SMALL BUSINESSES, BIG PAYOFFS

WHITE PAPER

Small businesses continue to be the gateway to growth opportunities for bankers looking to expand their portfolios.

Navigating the New Lending Landscape

How Lending to Small Businesses Is Moving the Industry Forward Post-Pandemic

As financial institutions look beyond the consumer and commercial lending channels for new opportunities, small business lending—and its potential to increase revenues—has captured their attention.

Small business lending straddles the continuum between consumer and commercial lending. But a small business loan is more than just a large consumer loan or a small commercial loan. Small business lending involves complexities and considerations that are different from both consumer and commercial lending.

The small business lender, for example, must become a trusted advisor to each particular business. They must be able to identify the owner's needs, analyze both business and personal cash flow and debt, and assess credit and repayment risks.

Developing these skills can have a significant payoff. Financial institutions that take a targeted approach to the small business lending market have an opportunity to build the type of trusted relationships that can result in increased revenues and profitability.

CHAPTER 1: What Makes Small Business Lending Attractive?

There are big growth and profit opportunities in lending small

Even though small business lending requires specialized knowledge, there are serveral reasons that it can be an attractive market for financial institutions:

Market Size

According to the U.S. Small Business Administration (SBA), there are 33.2 million small businesses in the U.S., comprising 99.9% of all firms.[1]

Growth

As they recover from the pandemic, small businesses continue to be a vital, growing part of the U.S. economy.

According to the 2022 Small Business Credit Survey: Report on Employer Firms, a collaboration of the 12 Federal Reserve banks, the number of firms reporting revenue and employment growth continued to build from their 2020 lows. What's more, 78% of firms surveyed expected revenue to either grow or remain stable over the next 12 months.[2]

Employer Firm Performance

Firms reporting...	2021 Survey	2022 Survey
Revenue growth	38%	44%
Employment growth	24%	29%

Source: 2022 and 2023 Reports on Employer Firms

Profitability

For small businesses, obtaining the funding they need is a top priority. Although small business owners are price and interest rate sensitive, their desire to secure funding may trump their need to shop around for the most attractive rates. Because small businesses are often willing to pay more for credit in order to secure the capacity they need, the spreads on these loans are often larger than the spreads on mid-market or commercial loans.

In addition, while larger firms often rely on a chief financial officer or other executive to secure credit and negotiate loan structure and pricing, small businesses seldom have access to such in-depth financial expertise, giving small business lenders the opportunity to provide financial advice and deepen their relationships with the business owners.

Untapped Opportunities

For small businesses, getting the funding needed for growth is problematic. Of the small businesses surveyed, 40% had applied for traditional financing in the past 12 months, a rate that exceeds pre-pandemic levels. Only about half, however, were fully approved; smaller firms (by revenue) were less likely to have their needs fully met.[3]

Clearly there is a gap in the appetite of small businesses for credit and the ability of financial institutions to fund that need. Although peer-to-peer financing companies, such as Lending Club and Fundera, are gaining a foothold in the small business lending market, most small businesses would prefer to receive funding from traditional lenders. Even with the rise of alternative lenders, there is still significant untapped potential for those financial institutions that can meet the needs of small businesses.

To ensure profitability in small business lending, lenders need to understand not only how to position small business loans, but also the financial institution's credit products and risk appetite.

1 U.S. SBA Office of Advocacy, 2022 Small Business Profile
2 2023 Small Business Credit Survey: Report on Employer Firms
3 2023 Small Business Credit Survey: Report on Employer Firms

CHAPTER 2: What Makes Small Business Lending Unique?

Talking shop: Understanding the value proposition of small business owners and their needs

Because small businesses have different needs than retail or commercial borrowers, they pose different challenges for lenders. Even though it's common for small businesses—and especially "mom-and-pop shops"—to secure debt with personal assets, a lender with consumer loan expertise typically does not have the knowledge needed to lead small businesses through the loan process. And while commercial lenders may be well versed in business terminology and understand complex financial principles and loan structuring, they often aren't prepared to address the unique needs of the small business market. Small business lending is less about loan structuring and more about credit risk analysis for both business and personal financial conditions.

The following are some key ways that small business lending is different from consumer or commercial lending.

Value of Lender Partnerships

Like most consumer borrowers, small businesses appreciate quick underwriting decisions. But they also want to work with lenders who understand their business and its full financial picture, and who are able to offer recommendations to improve small business woes such as managing cash flow, improving operational efficiency, and structuring for growth.

In addition, small business owners are often interested in how their firm compares to its peers. Is it growing profitability at an appropriate rate? Is it operating efficiently and in a way that can support growth? Lenders who are comfortable in the small business market can share insights into the strength of the business and identify any red flags such as too little liquidity, inadequate infrastructure, or high human resources costs.

In other words, small businesses value lenders who can help them evaluate their performance based on benchmarking and industry averages and offer suggestions for improvement.

The financial institutions most successful in small business lending employ lenders who understand what small businesses value and work to meet those requirements. These lenders also serve as financial partners who can make recommendations on improving the financing of the business needs.

Less Financial Acumen

Often small businesses do not have a chief financial officer or someone on staff who has sole responsibility for—and experience and expertise in—finances. The vast majority of firms will rely on their Certified Public Accountant (CPA) for all things financial. Sometimes the only financial documents that a small business generates are tax returns.

CPAs focus on tax minimization and reporting business profits appropriately to the state and federal governments. In fact, one of the top financial concerns for many small business owners is their tax burden.

However, the strategies used to minimize taxes may be in conflict with the business' credit needs. A small business with lower reported income may pay less in taxes, but that same income may impact the business' ability to secure credit from a reputable financial institution when needed.

Commingled Business and Personal Finances

Small businesses—especially sole proprietorships and other microbusinesses—tend to blur the lines between business funds and personal funds.

It's not unusual for a small business owner to commingle funds, perhaps using profits from the business to fund personal debt or vice versa. The small business owner may take out a home equity line of credit (HELOC) to fund business expansion or to cover a delay in accounts receivables, or use profits from the business to fund a child's college tuition.

In Practice

A carpet installation business bid for—and won—the contract for a large corporation with multiple locations.

Previously, the business had worked on much smaller installations and used the same pricing scheme and similar margins. However, the pricing for a larger contract required different parameters that the business did not consider.

Since it had severely underbid the contract, the business wasn't able to hire supervisors to monitor the installations. Quality suffered and the corporate customer withheld payment until the problems were corrected.

The small business did not correctly project the liquidity it needed to wait for the accounts receivables to be collected. Unfortunately, the business did not recover.

A small business lender could have helped it plan for that working capital need.

Of business owners whose firms had financial challenges in 2022, 53% reported using personal funds to alleviate them.[4]

A small business lender needs to evaluate global debt service coverage and analyze how the small business owner's personal financial liquidity, debt, and cash flow impact the business financial situation and ability to repay the loan.

Risk Preparedness

There are many types of risks that can significantly impact a small business—or potentially even put it out of business. For example, a small business with fewer resources and cash reserves is more vulnerable than a large firm to business cycles and economic events such as recessions.

Operational risk is tricky for small business owners to predict and control. Issues such as the loss of a key employee or product defects can quickly derail a small business' profitability.

Small businesses are also vulnerable to natural disasters—and they often aren't prepared for it. According to the National Oceanic and Atmospheric Administration, in 2021 there were 20 separate billion-dollar natural disasters in the U.S. Twelve percent of small businesses reported natural disaster-related revenue losses that year.[5] Though statistics vary, all suggest that most small businesses do not have disaster insurance. Additionally, FEMA has estimated that as many as 25% do not reopen after experiencing a disaster-related closure.

Efficiency is Critical for Profitability

While the spread on small business loans is attractive, the smaller dollar amounts mean that financial institutions will need to fund more loans. Scalability—being able to efficiently underwrite and approve a larger volume of loans—is critical to success in small business lending.

Part of the puzzle depends on the financial institution's ability to automate and streamline small business lending to get these loans approved, booked, and monitored efficiently. Another part of the puzzle depends on the lender's ability to quickly assess the feasibility of the loan, identify risk, and then work to structure a loan to mitigate those risks.

The most successful small business lenders are constantly learning. Each business they work with, every lending need they assess, and every loan that is approved or declined adds to their experiential learning.

4 2023 Small Business Credit Survey: Report on Employer Firms

5 The Impact of Natural Disasters on Small Businesses: Findings From the 2021 Small Business Credit Survey

CHAPTER 3: What Are the Attributes of Successful Small Business Lenders?

In addition to creating loans and managing credit, small business lenders learn about owners' needs and challenges

The small business lending market is underserved, with many small businesses either unfunded or underfunded. Financial institutions can address this need for credit while leveraging small business lending to deepen relationships with customers and improve profitability—if they have lenders with the right skills. Here are five attributes of successful small business lenders:

They Connect and Communicate with Business Owners

Small business lending success requires that lenders connect on both a personal and professional level with business owners. These lenders need excellent communication skills and the ability to inspire confidence that they can meet the small business owner's needs.

Lenders should be comfortable networking with business owners at such events as chamber of commerce mixers or professional association gatherings. They should be cognizant of a potential borrower's relationship with centers of influence, such as attorneys and CPAs, and be able to leverage those relationships into additional banking opportunities.

They Understand What is Unique About Each Business

Small businesses, like their owners, are unique. The most successful small business lenders embrace those differences and seek to understand how an individual business' capital and operating cycles function and suggest products and services that are most appropriate based on these cycles.

It's important that the lender appropriately identifies the actual need and helps the owner identify potential future needs, before recommending proposed solutions.

Even within similar businesses, differences exist. An attorney in a solo practice will likely have a different borrowing profile from attorneys in a group practice. A fast-food franchise may have a different profile from a family-run delicatessen.

The key point is that a small business lender should be able to engage with a small business owner in a manner that demonstrates that the lender truly understands the business owner's needs and can recommend the correct loan product based on those needs.

These conversations—or "talking shop"—go a long way toward building a relationship and gaining credibility with a small business owner.

They Ask Smart Questions

Once the lender demonstrates that they understand the challenges the owner faces, it's time for the lender to drill down into the details of the business's immediate financing need, as well as its bigger-picture financing strategies.

There are a variety of questions small business lenders need to ask to identify the most appropriate products and services. What differentiates the business from its competitors? How does cash flow into and out of the business? Are payments received by cash or credit card? How much does the business pay for merchant services?

A small business that has higher-than-average operating expenses or cash flow management issues will not be as profitable as it could be. Alternatively, a business that does not collect its accounts receivable in a timely manner may create a cash crunch that reverberates throughout the business and hinders its ability to expand or grow sales.

In Practice

A pizza shop approached its financial institution for a line of credit. By understanding the very fast operating cycle of a cash- and credit card-based business, the small business lender was able to explain that a line of credit was not an appropriate product for this particular small business because it does not need to finance accounts receivables, and inventory turns over quickly.

Instead, the small business lender was able to recommend more appropriate products and services, such as a term loan for equipment to fund the pizza shop's expansion from two to three locations next year.

Or, perhaps the small business is paying above-average merchant fees on credit and debit card transactions. By bundling merchant services within a full relationship with the financial institution, the lender may be able to offer more attractive pricing.

A lender who can ask smart questions about a variety of topics, such as management expertise, organizational structure, growth plans, and the competitive landscape, can quickly get to the root cause of a funding need and add value to the relationship. These lenders can also quickly weed out poor loan candidates, rather than waste time going back and forth for additional documentation, only to ultimately decline the loan.

They Employ a Variety of Analysis Tools

Small business owners often intermingle business and personal funds. In order to analyze the business' ability to repay the loan, a small business lender must evaluate both the business financial statements and owner's personal financial statements and calculate global debt service coverage. Also, because tax returns are often the only professionally prepared financial statement a small business has available, the lender must be able to reconcile them with financial statements created in an accounting program such as QuickBooks.

Once a lender has a clear picture of the root cause of the need for funding, they should be able to analyze the facts. This requires a combination of financial analysis techniques, including ratio and cash flow analyses, and sensitivity analysis to predict whether the borrower will have the capacity to repay new debt.

The lender can then structure a credit package that meets the borrower's needs and stands an excellent chance of being repaid as scheduled. The lender should ensure that the repayment schedule both matches the business' available cash flow and is within bank policy and target profitability returns.

If the lender determines that the business' current capital structure is not optimal, they should be prepared to suggest alternative solutions through organizations such as the Small Business Administration (SBA) or other state and local economic assistance programs.

Finally, the lender should be able to advise the small business owner about ways to improve their financial position in order to qualify for small business loans in the future and leverage additional bank services to enhance their overall operations.

A lender who can ask smart questions about a variety of topics, such as management expertise, organizational structure, growth plans, and the competitive landscape, can quickly get to the root cause of a funding need and add much value to the overall relationship.

CHAPTER 4: Best Practices for Small Business Lending Success

How traditional financial institutions are powering their growth

Few lenders possess all the skills needed to succeed in the small business lending arena. There are a variety of ways to develop and enhance lenders' skills, including mentoring and coaching or hosting informal "lunch and learns" with senior credit officers. Attending conferences or roundtables are also appropriate and effective methods of improving skills.

For those new to small business lending, training can provide the foundation for skills required. For experienced lenders, the best training programs will allow lenders to test out of basic training and focus instead on more advanced skills. Blended learning can be highly effective for achieving skills proficiency.

The following recommendations can help foster success in small business lending:

Assess Skills

The first step in small business lending success is to identify any deficiencies in the banker's skill set, regardless of their experience.

After the institution has assessed lender skills, it can then provide the training that is customized for each individual lender. These skills include tax return analysis, general business acumen, risk identification, and the ability to assess the management skills of the small business' leadership team.

Gain Management Buy-In

When they understand how small business lending can increase profitability and deepen customer relationships, leaders will be eager to support training and experiences that increase lender performance in those key areas. This support should be communicated downward throughout the institution.

One of the most effective methods of supporting skills improvement is to take a top-down approach and ask everyone who manages lenders to become familiar with the training; to act as mentors to their lenders to support the training and transfer of knowledge; and to kick off any training by explaining how it will benefit both the organization and the lender.

The most successful small business lenders are constantly learning. Each business they work with, every lending need they assess, and every loan that is approved or declined adds to their experiential learning. Management should encourage underwriters to discuss with lenders the reason for a decline or counteroffer to further experiential learning.

Focus on a Niche Market

Some financial institutions have developed expertise in targeted industries such as professional services firms or medical practices. Focusing on niche lending markets has several advantages for financial institutions. First, the institution can shorten the length of the underwriting process, granting loan approvals more quickly by leveraging small business lenders who are well versed in a specific industry.

A small business lender with expertise of this kind is better able to ask the right questions upfront, reducing back and forth between the small business and the financial institution and improving efficiency.

Second, asking the right questions—and understanding the business—also allows the lender to identify risk factors and mitigate those risks before sending the loan to underwriting. A small business lender with expertise in medical practices understands the accounts receivables collections risk associated with Medicare and Medicaid versus private insurance, for instance.

These lenders are also able to weed out poor loan candidates much more quickly and manage customer expectations more appropriately upfront. Furthermore, they can offer valuable guidance to the customer to support them in their future credit journey.

Small business lenders should be able to engage with a small business borrowers in a manner that demonstrates that the lender truly understands the business owner's needs and can recommend the correct loan product based on those needs.

Focus on Efficiency

Financial institutions can improve efficiency by implementing a well-defined approval system based on the amount of the loan.

For smaller amounts, the institution can truncate the approval process and approve or reject the loan based on credit scores only, similar to an approval for an unsecured business credit card. Although these loans may not perform as well as those that undergo more intensive underwriting, the efficiency gains offset the slightly higher credit risk.

For higher amounts, the institution can employ credit scoring plus require fewer financial documents for underwriting, perhaps using only two years of financial statements. The underwriter can then prepare a more simplified cash flow or debt service coverage ratio for analysis.

Even larger loans can be approved efficiently if the financial institution offers well-defined loan products that do not require complex and time-consuming loan structuring.

Create the Right Culture

To foster success, create a culture within the small business lending area that recognizes success in making sound credit decisions, and supports and encourages learning and application of new skills on the job. Support this culture by providing time and study space in which to complete training; providing access to senior lenders for discussions about lending culture and policy; recognizing successful completion of training; and coaching for sustainment.

To ensure profitability in small business lending, lenders also need to understand the financial institution's credit products and risk appetite.

The credit department can play a crucial role in this regard, educating small business lenders on the approval process; techniques for evaluating cash flow, collateral, or other forms of support; and offering suggestions for strengthening the overall relationship. At the same time that the lenders are learning important skills, the credit team is being afforded leadership opportunities.

Finally, task the credit department with explaining the reasons for declines, so the lender better understands the institution's credit culture and risk appetite. In addition, they should advise on what is needed to get to a bankable opportunity. Forging communication between the small business lenders and the credit team enables the lender to focus on deals that fit the institution's profile. This partnership also supports the banker's continued experiential learning through collaboration.

Small businesses, like their owners, are unique. Those lenders who are most successful in small business lending embrace those differences.

Lending to Small Businesses Presents Continued Growth Opportunities

Small businesses throughout the U.S. are underserved by financial institutions, with many not receiving the credit they need. This presents an opportunity for financial institutions to expand their small business lending programs. But small businesses have different borrowing needs, and lenders with experience in consumer or commercial lending often lack the specific skills needed for small business lending success.

The key is to approach small business lending holistically and as a means of deepening customer relationships. Because small businesses are typically owned by a single individual or a small group of individuals, a small business lending relationship has the potential to increase the borrowers' overall relationship with the institution with deposits, personal loans, owner investments, and cash management. While the small business loan itself may not be highly profitable, the bundling of other products and services can turn a small business borrower into a profitable and attractive relationship.

The most successful small business lenders can connect and communicate with business owners, understand the unique requirements of small businesses, ask the right questions, and then apply their knowledge and understanding to tailor customized solutions to the individual business. Financial institutions that invest in their lenders and provide them with training in these skills will be the most successful in small business lending both today and into the future.

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