic adaptation to the circumstances of financing small businesses in urban America.

The Economics of Asset-Based Lending

The crux of asset-based lending is simple: if the business receiving the loan succeeds, the MESBIC gets repaid, and if the business fails, the MESBIC gets repaid. Asset-based lenders are collateral driven. Taxi medallions represent outstanding collateral: they have appreciated steadily in value and they are highly liquid. If the taxi owner defaults on the loan, the MESBIC repossesses the cab medallion and sells it for an amount exceeding the outstanding loan balance. Asset-based lenders are less concerned about the viability or the growth prospects of the minority business being financed than they are about the value of the collateral that protects them from loss in the event of loan default.

Beyond taxi medallions, loans to restaurants, laundries, and grocery stores are the second, third, and fourth most common type of investment in small business made by the U.S. MESBIC industry. These loans flow largely to Asian immigrant business owners, and they are concentrated in major urban centers of Asian immigration, particularly Los Angeles and New York. MESBIC investments in restaurants nationwide are more common than investments in all lines of manufacturing combined; investments in laundries are more numerous than investments in all lines of wholesaling combined (Table 1). The firms that MESBICs invest in are often operating in industries where tiny firms, such as restaurants, are widespread. But the typical small business financed by a MESBIC is not a tiny firm. The median MBE nationwide is a zero employee operation, but the median MBE attracting a MESBIC investment is an employer. The median MBE nationwide has annual revenues of less than $100,000, but the median MBE receiving MESBIC funds has annual sales exceeding $500,000.

A recurring theme in the scholarly literature is the chronic unprofitability of lending to inner-city MBEs operating in traditional lines of

business like restaurants and laundries (Bates, 1993). Yet MESBICs often target larger firms operating in this niche and operate profitably. To illustrate how MESBIC asset-based lenders service this market, the operations of Exim Capital provide a clear-cut model. Exim Capital is operated by Victor Chun out of his Fifth Avenue office in Manhattan. Along side his MESBIC, Chun runs an accounting firm. He approves less than one loan application out of every 20 submitted to his MESBIC. In reviewing loan applicants, Victor Chun looks at collateral, homeownership, strong business cash flow, and the applicant's business experience. He regularly finds solid applicants, even though many have been rejected by banks. Chun believes that local banks do not want to lend to small firms. Loan applicants seeking under $50,000 are discouraged because Exim Capital has learned that it is not economical to process such small transactions. Exim Capital is looking to make small business loans in the $50,000 to $150,000 range to experienced, high-net-worth owners. Approved loans must be secured by solid collateral so that payment will be forthcoming irrespective of the viability of the small business under consideration.

Chun reviewed with me the collateral involved in six typical loans made by Exim Capital, which involved secured loans to Jee and Jung Cleaners; C.H. Kyung, Inc., and four other firms. Loan sizes ranged from $52,000 to $105,000 in these six transactions. Looking solely at collateral in the form of business and real estate assets owned by the borrowing firm and its owner (including business and residential real estate), the six deals offered collateral to Exim Capital ranging in amount from $162,500 to $801,000. In the case of one typical loan, Exim is the first lien holder on the borrowing business and the second mortgage holder on the personal residence of the owner of the borrowing firm, thus securing a $55,000 business loan with net collateral of $525,000. Quite irrespective of the success or failure of the small firm getting this $55,000 loan from Exim, Victor Chun is going to collect fully on the loan. All of Exim's other loans are similarly secured.

The inner-city environment has been Darwinian for MESBICs choosing to operate there: Exim Capital is a survivor, and typifies the mode of operation for the successful MESBIC doing asset-based lending to small minority-owned firms in central cities. MESBIC asset-based lenders flock to collateral-rich borrowers and taxi medallions. Most Blacks and Latinos have personal net worth well under $100,000, as do nearly 75 percent of Asians in the U.S. Exim might consider financing a taxi medallion for someone with personal wealth of less than $100,000, but nothing else.

Financial Viability Among MESBICs

Small-scale, relatively inactive MESBICs are frequently not viable from a cost of operations perspective. Examining the consolidated income statement for all active MESBICs operating in 1993 (Table 2) reveals that the industry as a whole is unprofitable. Income statement data are presented in two distinct ways. First, mean absolute dollar amounts of income and expenses are recorded, and second, income statement items are normalized, i.e. divided by total assets on a firm by firm basis. The first method of data presentation in Table 2 effectively allows larger firms to dominate the statistics, while the second method has the effect of weighting each MESBIC equally when means are calculated.

The typical MESBIC (Table 2) generated 7.33 cents in revenues per asset dollar, while incurring expenses of 8.43 cents to generate those revenues. The resultant spread (revenues less costs) per asset dollar was minus 1.10 cents before taxes and minus 1.18 cents after taxes. Sale of securities (which represent prior equity-capital investments in MBEs) added more negative numbers to the bottom line: the mean MESBIC, on balance, lost 2.70 cents per asset dollar in 1993. Examining on the non-normalized means (Table 2) suggests that the larger SSBICs are doing better than the smaller ones: average revenues of $469,000 less costs of $411,000 produced net income of $58,000; after taxes and realized losses from sales of securities, the bottom line was reduced to minus $3,000.

For the MESBIC industry, 1993's financial performance was not an atypical year. Examination of industry financial statements for other recent years revealed patterns of 1) recurring losses from operations, 2) frequent losses from the sale and disposal of venture-capital investments, and 3) a high attrition rate (MESBICs going out of business) (Bates, 1996).

The smaller MESBICs are clearly doing worse than the larger ones. Picking an arbitrary cutoff and defining MESBICs with less than $2 million in total assets as "small," and the others as "larger," stark differences stand out on the expense side of the aggregate income statements. Over the 1987 to 1993 period, *loan losses and labor costs absorbed 38.8 percent of the total revenues of the average large MESBIC, versus 66.5 percent of the total revenues of the typical small MESBIC*. The group of small MESBICs incurred these high costs while investing in a portfolio of assets that was top-heavy in bank CDs (Bates, 1997a).

Surviving and Failing MESBICs from 1987 to 1994

The evidence summarized above associates MESBIC weakness with its small overall size (measured by total assets), high costs of operations, and venture-capital investments in MBEs. The highest yielding asset widely held by MESBICs is cash assets, suggesting financial strength may be maximized by avoiding investments in MBEs altogether (Bates,1997a). These findings are treated as hypotheses guiding an econometric investigation that differentiates surviving MESBICs from those that dropped out of the industry.

A group of 119 MESBICs that were operating in 1987 is traced to October 1994: 61 were still in business and 58 shut down. Table 3 summarizes balance sheet and income statements in 1987 for these MESBICs, broken down into groups of: 1) active firms, still operating in late 1994; 2) liquidated firms, forced into liquidation by SBA due to insolvency; and 3) firms that voluntarily departed from the MESBIC industry.

The liquidated MESBICs (Table 3) stand out as the most active investors in MBEs, devoting 68.1 percent of their assets to small business investments and 25.1 percent to cash assets. The active MESBICs, in contrast, invested 64.0 percent of their collective assets in small business investments and 29.7 percent was devoted to cash assets. The MESBICs that surrendered their charters largely held cash assets. The liquidated MESBICs also stand out because of their high expenses (8.6 percent of total assets) and their realized losses from the sale of securities. The average total asset size of the active firms ($5.3 million) exceeded that of the liquidated MESBICs (average total assets of $2.8 million) by a wide margin.

Table 3's mean statistics, by themselves, are not an accurate guide to the causes of liquidation among MESBICs. Asset holdings among the active firms, for example, are skewed by a few highly-liquid MESBICs. A series of logistic regressions was undertaken to identify MESBIC traits that have predictive power to differentiate surviving MESBICs from those that were forced to close down. These regressions defined active and liquidated firm status as the dependent variable: charter-surrendering MESBICs were not considered. The following hypotheses guide these logistic regression exercises.

1. Large MESBICs are more likely to remain active than small ones. While size is a powerful explanatory variable, it was excluded from

some of the regression exercises so that *consequences* of size of operations could be more closely analyzed.

2. Low-cost MESBICs are more likely to remain active than high-cost MESBICs.

3. Highly-liquid MESBICs are more likely to remain active than others.

4. MESBICs generating high loan losses more likely close than MESBICs that control loan losses.

5. MESBICs capable of producing (realized) capital gains on their MBE equity investments are more likely than others to remain active.

Results from the logistic regressions are presented in Table 4. Of the factors expected to predict MESBIC survival accurately, three emerge clearly as statistically significant determinants; a fourth is marginal. The larger MESBICs that control costs and invest successfully in MBE equity capital are most likely to remain in operation. Investing heavily in cash assets is a marginally significant positive factor, but not a robust one.

Table 4's econometric modeling is complicated by the fact that the larger-scale MESBICs *clearly* tend to be the ones most likely to control costs and invest venture capital profitably in small businesses. Scale economies operate both to hold down the cost of operation and to make possible the kind of portfolio diversification that is a prerequisite for intelligent venture-capital investing (Bates, 1997a). Yet being large, by itself, neither guarantees control of costs nor viability among the venture-capital investments. The average size of the surviving MESBICs in 1987 ($5.3 million in assets) is nearly twice that of the MESBICs that shut down ($2.8 million in assets on average). Overly small size and hence scale of operations clearly tends to undermine the viability of MESBICs, particularly those operating with total resources of under $5 million.

The clearest message emerging from the econometric findings and the earlier discussion of the MESBIC characteristics described in Tables 2 and 3 is that failure-prone MESBICs are identifiable. Small MESBICs that generate high expenses per dollar of total assets are particularly likely to go out of business. Furthermore, active small business investing, particularly unsuccessful venture-capital investing, typifies failure-prone small MESBICs. Survival and profitability, for

MESBICs with total assets of under $5 million, is promoted by investing in bank CDs, not minority-owned businesses. Although this finding may explain why money-market investments are much more widespread than venture-capital investments in MBEs in the MESBIC industry, it also suggests that most small MESBICs are not capable of meeting the goals that justified creation of the MESBIC program in the first place.

Because they are often incapable of serving as providers of debt and equity capital for MBEs, they should not be holding MESBIC charters. Lacking the scale that is a prerequisite for cost-efficient operations and diversification of portfolio risks in inherently risky venture capital investments, such MESBICs generate negative profits (Bates, 1997a). Those who favor eliminating these ineffective MESBICs should be encouraged by the fact that they appear to be effectively destroying themselves. Chronic unprofitability erodes their net worth, and results in forced bankruptcy initiated by the SBA's Office of Liquidations (Bates, 1996).

One surprising finding emerging from the logistic regression equations is that loan loss provisions made by MESBICs in 1987 had no predictive power for delineating MESBICs still active in 1994 from the discontinued MESBICs (Table 4). Yet, controlling loan losses is vitally important for MESBIC survival and long-run viability. Discussions with SBAofficials overseeing the MESBIC program indicate that weak MESBICs consistently understate loan losses; they literally hide their losses. If a weak, money-losing MESBIC were to report heavy loan losses, officials from the SBA Office of Liquidations would quickly take note.

Returning to Table 4's econometric findings, the goal of identifying successful MESBICs merits elaboration. Being large (total assets of $5 million plus) facilitates cost control and success in investing in small businesses, while being small tends to produce the opposite effect. Yet being large, by itself, does not guarantee that a MESBIC will remain a profitable, active financier of minority-owned businesses. Successful lenders among the MESBICs are the asset-based lenders. The MESBICs sort into groups of successful and unsuccessful equity investors as well. MESBICs that make money from their equity investments dominate the ranks of the largest and most profitable firms in the industry. A case example of TSG Ventures is used to highlight MESBIC success in venture-capital investing.

TSG Ventures Inc: A Model of Successful Investing in Minority-Owned Businesses

TSG possesses the essential traits of a successful MESBIC: it is a professionally managed, well capitalized investment company operating on a large enough scale to diversify its risks and hold down its operating costs. TSG was formed in 1992 when Cleveland Christophe and Duane Hill led a management buyout of Equico Capital Corporation, a subsidiary of the Equitable Life Assurance Society. From 1981 to 1992, Duane Hill was the president and chief executive officer of Equico. TSG's success is properly traced back to Mr. Hill's appointment as president of Equico. Prior to joining TSG, he worked at J.P. Morgan for eight years, serving as a vice president. When Hill first arrived in 1981, Equico was an under-performing MESBIC. Possessing total assets of nearly $15 million in 1981, Equico managed to generate a net loss of $2.581 million in that year, caused primarily by writeoffs of bad loans. Mr. Christopher joined Equico in 1990. Previously, he had been senior vice president of the TLC Group, the leveraged buyout firm controlled by Reginald Lewis.

Equico was one of the nation's original MESBICs created by a major corporation, Equitable Life, and was chartered in 1970. By the end of its 1981 fiscal year, Equico, like so many other MESBICs of that era, had managed to generate a large cumulative deficit, $5.662 million, in addition to carrying a large unrealized loss on loans and investments. Judged by its initial capitalization, Equico was bankrupt. Equitable Life injected an additional $3.5 million into Equico during 1981 when Duane Hill took over as president, and Equico raised $1.0 million more that year by selling three percent cumulative preferred stock to the SBA.

In 1981, Equico resembled the overall MESBIC industry. Its investment activities were loan oriented, with its loan dollar volume exceeding its equity investments by more than a 10:1 margin. Major asset categories were 1) loans, $7.3 million; 2) equity investments, $0.6 million; and 3) money market investments, $6.1 million.

Like many MESBICs active in the 1970s, Equico often behaved like a community development bank, focusing on financing small minority-owned businesses. This emphasis was due, in part, to the fact that large-scale, growth-oriented minority-owned businesses were less numerous than they are today. Managers of MESBICs realized that small MBEs catering to minority clients were not an appropriate target market for venture-capital investing, so the emphasis was on providing loans to small-scale, community-oriented minority-business borrowers.

The problem with this investment strategy was that small, minority-owned firms were a high risk market for MESBICs specializing in lending. Most MESBICs lost money servicing this clientele (Bates, 1996).

Prior to Hill's 1981 arrival as president, Equico had tried to achieve viability by servicing two distinctly different markets — the small-scale, community-oriented minority firm, and the larger-scale MBEs that possessed growth potential. The problem with serving small, inner-city operations was one of continuing high levels of loan default. Equico had to move out of this segment because losses were sufficiently high to threaten its survival. The key element of Duane Hill's turnaround strategy for Equico was to drop the community-oriented "mom and pop" operations, and focus solely on larger-scale MBEs with growth potential. These firms could absorb equity investments and put the funds to profitable use financing the growth of the enterprise. Hill's shift from small operations to growing MBEs competing in the broader marketplace included a shift in Equico's investment strategy from loans to equity investments.

How did the new strategy work? A loan portfolio generates a steady cash flow for a MESBIC: repayments of principal and interest should pour in each month. New equity investments hurt cash flow: recipient MBEs use equity dollars to finance firm growth. Initial dividend payments are unlikely to be forthcoming if the young MBEs successfully generate high growth with their equity-invested dollars. Dividend payouts are more likely to be paid after a period of sustained growth has produced a large-scale, profitable, minority-owned business. It is difficult to judge what the equity investment payoff is to a young, rapidly growing MBE during the first several years of the equity investment lifespan. The immediate results of Hill's early years of running Equico, therefore, were:

1. Continuing losses and writeoffs from the $7.3 million loan portfolio inherited in 1981 from Equico's previous management.

2. Reduced cash flow from small business investments as the loan portfolio shrunk.

3. Minimal dividend income from the growing portfolio of equity investments in minority-owned firms.

Equico's cash flow as it shifted from being a lender to being a venture capital investor was propped up by interest income generated by invest-

ments in bank certificates of deposit. Equico's cumulative deficit initially rose from $5.7 million in 1981 to $10.0 million in 1985, reflecting the slow payoff to venture-capital investing.

During the first phase of Equico's turnaround the early 1980s, Duane Hill implemented an investment strategy that emphasized making equity investments in larger-scale MBEs that possessed growth potential. By the mid-1980s, that strategy cleaned up Equico's deficit-laden balance sheet, and put the firm on a trajectory of growth and profitable operations. During the 1985 to 1990 period, neither the SBA nor Equitable Life injected additional capital into the company. Equico's new-found financial strength was rooted in the operating strategy that Hill had successfully implemented.

How does one identify a larger-scale MBE that is capable of using an equity-capital investment to create firm growth, as well as appreciation in the value of the firm itself? The minimal requirements include 1) a very strong management team, 2) a proven product and/or service, 3) annual sales exceeding $1 million, and 4) a profitable operation in the past year. A firm with these traits would also have to present (or demonstrate) 1) strong internal accounting and financial controls, 2) audited financial statements, 3) strong personal credit ratings of the top managers, and 4) a written business plan with three- to five-year projections. The key element is having a firm run by experienced, successful, highly capable managers. Finally, a firm with the potential to grow ten-fold over the next five years is more likely to attract an equity capital than one on a slower-growth trajectory.

The 1990s saw Equico move into a leadership role in the MESBIC industry. TSG emerged as a premier venture capital firm in the MESBIC industry after its 1992 management-led buy out of Equico from its parent, Equitable Life. A comparison of 1981 and 1994 balance sheets indicates that the value of TSG's small business equity investments increased nearly twenty-fold, rising from $0.6 million to $10.3 million. Meanwhile, TSG realized net gains on investments of over $4.5 million during 1993 and 1994, *i.e.* its gains are real, not merely paper gains. Year-end 1994 balance sheet figures indicate that TSG relied upon its shareholders and internally generated earnings (retained earnings) as its sources of funds. Reliance upon debt was minimal. The important lesson offered by TSG is that a professionally managed venture capital firm can thrive by serving the equity capital needs of growing minority-owned businesses.

Lessons Learned

In light of its transition from a chronically unprofitable investment firm propped up by capital infusions from Equitable Life and the SBA to an industry leader, insights were sought from TSG's management team about how the overall MESBIC program may be turned around. Is it possible to move the MESBIC industry as a whole in the direction of TSG? Duane Hill suggests that such a move is not likely. A major barrier holding down the number of successful MESBICs specializing in venture capital investing is, according to Hill, the government itself.

Elaborating, Hill states that the SBA has not traditionally been interested in the viability of the MESBIC industry. Top administrators at the SBA, according to Hill, have often been political appointees who do not bring appropriate expertise to their positions. Their turnover is high. They cannot move the entrenched SBAcareer bureaucrats so they stop trying, which results in a situation of poor program management. Many of the SBA's current top administrators, Hill acknowledges, are capable and enlightened managers. Highly capable managers have held top SBA appointments in the past and their willingness to take on the bureaucracy has typically declined rapidly with their tenure. Is the situation today any different? "It is hard to be optimistic," Hill states.

What is wrong with the bureaucracy that makes it such an impediment to create a thriving MESBIC industry? The SBA, according to Hill, prefers to have MESBICs financing unsophisticated minority business owners: "college graduates with corporate experience are not socially or economically disadvantaged." Yet these are precisely the kinds of owners TSG seeks to finance.

Hill paints a dismal future for the industry, but he also points out a possible road to reform. The top SBA officials in the 1990s, according to Hill, were more tolerant of successful MESBICs than their predecessors, and this attitude has even penetrated the bureaucracy to some degree. If the SBA's leadership truly was to reform the entrenched bureaucracy, real progress could be forthcoming. Hill is not optimistic. He believes a more likely scenario is that the SBA will drive the most successful MESBICs out of the industry.

Lessons for Community Development Financial Institutions

The CDFIs that have been so actively promoted by the Clinton Administration began operating in the mid-1990s with funding that partially reflects subsidies from the federal government. Funding small

businesses in inner-city, low-income minority communities is a major part of their mandate. The fact that the vast majority of the MESBICs chartered since 1969 had similar missions and went out of business should be noteworthy to CDFI planners (Bates, 1996). Two distinct types of small business financing dominate among surviving MESBICs that operate profitably 1) asset-based lending that is collateral driven, and 2) venture-capital investing targeted to large-scale MBEs run by sophisticated, highly experienced business managers. Have we learned the right lessons from the MESBIC experience?

Heeding the lessons of 30 years of MESBIC operating experiences is not apparent in one of the premier CDFIs, a financial institution organized in the Atlanta empowerment zone in August 1996, a Community and Individual Investment Corporation (CIIC). Identified as a "for-profit" entity, the Atlanta CIIC's mandate includes funding:

1) Micro loans, ranging from $1,000 to $5,000 to finance inventory, working capital and equipment for home-based businesses and self-employed individuals;

2) Start-up loans and "micro-equity" investments, ranging from $5,000 to $50,000 to finance inventory, equipment and facilities and other costs for businesses with fewer than three years of operating or earnings history;

3) Expansion loans of up to $500,000 for the acquisition of inventory, equipment and facilities for established firms whose growth plans exceed internal financing capacity;

4) Commercial mortgage loans of up to $500,000 for the acquisition and improvement of income property within the empowerment zone and linked communities.

All of this broadly resembles the strategy guiding the Equico MESBIC in the 1970s that targeted the small firms operating in the local community, as well as the larger-scale firms possessing growth potential. Of the many scores of MESBICs that pursued such investment strategies in the 1970s, none remain today. Most went broke; the survivors radically changed their investment strategies and became the Exim Capitals (asset-based lenders) and the TSGs (high-end venture capital investors) of today. CDFIs (and their CIIC variants) that pursue a strategy of risky small-business investing will experience similar fates.

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Table 1
Industry Distribution of Firms Invested in by MESBICs during 1993

A. Broad Industry Groups	Number	%
Farm, Forestry, Fishing, Mining	6	0.5
Construction	32	2.9
Manufacturing	73	6.6
Transportation, Communication	517	47.9
Wholesale	46	4.2
Retail	204	18.5
Finance, Insurance, Real Estate	15	1.4
Selected Services	208	18.9
TOTAL	1101	100.0

B. Selected Specific Industries with Numerous MESBIC Investments	
Taxi	464
Grocery	54
Restaurant	80
Laundry	57
TOTAL	655

Source: Form 1031 data from internal SBA records.

Table 2
MESBIC Industry Income Statement, 1993 (mean values for 101 active MESBICs)

	$Amount ($thousands)	% of total assets (calculated firm by firm)
A. Revenue		
1. Interest on business loans	409	5.73
2. Dividend income	4	0.20
3. Misc. business income	7	0.18
4. Total of 1, 2, and 3	420	6.11
5. Interest on cash assets	28	0.84
6. Other income	21	0.38
7. Total revenue	469	7.33
B. Expenses		
1. Cost of funds	148	1.53
2. Labor costs	122	3.15
3. Misc. operating costs	99	2.14
4. Provision for loan loss	42	1.62
5. Total expenses	411	8.43
C. Profit		
1. Net pretax income	58	-1.10
2. Income taxes	3	.08
3. Net income after taxes	55	-1.18
4. Realized gain on securities	-58	-1.52
5. Profit net of securities losses	-3	-2.70

Source: Internal SBA records

Table 3
MESBIC Industry Consolidated Balance Sheet and Income Statement, 1987
(all values are means expressed as a percentage of total assets)

ASSETS	Active firms (%)	Liquidated firms (%)	Surrenders (%)
1. Debt in small firms	53.9	56.1	23.4
2. Equity in small firms	10.1	12.0	14.0
3. Cash, money-market investments	29.7	25.1	58.6
4. Misc. assets	6.3	6.8	4.0
Total assets	100	100	100
LIABILITIES + NET WORTH			
Total Liabilities	19.5	23.7	15.9
NET WORTH			
1. Private capital investment	43.3	46.9	61.5
2. 3% preferred stock sold to SBA	40.2	36.1	32.8
3. Undistributed earnings	(3.0)	(6.4)	(10.2)
Total net worth	80.5	76.4	84.1
PROFIT and LOSS			
1. Total revenue	9.4	8.9	7.7
2. Total expense	7.7	8.6	7.2
3. Net income before tax	1.7	0.3	0.5
4. Net income after taxes	1.1	0.0	(0.2)
5. Realized gain (loss) on securities	2.1	(0.3)	(0.9)
N	61	46	12

Source: SBA internal records

Table 4
Explaining MESBIC Survival over the 1987-1994 Period

A. Logistic/regression analysis of patterns of survival and failure among MESBICs.

Variable	(1) Regression coefficient (std. error)	(2) Regression coefficient (std. error)	(3) Regression coefficient (std. error)
Intercept	-.366 (.326)	-.353 (.331)	.890* (.453)
Capital gain	--	--	11.555* (5.309)
Cost	--	--	-8.411* (4.008)
MESBIC size	.00013* (.00007)	.00013* (.00007)	--
Liquidity	.849* (.515)	.854* (.516)	--
Loan loss	--	-2.53 (1.527)	--
n=107 -2 Log L (Chi square)	137.7(8.5)	137.7(8.6)	138.0(8.3)

*Statistically significant, five percent significance level

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