GARNET CAPITAL ADVISORS

Small Business Lending: Banks, FinTech, or SBA?

WHITE PAPER

TABLE OF CONTENTS

02 Introduction

02 Small Businesses Encounter Lending Challenges

03 Community Banks' Dwindling Numbers

04 Underwriting Challenges

04 Rise of Alternative Lending

05 Growing Borrower Adoption

06 SBA Innovation

07 Outlook for Small Business Lending

Introduction

Small businesses have always had a harder time securing financing than their larger brethren, but these challenges have grown even worse in recent years. As economic conditions have improved, fledgling firms have been seeking additional capital to invest and expand. While demand for credit from this sector is growing, many banks are reluctant to provide them the financing they need.

Regulations have grown increasingly stringent, and banks have become more risk-averse, implementing stricter underwriting guidelines. In addition, banks are reluctant to incur the costs required to facilitate small business loans. While community banks have traditionally worked with smaller organizations, there are fewer of them around that are active commercial lenders.

In response to this situation, alternative lenders have been picking up the slack and providing smaller firms the funding they need, and the speed they desire. These FinTech companies take a whole new approach to helping borrowers obtain funding, leveraging innovative models and technology to meet borrowers needs and connect investors with lending opportunities.

Small Businesses Encounter Lending Challenges

Federal Reserve figures illustrate the challenges small businesses are facing in their attempts to secure credit. The 2014 Small Business Credit Survey showed that 52 percent of the smallest firms- reporting annual revenues below $250,000- received no financing at all. 25 percent of these companies received all the funding they requested.

In contrast, 36 percent of companies with revenues between $250,000 and $1 million reported receiving all the credit they asked for, and 50 percent revealed their request generated no funding.

Firms of a larger scope fared far better, with 60 percent of organizations bringing in between $1 million and $10 million in annual revenue managing to secure approval for all financing requested. For those organizations generating more than $10 million in revenue for year, this figure shot up to 70 percent.

The smallest banks are disappearing for many reasons, including acquisitions and failures and the inability to meet the current regulatory burdens.

SMALL BANK LENDING

Community Banks' Dwindling Numbers

While many experts have observed that community banks are falling in number, they have provided varying figures on how quickly this shift is taking place. Brayden McCarthy, head of Policy & Advocacy at Fundera, has said that there are fewer than 7,000 of these institutions left, compared to 14,000 in the 1980s.

Financial expert J.V. Rizzi offered alternate data, stating in American Banker that between 1985 and 2014, the number of community banks with less than $100 million in assets fell to 1,900 from 13,000. In contrast, the number of organizations holding between $100 million and $1 billion in assets rose to 3,900 from 3,800, noted Rizzi, a banking industry consultant and investor.

The smallest banks are disappearing for many reasons, including acquisitions and failures and the inability to meet the current regulatory burdens. In addition, few new banks have been starting up, noted McCarthy. Charters have been few and far between, and managed to reach zero in 2011, a first in Federal Deposit Insurance Corporation history. Rebel Cole, professor of finance at DePaul University, spoke with American Banker about the impact of this trend.

"Community banks are disappearing, and that has profound implications for the economy," he told American Banker, stating that society's insufficient business capital is tied to labor market weakness. "Small businesses have always done the most hiring but a lot of them can't get loans."

He emphasized that while the amount of small business capital increased in 2014, the improvement was minimal and fell far short of what was needed to help invigorate business conditions. Cole estimated that for the economy to simply recover to where it was in 2008, companies would need the increase to be 10 times what it was in 2014.

Underwriting Challenges

Another development that has served to undermine small business lending is the expenses associated with underwriting credit applications. Small companies looking for financing are highly diverse, and this situation combines with the varying uses of borrowed funds to make it harder for financial institutions to develop standards they can use to assess applicants.

Many lenders are working with outdated means to assess the creditworthiness of their applicants, and when these financial institutions do find suitable candidates, the expenses associated with originating loans are high. Regardless of whether the debt extended has a principal of $100,000 or $1 million, the transaction costs will be similar. However, the profit incentive is less when it comes to lending smaller amounts.

Due to this situation, many banks have stopped making loans below a certain amount, and while the aggregate dollar volume of banks' commercial and industrial loans below $250,000 may have risen in recent years, FDIC figures show that it is still 11 percent less than the pre-crisis high of $199 billion, according to American Banker.

Alternative lenders are harnessing new methods for assessing credit, leveraging innovative technology, new credit models and alternative data.

Rise of Alternative Lending

As small companies' need for credit frequently goes unfilled, alternative lenders have been jumping on this opportunity to provide credit in new and innovative ways. Industry expert Sam Hodges provided some insight into this in a recent piece published in Entrepreneur Magazine.

Hodges, co-founder and U.S. managing director of online marketplace Funding Circle, stated that these alternative lenders are harnessing new methods for assessing credit, leveraging innovative technology, new credit models and alternative data. This situation is a pretty far shot from previous times, when applicants would walk into banks carrying an array of documents in an attempt to secure financing.

"We're doing what banks did 50 years ago for small business owners," Hodges told MainStreet. "I think that companies like the Funding Circle [are driving] a generational shift in how finance is sought and how money is lent."

Many innovative lenders have been leveraging other sources of data – ranging from Yelp reviews to real time cash flow – to assess how likely borrowers are to pay their debtors back.

Hodges stated in Entrepreneur Magazine that although alternative lenders are changing the game, potential borrowers should not succumb to myths about their ability to obtain financing. For example, those approaching such organizations should not assume their fate lies within the hands of a software program. While technology may help conduct the initial due diligence on a borrower, many new lenders will incorporate some human interaction and underwriting as well.

Aside from that, Hodges stated that applicants do not need perfect credit to receive funds. Instead, he said that many innovative lenders have been leveraging other sources of data- ranging from Yelp reviews to real time cash flow- to assess how likely borrowers are to pay their debtors back.

Growing Borrower Adoption

While these alternative lenders continue to take hold of the market, a growing number of borrowers have been benefiting from the resources they provide, including entrepreneur Kevin Pereira, who secured a $22,000 line of credit to finance a business he co-founded, according to MainStreet. Pereira, who is originally from Silicon Valley, was surprised when his initial attempts to obtain funding through Wells Fargo failed. Apparently, he was not alone in having this reaction.

"I had both of my bankers at Wells Fargo be completely astounded that I couldn't get a loan," Pereira, who helped launched Wet Shave Club in Tampa during May 2014, told MainStreet. "They couldn't believe it themselves, because in December we did over $65,000 in sales, and it all went through my Wells Fargo account."

In spite of this initial difficulty, Pereira was able to obtain financing through Kabbage, an Atlanta-based online financing company that lends to small businesses, according to MainStreet. The company has been growing rapidly, lending $400 million in 2014 and roughly one-third of that sum in 2013, stated Kathryn Petralia. Kabbage's strong expansion may be part of a broader trend, as she said that online lenders are emerging everywhere.

SBA Innovation

Many small business owners have an urgent need for credit.

As the market for small business lending continues to evolve, the Small Business Administration- which many consider a slow and difficult source of loans- has been working on tools that will enhance the government agency's ability to match borrowers with lenders.

In February, Administrator Maria Contreras-Sweet announced the SBA would launch a new tool- Leveraging Information and Networks to access Capital (LINC)- on its website. Using this form, small business owners can answer 20 questions and be connected with a lender within 48 hours. Once entrepreneurs have supplied the needed information, every lender within their county- as well as those further away- will receive the data.

Many small business owners have an urgent need for credit, Contreras-Sweet noted in a statement.

> *Effective today, LINC will bring entrepreneurs and SBA lenders together. There's a hunger among entrepreneurs to find financing to get their business off the ground or take the next big step in their expansion plan. The SBA stands there ready to help them, now with a few simple clicks. Across the country, thousands of small business owners pound the pavement every day looking for term loans, equipment financing, lines of credit, invoice financing and real estate loans to help them hire and grow. If you have a bankable business idea backed by good credit and sound financial planning, the SBA wants to streamline the process for you to get the capital you need.*

When LINC went live, 124 lenders spanning all of the SBA's lending programs were using the tool. The SBA planned to start by networking small business entrepreneurs with nonprofit lenders that focus on Community Program loans, micro lending and real estate financing. Further down the line, the SBA plans to incorporate more traditional banks.

Outlook for Small Business Lending

As the environment for small business lending continues to progress, some banks may have a hard time keeping up, at least for the time being. However, in the long-term, banks will once again become active in this space, and some already have. To keep up with the competition, these industry participants will have to use a new approach, one that makes greater use of technology and is friendlier to borrowers.

While banks will need to overcome several challenges to once again play a key role in small business lending, online lenders can also expect to encounter difficulties over time, according to The Huffington Post. As the market for these Fin-Tech companies expands, they will face rising scrutiny in many areas, including their revenue, business operations and regulatory environment. In the meantime, small business owners looking for short-term credit will have the choice of the traditional or the alternative.

SOURCES

http://www.newyorkfed.org/newsevents/news/regional_outreach/2015/an150115.html
http://www.newyorkfed.org/smallbusiness/joint-small-business-credit-survey-2014.html
http://www.newyorkfed.org/smallbusiness/SBCS-2014-Report.pdf
http://www.biz2credit.com/small-business-lending-index/january-2015
http://smallbiztrends.com/2015/02/biz2credit-lending-index-january-2015.html
http://www.americanbanker.com/news/community-banking/banks-rev-up-small-business-lending-amid-critics-new-competitors-1072743-1.html
https://www.fundera.com/blog/2014/08/29/bank-lending-small-businesses-isnt-recovering/
http://www.americanbanker.com/bankthink/dont-blame-dodd-frank-for-dwindling-number-of-community-banks-1073514-1.html
http://www.entrepreneur.com/article/236996
https://www.mainstreet.com/article/small-business-loans-down-at-banks-expect-more-online-lending
http://www.prnewswire.com/news-releases/sba-announces-new-online-tool-to-match-lenders-to-entrepreneurs-300035024.html

GARNET
CAPITAL ADVISORS

500 Mamaroneck Avenue | Harrison, NY 10528
914.909.1000 | www.garnetcapital.com