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## Locally Sourced Capital for Small Businesses in Rural Communities

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## Locally Sourced Capital for Small Businesses in Rural Communities

### Abstract

Lack of adequate access to capital is a major barrier for rural entrepreneurs. Washington State University Extension and the Association of Washington Cities partnered to explore and test an innovative local investment approach that provides access to capital and engages the community in the success of individual businesses. The approach offers local residents the opportunity to invest in local businesses and entrepreneurs the opportunity to find funding through an alternative method. The pilot project engaged more than 26 investors in two communities and led to investment in multiple businesses.

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## Introduction

Small businesses are the drivers of the U.S. economy. They account for over 64% of the new private sector jobs created, but an alarming five out of 10 new businesses fail within the first 5 years of starting (Small Business Administration, 2014). But why do they fail? The recent financial crisis and economic downturns have led to a significant reduction in the availability of capital and credit, especially for cash-strapped individuals and small businesses (Laderman & Reid, 2010). In a recent study by Pepperdine University, small-business owners shared their thoughts about best policy instruments for helping spur U.S. job creation. A top answer was "increased access to capital" (Everett, 2015). The issue of access to capital only gets worse in rural areas, as the economic downturn caused many lenders to retreat from these areas, leaving vacant buildings and lost start-up opportunities for rural businesses. Small businesses in the rural United States encounter barriers such as low population density and geographic isolation, which result in limited access to markets, capital, labor, peers, and infrastructure (Dabson, 2002). The lack of access to capital continues to plague small businesses, yet it, along with credit, is vital to spurring the start-up and growth of businesses (Samila & Sorenson, 2011).

There are federal policies and programs that address the issue of access to capital in rural communities. For

example, many agricultural and rural small businesses enjoy preferential access to loan capital at below-market interest rates from the U.S. Department of Agriculture (Edelman, 2015). More recent policy innovations have been created to allocate capital to specific segments of businesses associated with criteria such as low income, economic distress, and declining-population census tracts (U.S. Department of the Treasury, 2014). Still, gaps exist, and small businesses have no place to turn. So with fewer resources and credit lending tightening, Extension needs to identify alternative sources of capital to help rural small businesses start and grow. Extension agents need to seek alternatives to help local businesses succeed. One alternative is to look locally at customers and residents who can play a role in providing capital and support filling a gap of necessary funding (Ordanini, Miceli, Pizzetti, & Parasuraman, 2011).

The purpose of this article is to introduce a Washington State University (WSU) pilot project targeting local investment opportunity networks as an avenue for creating access to capital locally for small-business owners.

## Program Description

WSU Extension and the Association of Washington Cities (AWC) partnered to discover different financing mechanisms for helping businesses get started and/or grow. The pilot project focused on a program developed in Port Townsend, Washington, called Local Investment Opportunity Network (LION). The pilot project involved three small cities that varied in size:

- Davenport—population 1,682,
- Chewelah—population 2,593, and
- Sequim—population 6,669.

LION is a network that connects local investors with local business owners who need capital. The program brings a community together and culminates in "business spotlights," networking events at which local businesses are introduced to local investors. For business owners, LION offers an avenue for borrowing money from neighbors, customers, and others interested in their success. For investors, LION offers means for seeing where their money is going and whom it is helping. The program enables residents to invest in what they know and can see, the local businesses that make their community the unique place it is.

## How Does It Work?

The process of making a business-investor connection through LION involves four steps:

1. An interested business applies to the LION network through a standard application process.
2. The designated LION contact directs the application and funding opportunity to relevant investors in the network.
3. Interested investors contact the business directly and vet out the opportunity.
4. The deal is negotiated, and the deal is funded.

## What Are the Pros and Cons?

As with any such initiative, the LION program involves advantages and disadvantages for those involved.

### *Pros*

- The level of familiarity and knowledge that comes with a local investment can provide investors with greater insight into the business.
- Interest rates on loans generally reflect the higher risk premium.
- Dividends and repayment may also take the form of in-kind payment.
- The rewards are more than financial; by investing in a local enterprise, residents support their local economy and increase the local quality of life.

### *Cons*

- Securities and Exchange Commission regulations involve strict guidelines that must be adhered to when creating a security.
- Private transactions carry risk. There is no regulatory oversight or recourse, and investors must conduct their own due diligence.
- If a loan is unsecured, the investment could potentially be lost if the business fails.
- Equity investments are likely to be illiquid and long term, with no easy way to cash out.

## What Is the Upshot?

The LION program is about connecting the dots between socially minded citizen investors and locally owned business, and it is about communities investing in themselves. The program involves participants such as citizen investors, business owners, local economic development councils, elected officials, and others—ordinary people who care about the idea of the businesses in their communities working together to start successful local investment networks at a grassroots level.

## Program Evaluation

At the time this article was written, the pilot project had resulted in two investments in Chewelah, for a restaurant (marketing) and a local brewpub (capital and equipment), and the network had over 12 new resident investors. In Sequim, there were over 14 investors and two potential investments in local businesses in the agriculture industry. The small population size of Davenport made it more difficult to get the necessary investors and deal flow to make the pilot project successful there.

## Conclusion

With funding retreating in rural areas, Extension needs to identify alternative capital options for rural small businesses. Without adequate, affordable capital, many Main Street businesses may have to close their doors. LION is a program designed to engage residents in making their communities great places to live and filling the funding voids that so many small businesses encounter.

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