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Inside the broken small business finance system

By Elizabeth Macbride

Early this month, the National Federation of Independent Business released another dismal monthly report on small business hiring. Many of the owners surveyed see weak demand and remain fearful about the future. Don't expect them to be leading the nation into recovery anytime soon.

But another group of entrepreneurs is willing to take calculated risks on the recovery if only they can find the capital to do so. They show up in surveys, too. A recent one by Pepperdine University found that access to capital was the No. 1 business issue for half of private companies nationwide.

Both the total volume and total value of small business lending in New York state tumbled by nearly half between 2006 and 2009. Constrained by old underwriting traditions that arguably place too much emphasis on real estate prices and new capital-reserve requirements imposed by financial reform banks are still seen as miserly, especially in the tricky small business lending market.

Manhattan-based Newtek Business Services Inc., a publicly held company that is stepping into the

that's crazy. I'm surprised their noses don't grow. There's almost nobody that can meet their ridiculous underwriting standa

But there's more to the story of the small business credit drought than overly nervous bankers. Many people involved in getting money to small businesses, from venture capitalists to nonprofit lenders, say the small business financing system remains in disarray nearly three years after the start of the recession.

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As traditional bank lending languishes, credit cards a central facet of small business financing in recent years have become a much less reliable and costlier source of both startup and operating capital. Venture capitalists, too, have pulled back sharply, as the underlying economics of their business have changed.

Meanwhile, a growing number of alternative lenders are stepping into the gaps left by established players. But they are making loans in numbers too small to have a real impact.

It's hard to get a complete view of the fractured financing system for small business. (Even the Federal Reserve Board, which this past summer held a national conference on increasing capital flows to small businesses, bemoans the dearth of data.) But studies suggest, and interviews with both entrepreneurs and executives in finance confirm, that the system is fundamentally in transition and, unfortunately, changing too slowly to provide much economic growth at this stage of the recovery.



Attorney Eric Dixon sat down at his 23rd Street office last month to check his accounts online, including that of a credit card issued by J.P. Morgan Chase. He was surprised to see that the minimum payment on an account balance of less than \$5,000 had jumped into the triple digits.

Mr. Dixon insists he's never missed a payment—he uses the card for the occasional marketing purchase and as a cash-flow cushion—so what he saw came as a shock: The rate had jumped from 6% to 9%.

J.P. Morgan says it is not raising rates on its small business cards, but could not offer more details about Mr. Dixon's story. But the scenario Mr. Dixon describes is increasingly common. Small businesses weren't covered in the new financial reform bill that enacted consumer protections against practices like hair-trigger rate increases.

What makes this a more serious problem is that credit cards have quietly grown into the central piece of the small business financing system. As bank loans became harder to come by and the paperwork more demanding, business owners put their debt on their cards, sometimes at rates that would make consumers' eyes pop.

A survey by the Washington, D.C.-based National Small Business Association found that among companies with fewer than 500 employees, 34% carried more than a quarter of the company's overall debt load on a credit card.

More than 70% of owners with a card used for business expenses reported paying interest of more than 10%.

Mr. Dixon—who works for companies and people caught up in state investigations—has a client in the pet care business who financed her company entirely on credit cards. Debt in the six figures, at rising interest rates, is now crushing the company; she is, he says, considering personal bankruptcy.



At first glance, small business banking seems to offer an opportunity for healthy banks. The financial crisis decimated longtime small business lenders like CIT, but left other stalwarts like Wells Fargo standing.

The politicians certainly want banks to jump back into the Main Street lending business. Under political pressure, all of the major banks committed to increasing their small business lending this year—Wells Fargo's was up by 30% in the second quarter nationwide, compared with the year-earlier period; J.P. Morgan Chase's was up 37%; Citibank and Bank of America say their small business lending is up, too.

The problem is that everyone is coming off such low numbers from 2008 and 2009 that the increases are much smaller than they appear. The number of bank loans made to small businesses in New York state dropped to 203,832 in 2009 from 466,400 in 2006, according to the state Banking Department.

The return to normalcy is likely to be very slow, because of the hangover from the financial crisis.

Consider Wells Fargo. The bank's takeover of Wachovia, finalized this past spring, left one of the top small business lenders elsewhere in the nation with 21 bank branches in New York City. Wells Fargo aims to grow its share of the local small business lending market, says John Cole, business banking division manager for New York, New Jersey and Connecticut.

Yet it's harder to expand than it seems. That's because Wells Fargo hasn't changed its underwriting principles. As at most banks, underwriting for small loans is done partially via an automated system. Experts say banks' loan approval rates for small businesses fall between 20% and 30%.

Mr. Cole says that at Wells Fargo, loans are made based on cash flow plus collateral. Most small businesses' cash flow has declined, and most owners have seen the value of their real estate drop.

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Small Business Services and helps owners with a variety of tasks, including getting loans.

applications that were denied. That may be helping: A July Federal Reserve survey found that big banks nationwide had reported easing their small business lending standards for the first time since late 2006.

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But many observers say that expecting banks to take greater risks is nonsensical, in light of the fact that so many saw healthy profits last year, when they weren't lending much.



Where banks are hesitant to step, alternative lenders are wading in. Take Seedco. From its office on Broadway, it lends money to small businesses as a way of helping disadvantaged communities. With a loan portfolio of \$33 million nationwide, Seedco Financial is now set to lend \$20 million in 2010, and has recently added eight staffers to bring its employee total to 36.

Over the years, nonprofits such as Seedco and microlenders like Acción International and Grameen Bank, along with a handful of for-profit companies, had come to serve as a second tier behind the banks. But those distinctions are blurring now as the banks stay on the sidelines.

Newtek provides small business services such as website design and merchant services, but recently expanded its lending operation and is now poised to make \$75 million worth of small business loans through the government's SBA lending programs. In addition, it has a portfolio of \$50 million in short-term receivables financing.

Chief Executive Barry Sloane says Newtek's lending numbers may climb by as much as 50% in 2011.

While the doors at Seedco, Newtek and other alternative lenders are open wider to small businesses than the doors at banks are both organizations, for instance, embrace startup financing it's important to note that they also charge higher interest rates. Seedco's rates are typically 1 to 2 percentage points above a standard bank loan; Newtek charges varying percentage points over prime for 10- to 25-year loans.

The bottom line here for more small businesses? A higher cost of capital that sometimes isn't much less than what credit card companies charge their favored customers.



Meet a new breed of e - -based First Round Capital, which opened a New York office on Union Square in May.

First Round thrives on the idea that startups now require much less capital than they did 10 years ago, at the peak of the Internet boom. That's when many existing venture capital funds were born. Entrepreneurs no longer need the \$2 million-and-up investments VC shops are structured to make.

e of Manhattan-based CB Insights, -funds that were popular in the late

First Round seems to be one answer to the question. According to founder Howard Morgan, super-angels like First Round invest \$250,000 to \$1 million, with an average investment of \$500,000.

Indeed, Mr. Morgan financed his first venture back in 1992 to the tune of \$5 million; his latest, which he sold after only seven months, called for an investment of just \$750,000.

Yet the fact is, there simply aren't enough firms like First Round to make up for the lack of investment by other venture capital funds. VC investments in New York area companies dropped to \$1.4 billion last year, from \$2.1 billion in 2006. They are on track to climb this year, but nowhere near 2006's level. In 2000, venture capitalists made \$10 billion of investments in the New York area.

Still, First Round Capital's presence is a sign that the private equity world is adapting faster than other parts of the small business financing system. Interestingly, it's also one of the investors in On Deck Capital, a fast-growing Manhattan-based company that uses software to evaluate a small business's cash flow and makes small, short-term loans based on that cash flow.

On Deck has deployed \$80 million of capital in 3,000 loans nationwide. With default rates that are typical for portfolios of that size, the company says it is on track to double its lending this year.

Mitch Jacobs, chief executive of On Deck, says that the small business financing system has never worked well. The credit drought has worsened conditions for small businesses, he says, but that's not as important as what is turning into a window of opportunity for reform.

