



Starved for Financing: Is There Relief in Sight for U.S. Small Businesses?

Published : October 28, 2009 in [Knowledge@Wharton](#)

In mid-October, President Obama moved to raise the amount of credit extended to small businesses. If Congress approves his plan, the measures would enable community banks to borrow at low rates from the Treasury Department's Troubled Asset Relief Program (TARP). It would also raise loan caps on some Small Business Administration (SBA) programs. To qualify, the banks would have to show how they would increase lending to small enterprises.

The relief could not come a moment too soon. The job-creation engine known as small business has been slammed, not only because of falling demand but also because the normal flow of financing has slowed to a trickle. Small enterprises have created two-thirds of all new jobs since 1994 and they employ more than half of all private-sector employees. (The SBA's definition of a small enterprise is "an independent business having fewer than 500 employees.") In September, for the second straight month, they laid off more workers than mid-sized or large employers. Prior to August, small businesses had never been the biggest source of layoffs, according to employee payment and data firm ADP, which began tracking the figures in 2001. Meanwhile, the U.S. unemployment rate hit 9.8% in September, and many analysts expect unemployment to hit 10% or more before topping out.



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Last month, a survey by the National Federation of Independent Business (NFIB) found that expansion plans for small enterprises were at a 35-year low. That's no surprise, given that their usual sources of borrowing -- banks, government-secured financing, venture capitalists and credit cards -- are far more limited than a couple of years ago. The good news is that some tentative signs of improvement are turning up. Interviews with Wharton experts, banking officials and spokespeople from small business development organizations suggest that this patchwork of finance sources, all battered by the current financial crisis, is inching back towards pre-recession lending levels.

Wharton lecturer and small business expert Robert Chalfin, for example, notes that "community banks are still lending. They have been active. They're in business to support their communities." According to the Bureau of Labor Statistics and the American Bankers Association, community bank loans to small businesses are only down slightly in 2009 to about \$680 billion outstanding, from about \$700 billion in 2007. Now, Chalfin says, even larger banks are becoming more active, if only marginally. "I'm getting many calls from the large national banks, saying, 'If you've got clients, we would like to talk with them about lending them money' -- but they are not as quick to say 'yes.'"

According to the SBA, volume for its loans is 60% or more above the exceptionally low levels reached during the January-February period this year, in part a result of easier SBA loan terms. Earlier this year, the SBA had come under fire for its low loan volume at a time when small businesses were facing enormous financial pressure, and some critics say that loans still tend to be available only for the most stable small businesses. But now, the Obama administration's proposal could open the tap to 70,000 additional SBA loans over the next year. The fragile economic recovery, meanwhile, is helping banks to improve their balance sheets and open their purse strings a bit more.

Among other positive signals: An October survey by the NFIB found the lending environment had improved slightly since May, and a Greenwich Associates survey found that earlier in the year, eight of the top 10 U.S. banks were more willing to lend in the second quarter of 2009 than in the first.

Struggling, but Viable

One company's experience shows how a small business escaped the threat of insolvency with a timely liquidity injection. Ashland, Va.-based Daystar Desserts nearly went under because it could not get a loan. Toward the end of 2008, the company was obligated to buy a building it had been renting for five years from a company it acquired in 2003, according to CEO John Fernandez.

The building was valued at \$2.4 million. Says Fernandez: "We had a good scenario. We'd been paying rent. We could show we had the ability to pay." However, the real estate market was plummeting and banks weren't lending -- not even to fundamentally healthy companies such as Fernandez's. With 54 employees and about \$15 million in annual revenues, Daystar was growing. And while its "financials weren't perfect, they were in good shape," Fernandez says. Still, three banks turned the company down. That transformed a seemingly viable situation into a life-or-death struggle for the business. The problem, he says, was the banks and the real estate market, not the company's balance sheet.

Help came in the form of an SBA 504 loan under America's Recovery Capital (ARC), the SBA's new program for small companies that was already in place before President Obama's announcement. According to Jonathan Swain, the SBA's assistant administrator for communications, "ARC is one small program, strictly for debt repayment, not for working capital -- a one-time temporary program that Congress asked the SBA to create under the Recovery Act." Businesses can apply for these loans to pay off debt or to reorganize. "It's really a bridge loan," says Swain. "This is a unique program targeted to a specific kind of business owner --struggling, but viable."

Daystar Desserts secured its SBA-backed loan with 6% interest, saving an estimated \$150,000 compared with what commercial banks would have charged. Additionally, Fernandez says, "We saved \$9,000 in upfront fees." SBA 504 and 7(a) small business loans have been around for years (504 for commercial real estate and equipment; 7(a) for general purposes). But this year, under ARC, Congress asked the SBA to change the requirements by eliminating the upfront fee altogether and increasing the amount of the loan guaranteed from an average of 75% to around 90%. "Lifting the fee makes it easier for banks to lend," says Hayley Matz, an SBA spokesperson. Under the program, the average 504 loan is around \$200,000. Now, President Obama wants to expand the 7(a) loan pool by tapping TARP money.

Swain says that ARC loans represent about a quarter of all SBA programs. There have been 2,700 loans so far under ARC, with plans for 10,000 loans altogether after a ramp-up period. SBA-backed loans are made available through banks. As of September, the total volume of 504 and 7(a) loans approved was \$1.92 billion, up from \$1.09 billion in April. Pre-ARC, in August 2007, both loan groups totaled \$1.94 billion -- close to where it is today.

According to Therese Flaherty, director of the [Wharton Small Business Development Center](#), banks won't generally give a company an SBA loan if they are comfortable doing it from their own funds. "SBA loans mean more paperwork for the banks." The SBA comes in, she says, "when a bank isn't quite ready to do the loan."

For Daystar Desserts, the process was "paperwork intensive," recalls Fernandez. "But a 504 loan is administered through development companies that partner with the SBA.... The process was not simple. But by all means it was doable."

Alternate Financing Sources

What are some other sources of financing for small businesses that might not qualify for an ARC loan through the SBA? According to Wharton's Flaherty, "One of the obvious opportunities is to look at micro-loan funds that typically lend up to \$30,000. Micro-loan groups look beyond your personal credit, with more depth into your business." And many offer technical assistance to business owners to help them manage their debt and pay off their loans.

The SBA launched a microloan program in 1991 to provide loans of up to \$35,000 to small businesses. The SBA makes funds available to nonprofit community-based lenders such as community development financial institutions, which make loans to local eligible borrowers with a term of no more than six years. Additionally, a handful of regional microloan programs exist across the U.S. For example, beer maker Samuel Adams recently partnered with micro-lender ACCION USA to help food, beverage and hospitality entrepreneurs in New England with loans ranging from \$500 to \$25,000 to expand or start a

business, purchase inventory or equipment, or pay licensing fees.

Another source available to some businesses: angel investors. "Angels work with small startups with a great potential to return the angel's investment," Flaherty notes. "An angel often takes equity. It's very private. You have to think about whom you are taking on as a business partner. At times, you can find a private investor who really cares about your business."

Though not easy to come by, angels might be a better source today than venture capital, where activity is down significantly, according to VentureSource, the Dow Jones database that tracks venture-backed companies in every industry. Offering some proof that recovery is tentative, an October 17 VentureSource report said that, following an uptick in the second quarter, investments in U.S. venture-backed companies stalled in Q3, "putting 2009 on track to be the worst investment year since 2003." Venture capitalists invested \$5.1 billion in 616 deals in the third quarter of 2009, down 6% from the \$5.4 billion placed into 595 deals during the second quarter and down 38% from the \$8.2 billion invested in 663 deals during the third quarter of 2008.

Chalfin says there are other viable sources for small business financing, including credit cards, one of the largest lenders to small business. "The disadvantage is that the interest rates are very high. But the advantage is you can borrow. I've had people who needed to finance their business, generally for a short period, and via credit cards they obtained liquidity for 30, 60 or 90 days." Yet in recent months credit card companies have been lowering credit limits and increasing interest rates. According to the Pew Safe Credit Cards Project, the median lowest advertised credit card rate rose to 11.99% in July from 9.99% in December.

Community banks provided more than half of all loans to small business this year, and presumably they will be more active if the President's latest proposal involving low-interest TARP funds gets approved. (For that program, "community banks" are defined as having less than \$1 billion in assets). Community banks usually require a personal guarantee and ongoing monitoring, Chalfin notes. "They'll insist on looking at metrics of your fiscal soundness. They may have pre-payment penalties or charge points up front. They will usually insist on receiving copies of your financial statement and tax returns every year. And they'll want collateral." On the other hand, there are some clear advantages to working with community lenders. "They can provide more than money," Chalfin adds. "They can provide contacts. They can introduce you to people who may have industry expertise."

In general, he says, lenders are much more conservative and more cautious. "They want the business owners to contribute equity into the deal. They're doing more reference checking, asking for more collateral, such as mortgages."

Certain sectors may have an easier time securing loans, too. According to Wharton management professor [Raffi Amit](#), online businesses featuring social networking and other Web 2.0 platforms are likely to be able to raise money faster and on better terms than other sectors. Online organizations will have an easier time "because in principle, they require much less cash so you will be cash flow neutral or positive after investing less capital," says Amit. "Just \$200,000 or so can get you cash positive." Another sector with a better track record for securing loans is clean energy, primarily because the government is making it attractive by providing incentives in order to reduce emissions and energy dependency on other countries. "That's a priority for this administration and investors will understand that."

VentureSource data underscores Amit's assessment: "For the first time, Web 2.0 investments surpassed the software sector," the company said in a recent statement. "Although the IT recovery has been sluggish, this quarter's investments in the web-heavy information services sector are nearly double the investments made in the first quarter of this year."

As always, however, "The best source of money is not to need it," says Flaherty. She knows of companies that are looking at their business and finding ways to avoid having to take out loans. "It's a good time to review a business's marketing and advertising costs," she says. "Are they advertising in English in places where no one speaks English? Have they adjusted for Internet and print ads and PR? We see people doing this who weren't doing this before." And a good number of them, she adds, are rethinking whether or not they even need a loan right now.

Flaherty's thinking is confirmed by the American Express survey of small business owners. In August, 71% of respondents claimed that over the next six months, they would manage their businesses by cutting expenses -- up from 30% in March 2003 and 48% September of 2007.

"I'm optimistic," says Flaherty. "I'm seeing a great many small businesses that are doing well, that adjusted months ago and are starting to see real increases in sales and a recovery that's making a difference to them."

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