SOME RECOMMENDATIONS FOR
THE MASSACHUSETTS INDUSTRIAL SERVICES PROGRAM

by

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Some Recommendations for
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ABSTRACT

This thesis is intended for use by the Business Services
Division of the Massachusetts Industrial Services Program in
setting policy for the Economic Stabilization Trust. It looks at
the role of the Trust in the context of an imperfect capital
market, and discusses several issues of concern to proper
operation of the Trust. The major questions addressed are: how
should the Trust target its financing? how should the Trust
price its financing? how should the Trust incorporate non-
financial concerns into a financing decision? how can the Trust
obtain additional funding for investment and operating expenses?

Principle conclusions are as follows. First, before
agreeing to participate in a turnaround or buyout, the Trust must
ensure that a business is genuinely unable to obtain suitable
funding from other sources and that it is likely to be viable and
able to repay the Trust's investment over the long term. If the
Trust is too risk averse or, conversely, acts in a risk ignorant
fashion, it will be ineffective in its economic stabilization
purpose.

Second, the Trust should have a general policy of charging
firms for capital at rates commensurate with risk according to
the standards of the market. Capital subsidies are almost always
unnecessary and unwarranted for troubled mature firms. However,
considerations of financial return should not be allowed to
dominate the Trust's investment decisions.

Third, the Trust should develop a consistent policy for
evaluating the potential social benefits of investments so as to
maximize the overall public benefit of the Trust's capital. This
should be accomplished through prescreening, portfolio selection
with regard for non-financial considerations, and incorporating
social concerns in investment agreements to ensure
accountability.

Fourth, the Trust should seek to reduce its dependence on
legislative appropriations, and thereby avoid political
pressures. Program Related Investments of philanthropic
foundations are suggested as one possible source of additional
investment capital for the Trust. Charges to client firms for
business services are discussed as a likely source of operating
capital.

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Preface

The creation of the Massachusetts Industrial Services Program (ISP) provides a unique opportunity in the history of state economic policy. For the first time, a state agency exists with a mandate to specialize in the problems facing firms in mature industries and the needs of their workers. Moreover, the ISP, through its investment financing arm, the Economic Stabilization Trust (EST, or the Trust) has the capability to make direct investments of public capital in troubled firms to effect turnarounds and save jobs.

The attached report is intended to assist the director and staff of the ISP in their efforts to develop policy for proper use of the EST. In particular, it looks at the Trust in the context of an imperfect market and a political environment to develop recommendations on four major issues:

- how can the EST’s capital be targetted to firms in an appropriate fashion?
- what should the EST charge firms for using its capital?
- how can the beneficial social impacts of EST investments be secured?
- what are some non-state sources of funding for the EST that can help it to avoid overreliance on legislative appropriations?

While discussion of these issues is undertaken with the needs of Massachusetts’ ISP in mind, it is hoped that this report may be of some general use to other public purpose financial assistance programs.
Chapter 1 Introduction

1.1

Successful development and utilization of the Massachusetts Economic Stabilization Trust is a difficult and ambitious undertaking. The EST must link job retention with sound investment strategy. It must build institutional credibility and autonomy in order to interact successfully with the private sector, yet deal in highly risky and emotion charged situations within a political and public environment.

The aim of this report is to provide a basis for understanding the major issues facing the EST and discussing strategies for addressing them in accordance with the Trust's enabling legislation, its need to bridge public and private sectors, and the experience of other development finance institutions. These issues are:

First, how can the Trust target its capital to firms with an appropriate level of risk so as to ensure maximum beneficial impact on Massachusetts' economy? To be of any legitimate benefit to the state's economy, the EST must use its capital to finance mature manufacturing firms that are considered inappropriate for investment by private sector financiers. At the same time, although the Trust is not held to standard "prudence" requirements, loans and investments must be made in a financially responsible fashion in order to protect the public's funds and ensure the credibility of the institution.

Second, how should the Trust price its capital? By statute, the Trust is not to invest on the basis of direct financial return on investment. However the proper pricing of capital is
an essential consideration for any investment institution, public or private, and is a necessary topic of EST concern. Over or underemphasis on financial return will weaken the performance of the Trust.

Third, how can the Trust achieve its ultimate goal of avoiding the social costs to Massachusetts citizens and the fiscal costs to state and local governments of plant closings and layoffs? The Trust is charged with incorporating these nonfinancial benefits in its investment decisions. The Trust's administrators need to develop a method for doing so in a sound and consistent fashion.

Fourth, from where can the Trust obtain additional investment and operating capital? The EST's effectiveness in the long run depends on its viability as an institution. To grow and thrive, the EST will have to go beyond its relatively small state funding and seek out other sources of investment and operational funds.

The following four chapters try to develop an understanding of these questions in order to guide the Trust's operation in appropriate directions. The analysis and recommendations are based on a review of development finance literature, planning studies and informational materials from development finance and technical assistance programs, and personal interviews.

1.2

Chapter 2 brings out some of the issues that must be understood before the EST can assume an appropriate level of risk in its investment activities, and an appropriate role in
Massachusetts' business and financial markets. It focuses on ways in which the Trust can achieve the proper balance between risk avoidance and risk ignorance in its investment activity.

A well operated EST is a market perfecting institution. Its expertise in the needs and problems of mature firms will allow it to overcome the inefficiencies in the Massachusetts capital markets. Biases against certain industries or ownership forms on the part of many institutions, the high cost of information and transactions, the general risk aversion of many private investors and the exclusion of non-financial public benefits from private sector investment calculuses can contribute to the unavailability of "timely high risk capital for corporate restructuring" that the EST is intended to address. In determining the suitability of an applicant firm for EST assistance, the Trust must consider whether the firm is a victim of flaws in the market for capital which result in the label "too risky" being applied inappropriately from the public standpoint. The requirement that the Trust invest only in endeavors that can not find sufficient financing elsewhere serves to enforce this "market-correcting" role, and define the Trust's market niche. If a firm with other access to capital receives EST financing, the agency has merely substituted one source of capital for another with no impact on the overall availability of funds for economic development.

On the other hand, the EST is, for good reason, restricted by statute to investing in "economically viable" firms that have a "reasonable chance" of survival as successful businesses. If capital is provided to unsound firms, the loan or equity
investment is lost as the firm quickly fails. And the EST can help to reduce the risk of its portfolio even further by developing and monitoring a restructuring plan for every successful applicant, including covenants in financing agreements, and emphasizing coventures to spread risk.

In sum, the proper role of the EST is to provide financing that is too risky for other financial institutions but not such a gamble that it is likely to be lost. Inability to achieve this balance will render the Trust ineffective as an agency of economic development in Massachusetts.

1.3

Chapter 3 addresses the very important question of the proper pricing of EST capital. It recommends that the Trust invest with the expectation of a market based return commensurate with risk on its portfolio of projects. The need for institutional credibility demands that the EST not be seen as merely another government giveaway program.

Proper lending or investment strategy considers two dimensions: risk and financial return. The primary goal of achieving a non-financial return for the people of the Commonwealth does not mean that financial return can be ignored. There are a number of important reasons for the EST to charge its applicants at standard market rates for their capital. Most importantly, in most instances it is the availability of capital that is at issue, not its cost. If the Trust is successful at targetting its funds to those opportunities "missed" because of the imperfections of the market, it should be able to price its
capital according to market standards. Subsidizing a troubled firm's capital costs is tantamount to rewarding it for the internal inefficiencies or inability to compete in the marketplace that led to its plight.

However, the chapter also cautions against the use of financial return as a sole or even principal motivation for an investment decision. It suggests the use of creative financing methods to avoid the imposition of high capital costs on a firm during the difficult early years of a turnaround. It emphasizes that even the best deals from a financial standpoint are not necessarily the best deals for the EST to make, given its economic stabilization mandate.

1.4

In contrast, Chapter 4 addresses the incorporation of non-financial return in investment decisions. It includes some discussion of what the relevant social benefits are, how these can be included in investment decisions by prescreening and during formal evaluation, and how they can be maintained over time by incorporation into financing agreements. The chapter also considers how the non-financial return from EST funds can be maximized by a suitable portfolio selection process, including the investment of funds that are "uncommitted" to specific projects.

The EST is charged with reducing the social costs of a layoff or plant closing and with obtaining the fiscal benefits to the state and municipalities of maintaining the operations of businesses in Massachusetts. Maximization of social and fiscal
return to the state is a proper objective of the Trust’s investment strategy. However, this maximization should not be unconstrained. A firm’s long run viability must always be paramount in an investment decision. Moreover, in light of the Trust’s limited resources, and the arguments against subsidizing capital, desired non-financial benefits and distributional considerations can serve as a basis for rationing a limited pool of capital, rather than as a basis for pricing that capital.

1.5

Chapter 5 discusses briefly two potential sources of funding support for the EST. Program related investments are made by many philanthropic organizations for reasons and in a manner quite consistent with the operation of the EST. These might be sought as a complement to the Trust’s investment funds. In addition, by charging firms a reasonable price for consulting services, the EST/ISP can increase its operational budget.

The EST’s initial $2 million capitalization, combined with the $4 million requested for fiscal 1986, is a relatively small amount of capital for an institution that is likely to invest an average of one-quarter to one-half million dollars per deal. In addition, an operational budget of $340,000 for the first year sets a limit on the work that can be done by the EST/ISP staff.

While annual appropriations from the Legislature can keep the Trust from running out of available investment or operational capital altogether, an overreliance on this political body is inappropriate and disadvantageous for an institution like the EST which must invest without regard to political pressures or
implications. The Trust should not feel itself pressured into making unsound deals or avoiding good ones out of a concern over the next year's funding level. The EST is authorized to take advantage of any additional funding sources that it can find, and to do so is an important strategy for the fund's long term survival.

1.6

The Economic Stabilization Trust will be a stronger organization if it operates with an understanding that it exists to take advantage of the investment opportunities that are left unfinanced because of imperfections in the capital markets. By compensating for these imperfections, the Trust is able to make investments that are overlooked by traditional investors. In doing so, the Trust has the opportunity to earn a financial rate of return equivalent to that which private investors would seek in assuming investments with a similar amount of risk. As a public institution, the Trust also has a responsibility to incorporate non-financial considerations in its investment decisions and because it is a public entity, can incorporate the social and fiscal impacts of saving a troubled plant—factors ignored by most traditional financiers—within its investment calculus. Moreover, it can make investment decisions so as to address the capitalized inequities of society by distributing its limited resources to favor firms that maintain "good jobs," worker-owned firms, and those located in depressed areas. In addition, the directors of the Trust should, even in this early stage, operate with the long term effectiveness of the Trust in
mind, and work to reduce its dependency on the state legislature for operating and investment capital.

The remainder of this report provides the EST with guidelines for success. It draws on supporting evidence from theory and from the experiences of other development finance institutions. It is hoped that these guidelines will help the Trust's administrators to make the most of an agency with great potential for stabilizing and strengthening the declining sectors of the Massachusetts economy.
Chapter 2 Targetting the Trust's Capital

2.1

Any effective development finance institution serves to expand the availability of capital to businesses that are unable to get it because of the way the market works rather than through any inherent failings of their own. In order to be successful in its mission of stabilizing employment in troubled manufacturing firms, the EST must overcome the factors that make many traditional private investors reluctant to finance such firms. In this way, the Trust can take advantage of investment opportunities that have been overlooked or avoided by the private sector. In short, the Trust must fill a "gap," in the availability of capital by compensating for imperfections in the capital market.

Because the Trust has a preference for non-financial return and a duty to make the "high risk" investments that troubled firms need, it is authorized to have a higher loss rate on its investment portfolio than conventional lenders and investors. In addition, in order to ensure that the Trust stays within the capital gap-filling market niche established for it and does not duplicate the activity of private sector investors, applicants for EST assistance are required to show "due diligence" in trying to obtain financing from other sources. The Trust is in the seemingly precarious position of being a risk assuming investor of last resort.

However, the Trust must also exercise constraint in assuming risk. The Trust is required to consider a firm's economic
viability before investing. Some firms should not receive capital at all, because they are unable to provide an expected return -- both financial and non-financial-- sufficient to outweigh their likelihood of failure. Even those businesses that merit an investment of Trust capital can be made less subject to failure or low return through mechanisms such as business planning, technical assistance and monitoring.

The EST's acceptance of risk should not be in the form of risk ignorance. To the contrary, the primary task of the EST is to target its scarce resources to those firms with high risk that also promise a substantial chance of success and a consequential financial and non-financial return on the Trust's investment. This chapter attempts to help the Trust strike a proper balance between those firms that should not receive EST capital because they are too risky, and those that should not receive it because they are not risky enough. In short, it helps the Trust to identify and fill its "capital gap."

2.2 Overcoming Market Imperfections

In order to fill a capital gap, the Trust must be able to identify and compensate for the imperfections of the market. Proper targetting of the EST's limited resources requires an understanding of the imperfections in the capital market that affect mature firms, and the ways in which the Trust can address these imperfections. Four types of "imperfect" behavior are particularly relevant to the EST's role.

First, a conventional financier, faced with a chance to finance an endeavor such as the turnaround of a shaky but
promising mature firm or the worker buyout of a major corporation's branch plant, may automatically presume the investment to be "too risky" to be worth the return. This assumption may be based on a general perception that all such efforts are unduly risky.

Second, the financier may lack the information to assess properly the risk of the endeavor, and may consider it too costly to obtain what he/she needs to know. It is easier, less expensive, and involves less uncertainty to invest in more conventional businesses about which a great deal more is known, and so the unusual application is denied.

Third, the financier may know enough to consider the buyout or turnaround an acceptable risk, but may not consider it worth the cost or effort to perform the complicated financial packaging necessary to complete the deal.

Fourth, the risk averse private lender or investor may be unable or unwilling to bear all the risk associated with a given investment or may require an extremely high financial return to compensate for the possibility of a failed investment.

These market imperfections -- prejudicial behavior on the part of financial actors, excessive information costs, high transactions costs, and extreme risk aversion among investors -- can all be addressed by the EST. The key to the Trust's success in correcting for capital market imperfections will be its ability to develop a specialized expertise in evaluating and meeting the needs of its set of target firms.
Avoiding Prejudice

Wintner notes that obtaining financing even for eventually successful worker buyouts of mature firms is often a problem because financing institutions are unfamiliar with or adverse to the concept of worker ownership, and have a blanket assumption that the previous owners "would not have planned a shutdown if the business were potentially profitable." [1] Litvak and Daniels point out that "political disTrust of the goals and implications of new organizational forms," can cause an investment institution to ignore an otherwise acceptable deal.[2] Both of these are examples of the prejudging of an investment. Financial institutions might also discriminate against certain businesses based on the kind of product they make or their locations. The use of irrelevant characteristics to categorize and dismiss a potential investment through "statistical discrimination" precludes the gathering of sufficient knowledge about its prospects.

The EST can address prejudice in the capital markets in two ways. First, the Trust itself can consciously refuse to discount an application based on the attributes of an industry, location, or ownership form. In this way, the EST might even perceive as "low risk," investments that conventional institutions assume to be exceedingly risky. The Massachusetts legislature created the Community Development Finance Corporation (CDFC) as an institution that could overcome the tendency of traditional investors to discriminate against investments in depressed areas of the state. Likewise, the EST can refuse to follow the general
tendency of investors to discriminate against worker owned firms, or those in stagnant industries.

Second, by agreeing to participate in a venture, the EST can alter prejudicial behavior on the part of other financing institutions. This is important for helping the Trust to leverage investment from more cautious institutions that may be reluctant to be "first in" on a deal. The director of the New England Trade Adjustment Assistance Corporation (NETAAC) has found that evidence of "government support" can lend credibility to a firm's fund raising efforts. [3]

Overcoming High Information Costs

Small businesses, troubled businesses, businesses in industries that are "out of vogue," privately held businesses, and businesses that have been slated for a shutdown or are undergoing a change of ownership are, as a rule, precisely those businesses for which the investor wants the most information before deciding to make an investment, and those for which this information is most difficult and costly to obtain. As a result, many potentially viable firms that have one or more of these characteristics will be unable to obtain capital from private institutions because of a reluctance or inability on the part of lenders and investors to gather the information needed to assess them. These financiers will, instead, concentrate on firms for which less, more readily attained information is needed -- sound, publicly held, or well-known businesses in stable industries.

The EST can compensate for this lack of inexpensive, easily obtained information in two main ways. First, through
specialization, the Trust can reduce its own cost of gaining information about potential investments. The EST’s access to in-house and external expertise in the needs and problems of mature firms and alternative ownership forms, its access to the state’s economic data base, and its capacity to obtain and analyze firm-specific information, all serve to reduce the cost of gathering information for use in evaluating an application for financial assistance. As a result, it is quite possible that the Trust will assess a firm more favorably than do risk averse investors with less information. Over time, as the Trust gains experience in analyzing particular types of firms and investments, economies of scale may result, information costs decrease further, and the Trust’s comparative advantage in providing high risk capital increase. This will allow the Trust to pursue investments that are too costly for private investors to investigate fully. It may also cause the Trust to price capital slightly lower than other institutions that are less familiar with the relevant industries, factor markets and actors and which therefore impute more risk to the deal.

Second, the Trust can prompt the involvement of other investors in its "high risk" ventures by serving as a source of free information on the peculiarities of mature industries and firms and alternative forms of ownership. Once such information is obtained by the EST, it can be virtually costless to spread it to other investors. A case study of the Bates' Fabrics ownership transfer notes the reluctance of one bank to take on a "loan with two unknowns -- the [Employee Stock Ownership Plan] and the FmHA guarantee." [4] By actively familiarizing banks and other
investors with such alternatives, the Trust may increase their willingness to finance economic development. This could be accomplished by sponsoring seminars, distributing published material, or making personal contact with investment officers.

The Trust's easy access to relevant information can also prove beneficial in cases where time is of the essence. A rapid infusion of capital is often necessary to successfully implement a turnaround plan while the business is still viable. Yet the time frame for private investment decisions is usually quite long, Several months or more may pass before the deal can be closed. Long turnaround on financing decisions has been cited as leading to the failure of many firms that could otherwise have been helped by Federal Trade Adjustment Assistance. [5] By maintaining contact with and providing information to other investors, both public and private, the EST may be able to leverage money faster from these other sources.

**Overcoming High Transactions Costs**

The time and difficulty involved in completing transactions involving several parties, non-traditional financing methods and unusual ownership forms can lead to the unwillingness of the private sector to take on deals of this nature. Given the high costs of complicated transactions, many will not be completed, even though from the standpoint of risk and return, they might otherwise be considered suitable.

Through its specialization in complicated financings, the EST can address this market imperfection. Specialization should
allow the Trust to overcome some of the costs of drawing up complicated business plans, monitoring investments, and arranging intricate financial packages and investment agreements. This can allow the Trust to make deals that the private sector would not complete on its own and to price capital lower than institutions that are less familiar with complicated transactions. By acting as the "packager" of deals involving other public and private investors, the EST can reduce the transactions costs as well as the information costs of other institutions and may be able to leverage more or lower priced capital from them. The Trust was originally conceived as "the deal maker," and has an important role to play in that regard. [6]

Overcoming Risk Aversion

The risk aversion of private sector investors also prevents many worthy investments from being financed. High risk deals will not be made if the risk of each individual investment cannot be spread among a number of investors' portfolios, if each investor can not "pool" his/her investments so as to reduce overall portfolio risk, and if the return expected by an investor does not compensate for the risk incurred in making the investment.

By its willingness and ability to address the constraints of risk aversion, the Trust can complete deals that would not be made by private sector financiers. The EST automatically spreads the risk of an investment by its status as a publicly funded institution. It can also help other financiers to spread risk by coventuring with them. Although the Trust is restricted in its
ability to pool risk through a diversified portfolio, there are ways in which the effects of these restrictions can be reduced. Finally, the Trust is able to consider the non-financial benefits of avoiding a plant shutdown as additional compensation for assuming risk -- something private sector investors are unwilling to do.

**Risk Spreading**

Inherent in the Trust's status as a publicly funded institution is a powerful risk spreading technique. The risk assumed in an investment is effectively spread among the millions of taxpayers who have contributed to the Trust's capitalization. In this way, the EST is by nature more effective at taking on risk than investment institutions backed by fewer individual investors.

Moreover, the Trust can also reduce the perceived riskiness of an investment by its emphasis on coventures and leveraging financing from other sources. In this way, the EST's limited amount of capital will be spread among a greater, more diverse set of investments than if it acted as the sole supplier of bigger individual investments to fewer firms. In this way, too, the Trust can "share" the risk of a failed investment with other institutions. A 1982 report criticizes CDFC for assuming excessive risk by its inability to coventure with other capitalists. This failing was attributed to the agency's low profile and lack of credibility in the investment community. [7]

**Pooling Risk Through Portfolio Diversification**

The Trust can also limit the impact of high risk investments
by concern for the makeup of its portfolio. The Trust's mandate to invest in troubled mature manufacturing firms in Massachusetts, hinders its ability to pool away risk through the common strategies of diversification by industry sector and geographic location. Still, the Trust can avoid an overemphasis on any one type of firm, and might invest in businesses with nationwide or international markets, as well as those that sell primarily in New England or Massachusetts.[8] Kentucky Highlands Investment Corporation (KHIC), an economic development-motivated venture capitalist in Eastern Kentucky with an admirable record for investment success and job creation has reportedly developed "portfolio guidelines regarding mix of industry types, labor-capital tradeoffs and technology level ... geographic distribution, investment volume (by deal and dollar amount) and debt : equity mix." This "ensures against a reactively generated, unbalanced and therefore, additionally risky portfolio."[9] It is suggested that the EST likewise reduce portfolio risk through some efforts at diversification.

Considering Non-Financial Return

Another extremely important way that the EST compensates for the imperfections of the market is by its consideration of non-financial benefits when analyzing the tradeoff between risk and return on investment. A private sector financier will concern himself only with financial return and may not be willing to complete a deal if there is too much uncertainty about the expected return. The Trust can undertake investment with a wide variance in expected financial return if it is able to ascertain
that non-financial return is likely to be high. Chapter 4 looks in detail at the internalization of non-financial "externalities" in the Trust's investment calculus.

2.3 Expanding Capital Availability

The EST's success at addressing market imperfections depends on its ability to hold to the "fundamental economic development principle" that public funds should not be used to displace private investment.[10] It is in this light that the requirement that an applicant for EST capital demonstrate "due diligence" should be interpreted, and the concept of an EST "niche" in the market for capital be understood.

Due Diligence

The best way to ensure that the EST is not displacing capital from other sources is to interpret strictly the requirement that an applicant have made a diligent attempt to secure funding from other sources before receiving EST capital. Various institutions and programs apply similar rules, and the most common interpretation is a "three bank" requirement. Before agreeing to a deal, Massachusetts Capital Resource Company requires that an applicant have a BAA bond rating and certify that it has been turned down by three other institutions.[11] The Federal Office of Economic Opportunity's Community Economic Development funds were available in the 1960's and 70's to projects that had been denied financing by three banks.[12] Small Business Administration programs also nominally apply a "three bank" requirement.
In applying this rule, the EST should make a practice of helping applicants to contact all suitable quasi-public financing sources as well as any private lenders or investors thought to be particularly appropriate for participation in a specific deal. Among the quasi-publics, MCRC has over half of its portfolio of more than $125 million in mature industries and has experience in turnaround and leveraged buyout situations. Massachusetts Business Development Corporation (MBDC) makes about one-fourth of its investments in the form of leveraged buyouts. Community Development Finance Corporation (CDFC) also has a considerable degree of experience (both successful and unsuccessful) with buyouts and turnarounds of mature firms. The Trust's role in packaging capital from other sources is at least as important as its direct financial participation in a deal.

Requiring a firm to make a concerted search for capital from other sources before coming to the EST does not impose a hardship on either the firm or the Trust. A guidebook for companies looking for capital suggests that any firm should start its search by making calls to a half-dozen financial institutions. The more institutions that have a familiarity with the firm's needs, problems, and strong points, the easier it should be for the EST to find partners if it decides to invest, and the more sources of opinion and advice the EST staff can call upon in the event of a questionable application. The Trust might want to distribute its own manual to guide firms in their search for capital.

Furthermore, applying due diligence ensures that the EST (or any development finance institution) has a clearly defined role.
to play in the relevant capital market. This has the additional
effect of helping to legitimate the institution in the eyes of
other investment organizations. MCRC's rule is intended to
emphasize that the company is not taking business away from banks
and other investors on whom it relies for referrals.[16] Kentucky
Highlands Investment Corporation (KHIC) follows similar reasoning
in its policy of deferring to banks as primary lenders.[17]

Due diligence in a capital search should not be limited to
banks and other outside institutions. A firm's own resources
should be carefully examined. In his study of the Federal Trade
Adjustment Assistance program, Weiss highlights the "General
Bearing" case in which he concludes that a public investment was
unnecessary because the firm had disguised its access to internal
resources that were sufficient to effect reorganization. To
prevent such abuses, the Trust might require that the applicant
submit audited financial statements including full disclosure of
liabilities and assets, and that top management pledge personal
property as collateral.[18]

For a similar reason, one policy that the EST should
adopt is that of not making capital available to branches of
conglomerates or multi-state corporations. MCRC addresses this
issue by refusing to invest in a company that is more than 10
percent owned by a company with a higher bond rating.[19] The
EST should consider applying a similar requirement.

The literature on capital mobility as well as the experience
of many local branch plants show how easily capital can be
transferred from one branch to another based on the parent
company's convenience. The failure of a branch plant of a large corporation is often a conscious decision by the parent company, or else an inadvertent result of the parent's poor management.

Owners can remove capital from branches by redirecting profits, allowing equipment to depreciate for tax purposes, selling off or removing physical capital from less profitable branch plants, and ultimately declaring a plant shutdown.[20] Absentee ownership may impose diseconomies due to improper attribution of overhead, restrictive purchase and sales requirements, and other practices.[21] These actions may be wholly unrelated to the potential viability of the plant as a unit, and even to the abilities of a plant's management in the absence of external control. Local management may have little control over or even knowledge of corporate decisions.[22][23]

A relevant case example is that of Hasbro-Bradley, Inc., which in 1980 received public assistance in the form of $1 million of interest-subsidized IRB's from the state of Illinois for their Playskool subsidiary plant in Chicago. The decision to approve the low interest bonds was based on a company promise to expand production capacity and employment in Chicago. Not only did the size of the workforce decline almost immediately, but in late 1984, the firm announced its decision to move the plant's operations out of state, belieding the long term economic development intent of the public financing.[24]

A similar story is that of Farberware Corporation which employs 1700 in the South Bronx. In 1980, the city and state of New York packaged $8 million to keep Farberware in the city. By 1984, the company president was once again threatening to leave
unless the city and state provided another $3 million in aid.[25]

Faced with a request for capital assistance from a failing branch plant, the Trust should work only to arrange a buyout by workers, management, or other non-conglomerate purchasers and should not consider lending to or investing in the plant under the same ownership. (This should not preclude an EST investment when the firm that is selling its plant presents a source of partial financing for the buyout effort in the form of preferred stock or subordinated debt.)

The Implications of Failed Investments

By requiring through "due diligence" that an applicant for capital be unable to meet the market’s standards for obtaining financing, the EST is able to ensure that its own efforts to compensate for market imperfections are alleviating a genuine capital gap. In large part, the Trust fills this capital gap by accepting a greater degree of uncertainty about the return from its investments than would be allowable to more risk averse financial institutions. In accepting this risk, it is possible that the Trust will encounter a higher investment loss rate than traditional lenders and investors; indeed the enabling legislation explicitly recognizes this fact.

The EST’s director has expressed some concern over what investment failure rate should be expected, given the Trust’s mandate to seek out "high risk" investments. There is no precise standard for what an "acceptable" rate of failed investments or defaulted loans is. However, a look at the investment failure rates of some other institutional investors provides some
guidance for determining appropriate boundaries.

Within the capital markets, there is a wide range of experience with regard to write-off rates. At one extreme are conventional thrift institutions, which are very risk averse, and may make commercial loans with the expectation that only one-tenth to one-fourth of one percent of the loans made will be eventually written off.[26] At the other extreme, some well-regarded start-up venture capitalists will accept a 60 percent failure rate because their direct financial returns from equity positions in successful investments are so high.

Within the public sector, the range is just as wide. Pennsylvania Industrial Development Authority (PIDA) between 1956 and 1980, wrote off less than one-fiftieth of one percent of its loans.[27] CDFC, on the other hand, reports a failure rate of about 50 percent on its venture capital program, with 16 of 34 equity and subordinated debt investments written off at a cost of $3.6 million.[27] The Federal Trade Adjustment Assistance loan program had a 65 percent default rate until organizational changes were instituted in 1981.[29]

For different reasons, none of these publicly-capitalized institutions is providing financing in a proper "gap-filling" fashion. The PIDA figures suggest extreme caution on the part of the lending institution -- too much caution for a risk-assuming development finance institution. In this case, the extremely low write-off rate suggests failure rather than success as a public financing agency. "PIDA is not providing loans to firms which are any riskier than those financed by the private sector."[30]
On the other hand, the CDFC and TAA figures suggest that those institutions went beyond correcting true market imperfections to the point of rewarding inefficiency through risk ignorance. Such a tendency carries with it the penalties to an institution's credibility and stability associated with such high failure rates. As a result of the federal administration's disenchantment with this program, TAA has seen its funding slashed.\[31\] CDFC, originally designed to be self-sustaining, has returned to the state legislature for more financing -- assuming only a 20 percent failure rate in its recapitalization request's financial projections. Presumably, this is based on a more cautious process for assessing a firm's likelihood of survival.\[32\] To contrast, Massachusetts Technology Development Corporation, which has a loss rate of under 5 percent on its start-up venture investments, has received annual appropriations from the legislature to increase its investment base.\[33\]

The implications of a high failure rate are particularly relevant to the EST. Since the Trust is a capitalist of last resort, businesses seeking its capital will have already been turned down by traditional lenders and investors. But as noted earlier, successful coventuring is critical to the Trust's ability to address market imperfections by spreading investment risk, and also to its ability to make the most of its limited resources. It therefore will fall upon the EST to engineer a financing package involving other institutions. Some of the EST's most likely coventurers will be institutions that had initially refused the troubled firm but are newly persuaded by the presence of state money and technical assistance which can
absorb some of the risk and reduce transactions and information costs. If the EST develops a reputation as a poor assessor of the potential viability of a firm, or makes financially unadvisable decisions based on social and political considerations, it will be unable to persuade other institutions to enter into partnerships.

Moreover, the ability of the ISP/EST to save jobs by assisting troubled firms depends directly on the reputation it has among its potential clientele. If a firm that is in trouble and needs capital and consulting help perceives ISP/EST as a poorly run organization, it will be unwilling to seek or accept advice in the form of technical assistance or a restructuring plan. An EST with a track record of bad investments is hardly a credible source of management information for a troubled firm. The next two sections discuss ways in which the Trust can avoid unviable investment propositions, and how the Trust can reduce the likelihood of failed investments.

2.4 Avoiding Unviable Firms

There is one very important way in which the EST can insure that in assuming risk it does not incur loss rates as high as those noted for CDFC and TAA and that it maintains its integrity and credibility as a player in the capital market. The Trust must be certain to make a clear and comprehensive assessment of a firm's viability before supplying it with capital. It is essential to the Trust's success that it be able to do this well before making a loan or investment.
Assessing Firm Viability

Capital is a necessary but insufficient factor for firm viability, and in fact cash flow difficulties are invariably a result rather than a cause of less obvious problems. The director of Ohio Technology Transfer Organization notes that many firms will automatically assume that they can solve their problems with a million dollars, when the root cause of their million dollar shortfall remains and will continue to hinder the firm's profitability. The only way to find out whether an applicant firm is inherently uncompetitive and inefficient or suitable for a turnaround or buyout effort is to conduct a thorough diagnostic examination of the firm. The diagnostic should assess viability in terms of market demand for the firm's output, and the availability of suitable factors of production -- in particular, skilled and enthusiastic management. The Trust must be consistent in refusing to risk capital in firms with apparently poor future viability. There is no contradiction in being a "high risk" investor and expecting a priori that each individual investment will be a success.

One of the prerequisites for a successful turnaround is sufficient market demand for the firm's product(s) and a reasonable expectation that this demand will continue to exist. Alternatively, there should be the potential for the firm to alter its product line or marketing strategy to match shifts in the market. As an example, the Cornish Wire company in Williamstown, closed by its parent company because of a declining market for rubber coated wire, was the subject of a successful, job-retaining, state assisted buyout by a firm willing to convert
to production of plastic coated wire, a modern product with a sound market forecast. In contrast, Revere Sugar Corporation in Boston shut down as a result of nationwide overcapacity in the cane sugar industry. In the absence of sufficient markets for the firm's products, an investment to "save" this firm would have been foolhardy.[36]

The firm must also have access to suitable factors of production at a competitive cost. These factors include strong management, as well as appropriately skilled labor, raw materials, appropriate production technologies, energy, land and facilities, and transportation.

Management's suitability to implement a turnaround plan is a particularly important factor that is often underestimated. Poor management, as in an inability or unwillingness to make the tough decisions required to increase profits through "cutting fat," is quite often the determining factor in the firm's existing troubles. One of the reasons for CDFC's poor investment record has been its historic failure to pay adequate attention to the suitability of a venture's management team.[37] On the other hand, the highly successful KHIC devotes a great deal of attention to evaluating management quality in considering an investment.[38] The EST board's evident understanding of the crucial nature of strong management in a successful turnaround is an encouraging sign.

The inadequacy of other production factors also reduces the likelihood of a successful turnaround effort. Deerfield Specialty Papers in Monroe is plagued by high energy costs, inadequate
facilities, and poor access to transportation. Financial assistance to a firm like this is futile unless it can be used to somehow resolve these problems. Foster Forbes in Milford is experiencing high energy and transportation costs in comparison to its competitors, and faces periodic shortages of raw material for manufacturing glass. In addition, the market for the firm's products is questionable. Unless it is possible to overcome these obstacles to a successful turnaround, any investment of capital in a buyout effort would be unwise.

The firm's existing financial situation also reflects on its ability to survive a restructuring period. NETAAC requires a firm to have sufficient cash flow to last 12 months in order to be considered "viable."[39]

Information for assessing a firm's viability should be gathered from the formal application for assistance, as well as from site visits and additional research by the EST staff. In the end, assessing a firm's viability is necessarily a judgement call, but if done in a comprehensive fashion by skilled analysts, the chance of a costly error is diminished.

The expectation that an applicant firm will be viable throughout the term of an investment agreement must be a non-negotiable prerequisite to a favorable financing decision. This is in spite of the fact that short run considerations of the social impacts of a shutdown and ensuing political pressure may suggest that the Trust make capital available to temporarily prolong a firm's life. The Trust's capital should not be used as a means of merely delaying an inevitable shutdown. This point can not be overemphasized.
The Adams Printworks story is a local case study which shows the futility of making ill-advised investments to prolong employment under the pretense of saving a firm.[40] Despite troubles with management, the physical plant, and questionable market demand, public and private institutions provided over $3 million dollars in a last ditch attempt to save jobs in the depressed Northern Berkshires. In just over a year after closing the restructuring deal, the jobs initially "saved" were lost for good, along with a hefty investment of state money that could have been used more productively elsewhere. An MCRC staff member admits that participation in that deal was purely a gesture to political pressure. The company had no realistic expectation of ever seeing a return on its $200,000 investment.[41] CDFC also fell prey to an emotional response to the high unemployment of the Adams area and the hundreds of workers who would lose their jobs if the plant shut down. It was clear to them and others that the fiscal and social benefits of avoiding a shutdown merited a public investment even if the financial return were negligible. What in retrospect seems to have been discounted was that the firm faced problems in its management and operations that no amount of capital could possibly overcome. The shutdown was not avoided but merely postponed. With hindsight, it is evident that if the firm's viability had been properly assessed, the futility of the proposed turnaround effort would have been apparent.

In general, as in the APW case, direct assistance to workers, (as through the ISP Reemployment Assistance Programs),
is a far better long run strategy than helping to prolong artificially the life of a dying business. Even to the employees of a troubled firm, providing capital to defer a shutdown in the guise of "saving" a plant should not make sense. Workers will not look for new jobs if they feel that their old ones have been preserved. If they do continue to look for new jobs, the slight chance of restoring the firm to health diminishes as the experienced labor force leaves.

From the standpoint of the state's long run economic health, keeping open firms that are inherently or irreversibly uncompetitive and inefficient "will only intensify and delay the need for restructuring the economy."[42] Such firms' inability to find financing in the marketplace is no evidence of market failure, and therefore there is no role for the trust to play in providing capital assistance.

2.5 Reducing Risk

Once the Trust has determined that a firm is viable and has made a decision to provide some of the financing needed, there are a number of additional steps that it can take to limit risk and increase the likelihood of obtaining a return on its investment. The Trust can work with a firm to strengthen its turnaround strategy and can incorporate key points of the plan into covenants of the investment agreement. The staff of the EST can monitor adherence to the business plan and covenants, and if circumstances warrant, can recommend that the Trust modify the terms of an agreement in order to secure greater long term benefits.
Business Planning

As an arm of the ISP business services program, the EST has the capacity to work closely with a firm to devise a sound business revitalization plan, and can provide access to the technical assistance and consulting advice needed to implement the plan. Some of the most successful finance institutions devote substantial resources to improving the chances for success of their portfolio firms. KHIC, for example, spends "an inordinate amount of time" on developing management expertise in firms which they consider worth the investment risk.[43]

Investment Covenants

Even the best business turnaround plan is no assurance against failure if it is not followed. The Trust's enabling legislation allows operational requirements to be incorporated into the Trust's financial agreements. If a business strategy and a financial agreement are intertwined, there is an explicit incentive for the management of a firm to try to stick closely to an agreed upon plan of action. A financing agreement can coordinate repayment schedules according to the needs of the business plan, and can include terms that require management to seek consulting assistance. (ICA requires this of businesses that receive financing from its loan pool.[44]) Although some managers feel threatened by the imposition of covenants that might constrain them, reasonable covenants "are nothing more than a reflection of a good business plan." An agreement ought to give the management sufficient flexibility to run the business, while giving the investor "an opportunity to exert pressures in case
problems develop."[45]

Monitoring

The ability to exert these pressures intelligently depends on the extent to which the Trust maintains familiarity with a company once a financing agreement has been completed. Regular monitoring of all investments in the EST portfolio can serve to flag problems in their early stages. A number of organizations consider active monitoring of portfolio firms as essential to reducing the likelihood of encountering defaults and failed investments. The TAA program requires 8 hours of monitoring per quarter to ensure that a loan recipient is meeting a timetable of progress objectives.[46] ICA's revolving loan fund for worker cooperatives requires ongoing reporting and monitoring as a condition of the loan.[47] The poor performance of CDFC's portfolio has been attributed in part to the agency's lack of good monitoring practices.[48] On the other hand, MCRC plays an "inactive investor" role, and limits monitoring to regular review of covenants and financial statements.[49] It is likely that the EST will significantly reduce its rate of investment loss by continuing to monitor its portfolio firms frequently and regularly until the investments are repaid.

If through monitoring, the Trust finds that a particular firm is not adhering to its business plan as agreed upon in the financial documents, there are two options. One is to modify the agreement. The Trust is enabled to consent to modification of any terms of a financing agreement. If a change in circumstances external or internal to the firm makes the goals of a business
plan seem unrealistic or a covenanted activity detrimental to the health of the firm, then modification is the appropriate tactic. Macroeconomic forces, changes in goods market conditions, an unavoidable work stoppage, or a drastic change in management are all examples of circumstances that could prompt contract modification.

The other option is to foreclose on the loan or withdraw the investment. If management is uncooperative, and the health of the firm along with the safety of the public investment is at stake, then foreclosure is an appropriate response. To do so even once, would enhance the Trust’s reputation for “meaning business.” It would, however, carry a political cost. How could the EST, given its primary goal of employment stabilization, justify penalizing a business for violating its agreement, if that penalty meant that the firm would have to shut down or lay off workers? This tactic seems appropriate only when there is clear evidence that the firm is headed for a shutdown anyway. As such, it is the ultimate "risk reduction" technique.

2.6 Summary

This chapter has discussed the role of the EST in compensating for imperfections in the capital market in Massachusetts, with the goal of indicating what type of investments the Trust should select for its portfolio. On one hand, to meet its responsibility to increase the availability of capital to troubled mature firms, the Trust needs to assume a portfolio of firms that private sector investors view as unsuitably risky given the expected financial return. It can
accomplish that strategy by developing an expertise in the needs of mature industries to reduce transactions and information costs, and by its willingness and ability to accept "high risk" investments that have been overlooked by a risk-averse private sector. The Trust ensures that it is actually filling a capital "gap" by conscientiously applying the due diligence requirement.

On the other hand, the EST must invest its limited resources in a sound manner if it is to meet its duties as an agent of long run economic stabilization and adjustment. In this light, the Trust should assess a business' viability in terms of access to demand and factor markets before making a decision about investing in that business. EST financial assistance must form part of a legitimate solution to a firm's troubles, and can never overcome the effects of inherent or irreversible inefficiencies and uncompetitiveness.

Once deciding to undertake a risky investment, the Trust can help itself to reduce the likelihood of poor portfolio performance by creating and monitoring a sound business plan, and tying financial assistance to the turnaround plan through enforceable covenants. The fact that the Trust should make investments that are somewhat riskier than private sector prudence standards would warrant does not mean that it should act in a "risk ignorant" fashion.
Footnotes


[8] Diversification of this sort conflicts somewhat with the common state economic development goal of fostering in-state linkages between firms. Whether a policy of promoting these linkages is a sound one is open to some dispute. A too closely linked economy runs the risk that a failure in one sector will have negative effects that are locally concentrated and hinder the ability of the economy to readjust. On the other hand, some degree of local linkages may strengthen the ability of firms to survive in competitive markets.


[13] 51 percent of MCRC's assets and 60 percent of its portfolio firms are in "mature" industries.


[16] Tripp interview.

[17] Interview, Roy Moncrief, Kentucky Highlands Investment Corporation, April 8, 1985, (telephone).


[23] Harrison and Bluestone make an argument that is very relevant to the targeting of EST resources. They note that "small independently owned businesses can be expected to have high failure rates. They are generally more vulnerable to the business cycle, have more restricted access to debt finance... and have no parent or home office to bail them out of trouble. Corporate branch plants presumably have all of these advantages -- along with access to the corporation's own internally retained earnings -- as, in theory, do the subsidiaries of conglomerates. To the extent that the mode of operation of the modern conglomerate is organized around the acquisition of profitable subsidiaries, conglomerate closings are more likely to be the result of a planned strategy to increase company-wide profits. The closing of an independently owned business is more likely to constitute a truly involuntary failure." (Bluestone and Harrison, ob.cit., p. 378.)


[27] Counsel for Community Development, Inc., Development Finance in the Four Corners Region, Volume III, Cambridge:
Counsel for Community Development, p.111. (CCD-3)


[29] Weiss, p.70.


[31] McLaughlin interview.

[32] MCDFC, Recapitalization Report. CDFC emphasizes the fact that despite its high rate of portfolio loss, the overall return to the Commonwealth's initial $10 million investment, based on jobs created and increases in state and local tax bases has been substantial. While this may be true, the salient point is that the return could have been higher if the institution had made better decisions about which businesses to assist.


[34] Interview, Larry Palur, Ohio Technology Transfer Organization, January 8, 1985, (telephone).


[37] CCD-2, p.42.

[38] Ibid; Moncrief interview.


[41] Tripp interview.


[43] Moncrief interview. (Also see Giaimo memorandum "ISP menu of services").


p.22.

[47] ICA, p.3.


[49] Tripp interview.
Chapter 3 Pricing the Trust’s Capital

3.1

The previous chapter discussed the degree of risk which the EST should assume in an investment, defining a range of activity between "low risk" investments which can obtain capital from other sources, and excessively uncertain investments that pose such a likelihood of failure that the Trust’s involvement would be inconsistent with its purpose. But proper investment strategy considers two dimensions: risk and return. To most investors, seeking only to take advantage of the reward inherent in finding an opportunity in the marketplace, the financial return on investment is the relevant return consideration. The EST and other publicly funded development finance institutions consider both non-financial and financial returns in allocating capital. This chapter will focus on the latter, while Chapter 4 will discuss issues relevant to obtaining non-financial return on investment.

Although the Trust is "deemed to be investing not on the basis of a direct financial return," it is also enabled to "establish and collect such fees, charges and interest rates as the Trust shall determine to be reasonable." A portfolio of relatively high risk investments might still be carried without forfeiture of institutional credibility or substantial loss of capital over the long run if the terms of the loans and investments are such that the financial return obtained reflects the degree of risk assumed.
3.2 Why Charge for Capital at Market Based Rates?

It may be surprising that the EST, as a state capitalized development fund, should seek a reasonable return to account for risk rather than providing a substantial capital subsidy to needy firms. Many public lending programs attempt to encourage private investment by making capital available to firms that are unable to obtain it from traditional sources, and then doing so at substantially less than market prices.

But the purpose of a capital subsidy should be to redistribute wealth and create new wealth in order to compensate for some social inequity. The only inequity facing most firms that the EST will be asked to assist is that they have been unprofitable due to an inability to compete in relevant markets. The result of a capital subsidy to such firms is, like the provision of capital to firms that are not viable, to reward inefficiency.

Accordingly, the EST, like many very successful development finance institutions, should make capital available at market rates. Unless there is some extraordinary and compelling social equity reason for providing a subsidy and the business can show that a subsidy will make the difference between its success and failure, there is no strong argument for the EST to subsidize its capital. Certainly, the Trust should not make a general practice of providing subsidized capital. There are a number of reasons for this assertion.

First, in most cases, lowering the cost of capital will not make the difference between a viable firm and a questionable one. "If a business is basically sound, it can normally afford the
cost of capital."[1] The cost of capital is far less important than its availability.

Capital costs account for only about 14 percent of business expenditures.[2] Therefore, making a portion of the needed capital available at a marginally reduced rate will usually have a comparatively small effect on a firm's costs. For example, a 10 year loan of $250,000 at 12 percent interest results in monthly payments only about $550 higher than the same loan made at an 8 percent rate. Given the likelihood that the Trust will provide only a portion of the capital needed by the business, and that the rest will be provided at market rates anyway, it would take very large subsidies actually to affect most firms' viability. Even then, the only firms for which it would make a real difference would be those that even after a subsidy would be only marginally successful.

Second, even if a subsidy is not necessary to effect a successful turnaround, few firms would refuse to take the Trust up on such an offer. An analogy is drawn to the survey performed for the Massachusetts Industrial Finance Authority (MIFA) which showed that 35 percent of repeat Industrial Revenue Bond users were willing to admit that they would have expanded just as much and just as rapidly even if subsidized capital were unavailable. [3] Since the EST is not dealing with firms trying to decide whether expansion is financially appropriate but with bailouts and turnarounds of firms in dire need of capital, it can be assumed that close to one hundred percent of firms offered capital will accept it, no matter what the rate. There is no need
to shy from charging a price commensurate with the risk of this financing.

Third, the presence of a significant capital subsidy might attract nuisance applications by firms that are clearly unviable, or by those that have ample access to private capital. If it is made clear that the EST is not a mechanism for reducing capital costs, many such applications, and the use of time needed to process them, will be avoided.

Fourth, capital subsidies to firms based merely on their inability to pay back the investment on more stringent terms can promote the unattractive situation where the state government is subsidizing a firm against its in-state competition. Why, for example, should a healthy plastics company in Leominster have higher debt service than its otherwise less healthy competitor in Fitchburg merely because the former is able to obtain private financing and is therefore ineligible for EST dollars? The EDA loan program "solved" this problem by restricting eligibility to those firms that were not in direct competition with other firms. Of course, this criterion was unenforceable.[4] A better solution would be to have a general policy of making all investments with the expectation of a financial rate of return appropriate to risk, so that a healthy firm is not placed at a disadvantage because of its ability to obtain capital more easily.

Fifth, making the cost of capital reflect the risk contributes to effecting successful turnaround plans. Stringent terms can serve to impress upon management and owners of troubled firms the severity of the joint effort required to forge a viable business out of a troubled one. It is likely that sacrifices
will be required: management changes may be made, product lines and marketing plans altered, and the firm subject to austerity measures. If the owners or managers balk at "paying for" the risk incurred by lending institutions that fund their firms' restructuring, their integrity in following the terms of that restructuring are also called into question.

Finally, but not to be overlooked, the higher the financial return on the EST's portfolio, the greater the amount of capital available for reinvestment in the years ahead. A return that does not cover portfolio loss will result in a continual reduction in the size of the Trust. Ideally, the Trust should be thought of as self-sustaining.

The pricing policies of two financial institutions are particularly instructional. Massachusetts Capital Resource Company bases its charge for subordinated loans at about one point (depending on the internally assessed quality of the investment) above Moody's BAA rate for investments of the same term and maturity. MCRC will very occasionally, and only when warranted from the standpoint of a firm's survival needs, reduce the cost of a loan they consider to provide exceptional public benefit, particularly in the case of a minority owned firm. Even so, the capital is still priced at a rate equal to that charged the least risky of the other firms in its portfolio.[5] A significant portion of MCRC's investments are in mature industries and the company has participated in turnarounds and buyouts.

Kentucky Highlands has "no specific desired return on
investment," but holds fast to a policy of not subsidizing capital. Financial return on individual investments range as high as 200 percent for successful equity deals, while loans are made at typical market rates based on assessed risk. Since 1980, when its federal funding was cut off, KHIC has increased its capital base available for investments by over $4 million.[6]

The fact is that there are a number of advantages to requiring that firms repay loans to the Trust at a rate commensurate from the market's standpoint with risk incurred, and that equity investment provide the opportunity for the EST to be reimbursed with a competitive financial return. The administrators of the Trust should avoid the temptation to subsidize the price charged for loan or equity investments.

3.3 Helping Firms to Overcome High Capital Costs

It might be argued that the imposition of stringent interest or dividend payments on a troubled firm is actually no help at all. While the overarching issue is the availability rather than the cost of capital, many businesses will not be able to achieve the cash flow needed to service a traditional debt at market rates during the early stage of a turnaround. If a firm is in danger of failing financially, how can it be expected to survive stringent payment schedules and high interest rates?

Some policy makers would respond to this query by noting that in the rare case where reduced capital costs can make a genuine difference between saving a firm and having it fail, the Trust need not be dogmatic in its financial return requirements. As long as the investment is extraordinarily compelling in its
ability to provide non-financial benefit to the Commonwealth, a case might be made for reducing the price of capital somewhat below that warranted by risk.[7] As noted above, MCRC has taken this position when faced with a minority-owned enterprise of comparatively low expected profitability.

The EST need not forego financial return over the life of an investment, however, in order to allow for the troubled business' immediate cash flow requirements. The Trust has the ability to alleviate pressure on a firm when times are difficult, without needlessly subsidizing the cost of capital when the firm is able to repay at market rates.

First, the EST should not expect to recoup much or even any of its capital investment in the early stages of a turnaround. The EST's portion of a financing package is likely to consist solely or primarily of "patient" money: long term debt (much of it unsecured and subordinated) and equity.

Second, payback and dividend schedules can be configured to match the firm's business plan. The Trust can make regular use of such "creative" financing methods as the issuing of royalties, convertible debentures and warrants, deferred amortization, balloon repayment plans, and other innovations to alleviate some pressure on the firm during the first years of recovery.[8] Both MCRC and KHIC will defer principal payments on an investment, with the former making a practice of deferral for at least two years on most loans. MCRC also takes warrants and convertibles as "kickers" to increase its return on successful investments.[9] Such mechanisms allow the investor to reduce the interest rate on a debt because of the expectation of greater
returns in the future.

In addition, modification of stringent investment terms can be made in response to unforeseen setbacks in a firm's recovery plan. For example, a general downswing in the business cycle could very well delay the growth of a business, and might prompt a temporary relaxation in the schedule for repaying loan principal. If the Trust decides that a business is viable and worthy of state effort to save, it should not insist on inappropriate financing methods that hinder or halt a turnaround. In ensuring itself of a financial return the Trust should be certain not to contribute further to a firm's financial troubles.

3.5 Keeping Financial Return in Perspective

This chapter’s emphasis on achieving a reasonable financial return on investment does not, however, mean that the Trust should try to maximize its financial return without regard for its public purpose. The EST should be prepared to say "no" even to the best deal from the standpoint of financial return, if the economic development benefits to the state are not sufficient.[10] Ray Moncrief of KHIC notes that an organization like the EST will fail in its economic development purpose if it takes the attitude that it must make only the best business deals.[11] A case in point is CDFC which, in its earlier years, reportedly underemphasized its community development goals in working to meet a 21 to 24 percent target range for financial return.[12] The next chapter discusses the use of non-financial considerations as a means of allocating the Trust’s capital given excess demand.
3.5 Summary

As a rule, the best policy is that investments using state provided capital be made at a price commensurate with risk. Given the expectation of an occasional failure or poor performance among portfolio investments, the Trust should attempt over the long run to meet some minimum level of financial return. Under no circumstances, however, should financial return become the dominant goal of the Trust with regard to selecting firms for its portfolio. Once a firm's initial viability has been determined, the possibility of financial return should be considered along with the non-financial benefits of an investment in distributing EST capital.
Footnotes


[2] Litvak and Daniels, p.15.


[8] A warrant gives the investor an option to buy a certain number of shares of stock at a prearranged price, and often accompanies an arrangement for debt financing. Warrants are often used to induce an investor to take long term debt at a lower interest rate than would otherwise be required. Convertible securities are bonds or preferred stocks that can be traded in for common stock according to certain agreed upon conditions, at the holder's option. A royalty is an agreement to give a stated share of the profits from a specific product to an investor. These instruments allow an investor to obtain an additional but uncertain return based on the firm's performance. Such arrangements are potentially lucrative for the investor if the firm is very successful.


Chapter 4 Considering Non-Financial Returns in Investment Decisions

4.1

The ability of the Trust to attain a reasonable rate of financial return through taking advantage of market opportunities to fill a capital gap does not imply that the Trust seek blindly to maximize its financial gain. The best investment from a financial standpoint may have comparatively little social value to the Commonwealth. Not only must the EST target its financing to compensate for inefficiencies in the capital market, it must also address the inequities whereby some socially valuable businesses are excluded from receiving capital because they are not judged by the private sector to be profitable enough. "Narrowly defined private profitability is an insufficient criterion for [public] investment decision making."[1] The basic purpose of the EST is to reduce the social and fiscal impacts of plant shutdowns on the Commonwealth, and the Trust should distribute its capital with that goal in mind.

This chapter looks at the ways in which considerations of social and fiscal benefit can be incorporated into the Trust's portfolio investments. It discusses prescreening for minimum social benefit; the weighing of non-financial benefit during the decision whether to invest, including the concept of fiscal return and the opportunity cost of capital; and incorporation of these benefits into a financing agreement through covenants. As a related point, although something of an aside, a suggestion is made that the Trust consider investing funds that are uncommitted to specific projects with a similar attitude of social concern.
4.2 Prescreening

The EST should develop certain cut-off standards for one or two key factors that will serve to cull quickly, projects that are inappropriate for EST assistance.[2] These standards should be in addition to the statutory requirement that an applicant for assistance represent a "mature" firm looking to avoid laying off workers, or a potential purchaser of such a business. Jobs retained and wage rates are two indicators that could be used to weed out applications not worth EST persual. These factors are good proxies for a number of others, including state and local taxes retained, and social welfare costs avoided. This prescreening would take place immediately upon receiving an inquiry about EST assistance, and would precede any formal or informal assessment of a firm's viability.

It is reasonable to require that firms employ a minimal number of people in order to merit EST attention. It takes just as long to evaluate an application from a firm employing 25 as it does to look at the application of a 250 person shop. However, the social benefits of saving the latter are apt to be far greater. And limited staff time is likely to be as much of a constraint on the EST/ISP's effectiveness as limited financial resources. A reasonable solution might be to impose a cutoff somewhere between 10 and 50 employees based on the total employment of the firm's area.

For comparison, of the 181 troubled mature firms provided technical assistance or loans through New England Trade Adjustment Assistance Center during 1984, 44 percent had greater
than 200 employees, while 41 percent had fewer than 50.[3] In
setting this cutoff, then, it is important to realize that some
viable and worthy firms may be excluded. The Ohio Technology
Transfer Organization (OTTO), faced with similar social goals and
staffing constraints employs a flexible cutoff depending on the
current demands on staff time.[4]

It also makes sense to require that firms receiving EST
assistance be those providing "good jobs." David Gordon defines
a "good job" as one which provides "adequate wages and fringe
benefits, job security, and stable employment, decent working
conditions, and opportunities for both advancement and
control."[5] EST should not invest its limited resources in firms
which do not pay a living wage and provide at least some measure
of job security. If such "poor employment" firms do shut down,
their employees might be better off in the long run after
retraining and placement or even relocation to a better paying
job. CDFC requires that all of its loans and equity investments
benefit firms that provide full time year round jobs paying at
least 150 percent of minimum wage with adequate fringes.[6] The
Trust should be particularly wary about investing to save
companies that hope to base their future competitiveness on low
labor costs. Sound economic development promotes good jobs, not
just jobs.

Prescreening for a minimum level of social benefit before
performing financial analysis seems to be a common technique of
socially conscious investment institutions. A report to the Ford
Foundation on Program Related Investments notes that social
Criteria are used to "open the door," initially, while "financial criteria will make or break the case."[7]

4.3 Maximizing Portfolio Social Benefit

After a firm's application has passed "prescreening" and has satisfied a stringent analysis of long term viability, it should then be judged according to its potential for providing benefit to the Commonwealth. There are several ways in which this evaluation might be accomplished.

For one, the Trust might approve any investment that satisfies the criteria for a level of financial return appropriate to risk, and meets the needs of sound portfolio management. The assumption underlying this method is that social benefits are a "natural" side effect of sound economic investment. This presupposes that the Trust invest only to overcome inefficiencies in the capital markets without explicitly addressing the inequities that exist in the distribution of capital or looking for other desirable characteristics in its investments.

However, as discussed above, given excess demand for the Trust's investment capital, the mere fact that an investment can repay the Trust with a high financial return does not mean that it is the best choice from an economic development standpoint. There may be distributional considerations that cause an investment with a somewhat lower expected financial return to be a more compelling choice for the Trust's economic development purpose. As a public institution, the EST has the ability to favor those businesses that provide a chance to address
inequities in the way capital has traditionally been allocated and to account for those factors that are external to most private institutions' investment decisions.

In light of this, a second and more preferable method of assessing proposed investments would cause only projects that exceed a certain expected level of non-financial return to be forwarded to the Trust board for a final decision. Whether a deal passes this second stage "cutoff" could be determined by attempting to quantify the benefits through some type of point system. Alternatively, it could be based on the process of consensus among a number of staff members. The former has the advantage of ensuring that evaluations will be made consistently over time, however the difficulties of implementing a meaningful system of quantification will likely result in ad hoc evaluation as the preferred alternative.[8]

Given a constraint on the amount of capital available to the Trust, the theoretical goal of evaluating a project for non-financial return should be to maximize the total beneficial effect of the portfolio by comparing the benefits created with the amount of capital required from EST. A non-exhaustive list of factors to be considered formally or informally at this stage would include:

1) the amount of taxes a firm and its employees pay in Massachusetts;
2) the absolute number of jobs retained by the firm;
3) employment retention as a proportion of the relevant area's labor force;
4) the demographics of the firm's workforce (e.g. the predominance of older, low skilled, foreign speaking workers);
5) the availability of alternate jobs in the same industry in the area;
6) the extent of worker control or ownership of the revitalized firm.
7) the amount of capital to be leveraged by a deal.
8) an estimate of any indirect and induced effects of a successful turnaround.

Once an evaluation has been made, a satisfactory project should be forwarded, with analysis and recommendations, for final determination of its overall suitability for the Trust's portfolio.[9]

Bell provides a model for making portfolio decisions regarding investment in firms for economic development purposes. He suggests that development finance institutions consider financial return separately from non-financial return and address each as a separate objective of a well-configured portfolio. In this way, the tradeoffs in selecting a given project for financing are made explicit. While on rare occasions reducing the cost of capital for a particular project may be justifiable, given great enough non-financial returns and a clear need for a subsidy, income foregone by subsidizing one project can not be invested in another. Therefore, the greater the number of projects that need a financial subsidy, the fewer projects in which the institution can invest. On the other hand, by requiring a minimum level of financial return on a portfolio, the financier imposes upon itself an additional constraint. A
possible forfeiture of non-financial return is the cost of this constraint, while the benefit is the generation of income, plus whatever direct or indirect benefits the agency expects to achieve by requiring the minimum level.[10]

Another concept underlying the tradeoff between financial and non-financial return is that of the opportunity cost of the Trust's capital. Although direct repayment of the Trust's capitalization is not required (for sound financial reasons -- a debt financed institution would be unable to make equity investments) the underlying rationale of the Trust's creation is that a return to the Commonwealth is expected. This return is the fiscal return to the treasury achieved through the avoidance of social welfare expenditures and the retention of tax payments on payroll and property achieved by a successful buyout or turnaround. Fiscal return should, over time, exceed the compounded cost to the state of borrowing the Trust's capital appropriation for the EST to be a success in these terms. It is important for the Trust to account for the fiscal return that it creates. However, if the Trust gives proper emphasis to non-financial considerations in deciding whether to complete a deal, it should have no problem in attaining this minimum level of fiscal return.

4.4 Incorporating Social Concerns in a Restructuring Agreement

There are certain social concerns that the EST might want to promote but that it would be difficult to impose as a general requirement for receiving financing. It might, however, be possible to bargain for these concerns while negotiating an
investment agreement and to covenant them into a restructuring plan.

One term that should be incorporated into any investment agreement is the requirement that all funds supplied by the Trust be used solely within Massachusetts. MCRC imposes a like requirement, and in light of the earlier discussion about capital mobility, it is only common sense to do so. Only in this way can the Commonwealth be assured of reaping any social and fiscal benefits that occur as a result of its investment. (This requirement is not a part of the "voluntary social compact.")

Concern for the needs of the workers to be employed at the revitalized firm should be emphasized in a restructuring agreement. Proper working conditions, some degree of worker control or equity position in the restructured firm, compliance with the "right to know" law, day care provision and similar considerations would fall into this category. The EST should try to avoid, to the extent possible given questions of firm viability and competitiveness, the criticism of Britain's National Enterprise Board which is said to overemphasize the funding of productivity improvements at the expense of employment concerns, or the TAA program, which has received similar criticism.

Without this awareness, there is no insurance that aid given to a company will be felt by its workers. The Chrysler bailout, a model (although on a much larger scale) for the type of work that the Trust will be doing, included a drastic workforce reduction that was centered on the minority labor force of Detroit, the
location of 12 of the 15 plants shut down for good as a result of the restructuring agreement.[14]

The needs of the surrounding community should also be emphasized. Affirmative action goals, social responsibility in terms of the environment, and other community issues might be considered in developing investment agreements. For example, the Federal EDA requires that funded ventures be in compliance with Federal environmental regulations.[15] By incorporating such desirable traits in a written contract, the Trust can hold the firm accountable over the long term to maintaining an agreed upon level of benefit to the public.

At least one agency, the Greater London Council, even trades off reductions in the cost of capital for the incorporation of certain socially desirable outcomes in the restructuring agreement.[16] While this idea may be worth considering from a distributional standpoint, it does run contrary to our earlier observations regarding the needless subsidization of capital. Social benefit considerations should serve as a means of allocating a limited supply of capital.

4.5 Investing Uncommitted Funds for Social Gain

EST can and should carry its mandate to consider social factors in its investment beyond its economic development portfolio. Funds uncommitted to specific projects need to be invested, and this should be done in a socially conscionable way. There are a number of investment plans that achieve market rate returns while avoiding investment instruments that support anti-labor activity, apartheid, and other questionable practices. The
pension trusts of the Massachusetts state employees are one example of a public fund that is required by statute to be invested with a concern for such issues.

4.6 Summary

The consideration of benefits to workers, communities, and the state treasury in the process for selecting firms to be financed by the EST is clearly required by law and from the standpoint of sound economic development. It is most essential that an explicit and consistent policy be developed for evaluating this form of non-financial return. The objective of the evaluation process should be to maximize the benefit created by the Trust’s portfolio, subject to reasonable constraints on the portfolio’s achieving an overall financial return. As a public institution, the Trust has the capacity to internalize the social benefits that the private sector sees as externalities, and has the ability to consider distributional issues in allocating its limited supply of capital.
Footnotes


[9] To compare, the Greater London Enterprise Board, a financing arm of the Greater London Council, selects its portfolio with a laundry list of social considerations in hand. These include long term job creation, the potential for improvement in working conditions and labor/management relations, evidence of equal opportunities for minorities and women within the firm, "provision of much-needed services," development of new and socially useful products and services that might otherwise be ignored, fostering of new forms of ownership, employment in areas of high unemployment, and the preservation of an area's traditional industry. (GLEB brochure) ICA's Revolving Loan Fund bases financing decisions on the number of jobs created or saved, the representation of minorities and women among worker cooperative membership and management, and the hiring of workers who were unemployed or in a training program (ICA guidelines, p.1)


[16] "Greater London Council" (informational brochure)
Chapter 5 Other Sources of Funds for the EST

5.1

The EST is constrained in its ability to assist firms which fall victim to market imperfections by the limited investment and operational funding that it has received from the Legislature. The agency can overcome these constraints if it is able to obtain funding from other sources. This chapter will look briefly at possible sources of funds to supplement the legislative appropriations on which the agency will survive during its first year.

In addition to expanding the Trust's impact on economic stabilization by allowing it to look for more "market opportunities," the ability to obtain funds from non-state sources is important for purposes of insulating the Trust from political pressures to make unwise deals. As noted earlier, pressure to mistarget capital to unviable firms can be a significant factor in contributing to failed loans and investments. By the ability to tap other investment funds, the EST avoids a need to return to the Legislature as funds are committed; consequently, objective decision-making is easier.

Efforts in this direction are already under way with the ongoing attempts to secure a portion of the Thrift Institutions' Fund for Economic Development for use by the EST. An additional potential sources of investment capital is the Program Related Investment funds of philanthropic institutions, which can be used to supplement the Trust's. In addition, fees and charges for EST/ISP business assistance services can be used to offset some
of the agency's operational expenses.

5.2 Program Related Investments

Many philanthropic foundations use a portion of their endowments to pursue Program Related Investments (PRI's). These investments are made "to support projects that have both social and commercial components, where financial return is plausible and where some amount of risk -- often moderate to high -- is present."[1] As described in a 1984 report to the Ford Foundation, the goals of foundations pursuing PRI's are quite similar to those of the EST. Other findings in this report provide further evidence that cooperation between the EST and foundations that make PRI's could be mutually beneficial.

The criteria required by most organizations making PRI's are compatible with those of the EST. More than half of those surveyed in the Ford report require a sound management team, a worthy project unable to obtain commercial financing, and the likelihood of repayment within an acceptable level of risk. Another important consideration is the "likelihood that [the] PRI would leverage other money."

What is more, there appears to be a clear opportunity for an institution like the EST to address the needs of PRI-making foundations. Most foundations report that they actively seek out projects for PRI's, but that demand is low. On the other hand, although economic development is a goal of many foundations, case studies and descriptions of 29 PRI investments included only one that could be loosely interpreted as being a job-saving investment in a "mature industry."[2] Moreover, few foundations
provide any kind of business or technical assistance to the recipients of investments. By its ability to identify deserving businesses and to provide skilled assistance, the EST could be an ideal venture partner for these foundations.

Seeking investments from PRI's could be a legitimate way for the Trust to reduce the capital costs of those firms that actually need and deserve a subsidy. More than half the PRI's made are in the form of loans, and more than half of these are made at more than three points below prime.

It appears that PRI's are a potential source of additional financing for use in revitalizing mature industries in Massachusetts. Most individual PRI investments are between $100,000 and $1 million, although some are larger. This suggests two possible ways in which the EST could attempt to use PRI capital to augment the Trust.

For one, foundations could be included along with private and quasi-public investors in a financial package on an individual investment basis. In this way, they are simply an additional source from which the Trust can attempt to leverage risk financing.

Another possibility, in line with the Trust's desire to increase its own capital base, is for the Trust to attempt to secure financing directly from one or more foundations to be used as a part of the Trust's corpus. Ideally, this would take the form of an equity investment in the Trust from which the Trust could pay dividends out of its return from investments.

Alternatively, the Trust could access a revolving loan or similar debt arrangement from a foundation. This latter
arrangement is less preferred, because it restricts the Trust to
debt rather than equity financing where these funds are used. It
is unsound to make equity investments from a debt financed
capital source, since equity provides no guaranteed return to
repay the debt. It is suggested that some effort be made to
contact foundations with an interest in economic development in
Massachusetts to explain the purpose of the EST and to solicit
interest and involvement.

5.3 Charging Fees For Business Services

The ISP/EST business services division can maintain an
independent source of operational funding by charging firms for
its services. This strategy has both advantages and
disadvantages, and there are examples of successful public sector
technical assistance programs in both the "fee-for-service" and
the "free help" camps. It is likely that the business services
staff of the ISP/EST will want to provide a combination of free
and for-charge assistance, depending on the extent and type of
services supplied, and the circumstances of the firm receiving
help.

The argument in favor of charging for ISP services is akin
to that in favor of charging firms for EST capital. It is a
waste of the ISP's limited resources to provide services free-of-
charge to firms which can afford to pay for them and which, in
the absence of the ISP, would seek such services within the
private sector. On the other hand, there will be instances in
which the ISP will not want to charge for business assistance, or
may wish to subsidize its fees. This section makes recommendations on this issue.

In general, the ISP should charge for services rendered to any firm that is not in severe financial difficulty. The enabling legislation specifically mandates that the ISP not subcontract services to private consultants unless "the business is unable to pay for these services." "Ability to pay" should determine whether a fee is charged for services provided in-house by the ISP as well. The interpretation of "ability to pay" should be very narrowly defined, lest the ISP be used as a convenience by firms wishing to avoid paying for services that they would otherwise have to purchase.

By making a policy of charging for its business services, the ISP contributes to its credibility as well as its financial health. The agency will pose less of a threat to private providers if it competes on the same terms, and does not drastically undercut the prices charged by the private sector. The ISP's charges are likely to compare favorably to charges by private consultants, because the ISP can draw more easily on the vast information resources of government, because salaries and overhead costs are likely to be lower for the ISP, and eventually, because the agency will develop a specific expertise in the problems faced by mature manufacturing firms and the cost of gathering information will decrease commensurately. METAAC bills clients at $60 per hour because of these factors, while many private consultants charge in excess of $100 per hour.[3]

The bottom line is that by charging for its business services, the ISP will be able to increase its resources for use
in expanding its capabilities, and will avoid a total reliance on legislative appropriations for its continued existence. The ISP's stability over time will enhance its effectiveness at strengthening the state's industrial base. On the other hand, providing services for free requires that the business services program "prove itself" each year in the minds of the Legislature in order to receive funding to continue operations.[4] This can make the program overly subject to political whim. It is much harder to argue against a state-sponsored service that pays all or much of its own way through user fees and provides a significant public benefit besides.

An example of a successful program run along the guidelines suggested above is the Quebec Industrial Research Center (QUIRC), a government sponsored business assistance program that offers technology-related advice (as opposed to the ISP's likely focus on management, resource, and financial problem-solving). QUIRC receives some 30 to 40 percent of its annual budget from fees; the remainder comes from the provincial government and is used mostly for marketing, and to disseminate information and hire out for research with a general benefit to the province's industries. QUIRC consciously avoids competing directly with private consultants in its specializations, and makes frequent use of outside firms in its assistance efforts.[5]

QUIRC, however, seems excessive in its policy of charging all firms at cost for the assistance received, regardless of their ability to pay. If a firm has difficulty paying for services, QUIRC helps it to obtain aid for that purpose from the
Canadian federal government or from outside sources. Were the ISP to charge firms indiscriminantly for its business services, it would be forced to concentrate only on clients that are still financially healthy, and would be unable (in the absence of U.S. federal assistance for needy firms) to help those businesses that also need such services but are experiencing concurrent and related financial distress. There are certain circumstances in which the ISP will not want to charge firms for business assistance on a fee-for-service basis.

The ISP will not want to charge for services which are based on the program's ability to mobilize government resources and access information and assistance from state and quasi-public sources. In this role, the ISP merely acts as a clearinghouse and facilitator for other government agencies that would provide these services for free. Nor should the cost of monitoring investments, an internal expense of a financing institution, be charged directly to the firm being monitored.

The ISP may also want to set a cut-off level up to which all services provided are free of charge. An initial period of helping a firm without charge would serve to attract business, while allowing the ISP to determine what more detailed assistance was needed and available. The director of The Pennsylvania Technical Assistance Program (PennTAP) notes that it is very often not worth the cost of billing and accounting to charge a firm for very short jobs, and further observes that a charge-free period can serve to attract firms which may initially be reluctant to hire out for advice.[6] The Federal Trade Adjustment Assistance Program (TAA) provides up to three person-days of help...
free-of-charge.[7] The TAA program, however, also provides a subsidy to firms of 75 percent of costs incurred (up to $75,000; beyond this amount, the firm’s share of expenses increases on a sliding scale). The federal share of this arrangement has averaged between $30,000 and $45,000 per firm over the life of the program.[8] It is likely that this figure includes not only the cost of a diagnostic and a business plan, but also some "hands on" work by TAA staff and subcontractors. A subsidy of this magnitude negates most of the advantages of charging fees for services, as discussed above. In addition, if costs were of the order experienced by TAA, this would severely limit the number of firms that could be assisted, given the constraint of annual state appropriations. On the other hand, in the short run, some amount of subsidy might be appropriate since state funding is currently available, the ISP has no proven "track record" and it will take some time until services can be provided in a cost effective manner.

One situation in which directly billing firms for services rendered is surely inappropriate is in the instances where firms requesting assistance are in desperate financial situations, and need an influx of capital from the EST as well as business advice in order to ward off further difficulties. There are two steps to analyzing this issue.

On the one hand, charging a financially troubled firm for technical assistance merely increases the amount of capital it needs to regain its footing. And it is inappropriate to pay for the ISP’s services out of the limited investment capital of the
This is the situation in which CDFC and Massachusetts Community Economic Development Assistance Corporation (CEDAC) were put during the King administration. State funding for CEDAC technical assistance to firms and CDC's was curtailed, and CEDAC was forced to charge CDFC for services to CDC's and affiliated businesses. These charges were taken out of CDFC's investment income. To the extent that a firm needs to obtain more financing in order to afford needed business assistance, charging that firm for business services merely amounts to an accounting transfer from the EST's capital base to the ISP's operational income.

On the other side of the debate, is the opinion that at least some of the cost of assistance be incurred by the business itself, even if more financing is required as a result. Richard McLaughlin, executive director of NETAAC, feels that it is important to charge even firms that are in desperate financial circumstances, since their inability or unwillingness to pay even the few thousand dollars needed to perform an initial diagnostic analysis, provides an indication of the business' overall long run viability and suggests that further technical or financial assistance would be futile. For similar reasons, most investors in both the public and private sector charge an application fee of some sort in order to cover some of the costs of considering an application and to weed out frivolous inquiries. (The EST may want to do likewise, $500 is a common amount).

To solve this dilemma, assistance to financially needy
firms might be provided at a substantially reduced cost, with an agreement included that any subsidy could be recovered at a later date if the assistance is successful. CEDAC often executes agreements within a financial package to recapture some of its expenses from the recipient if the project succeeds.[11]

The business and financial services division of the ISP can avoid its sole dependency on legislative appropriations, and increase the resources available to expand its capacity, by making appropriate charges to its clients. Over the long run, it is quite possible that the costs of operating the business and financial services division of the ISP can be largely or wholly covered by such fees.

5.4 Summary

The EST’s concern with non-state sources of capital and operational funding is a legitimate one. It is only in this way that the Trust can be assured of stability over time and some degree of immunity to political influence on assistance decisions.

Private foundations are a possible source of additional investment capital through the use of program related investments. These are compatible in purpose and nature with the Trust’s investments in mature industries.

Fees paid to the business and financial services division of the ISP for technical assistance received by clients are a likely source of operational funding for that program. There are a number of reasons why such charges are appropriate in most cases.
Footnotes


[2] Ibid.


[4] Two technical assistance services contacted in the preparation of this report, the Ohio Technology Transfer Organization (OTTO) and the Pennsylvania Technical Assistance Program (PENNTAP) do not charge users for any services. These programs, however, are university-based and subsidized, and specialize in providing a firm with access to other sources of information (although they also provide more detailed research as needed.) The federal Small Business Development Centers, also university-based, provide consulting free of charge and training sessions at a "nominal" charge.


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