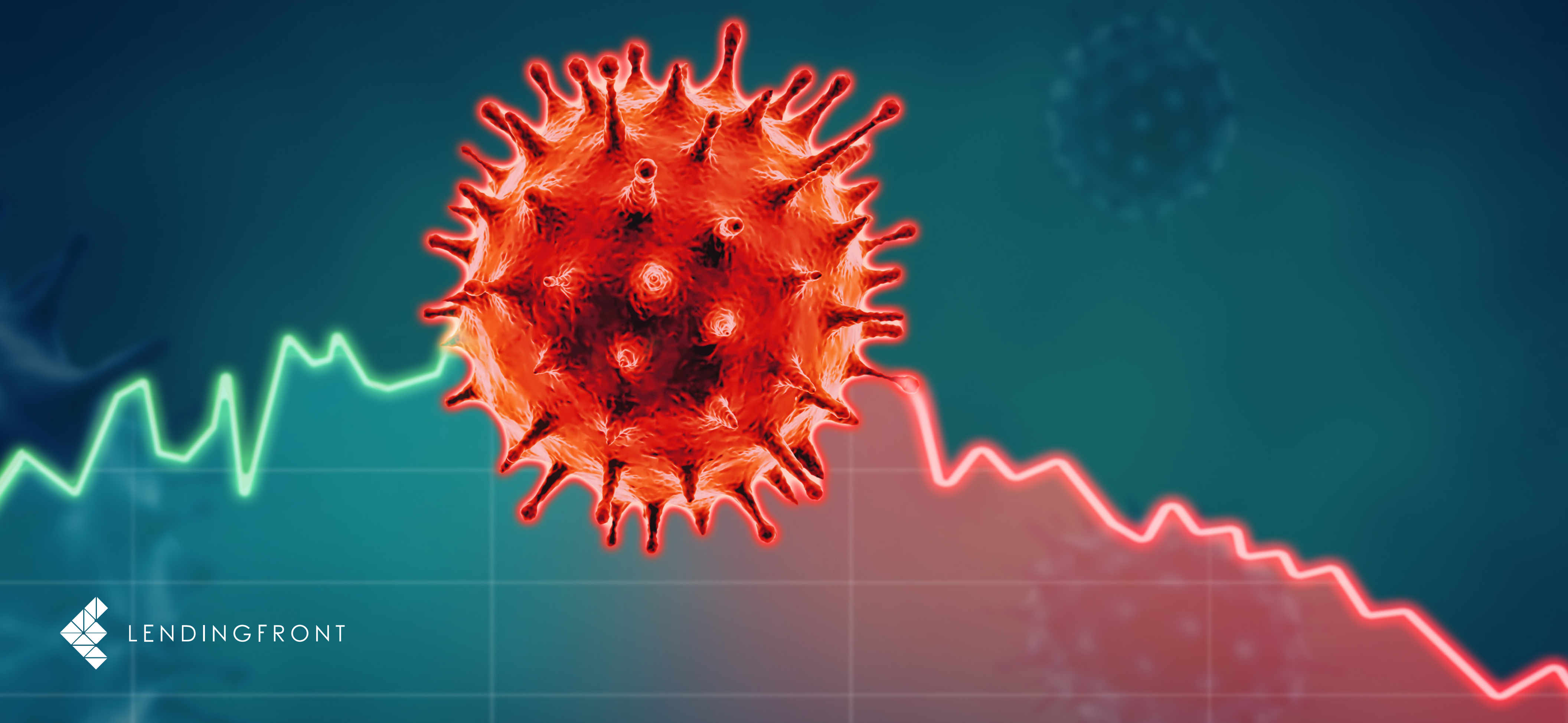
The Capital Needs of Small Businesses are Changing: Here's How Lenders Should Respond

A LendingFront Publication



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With Covid-19 on the minds of businesses and lenders alike, conversations about the capital needs of small businesses have revolved—with obvious justification—around the Paycheck Protection Program (PPP) and other forms of relief provided under the CARES Act.

Yet the capital needs of many small businesses don’t begin and end with the PPP.

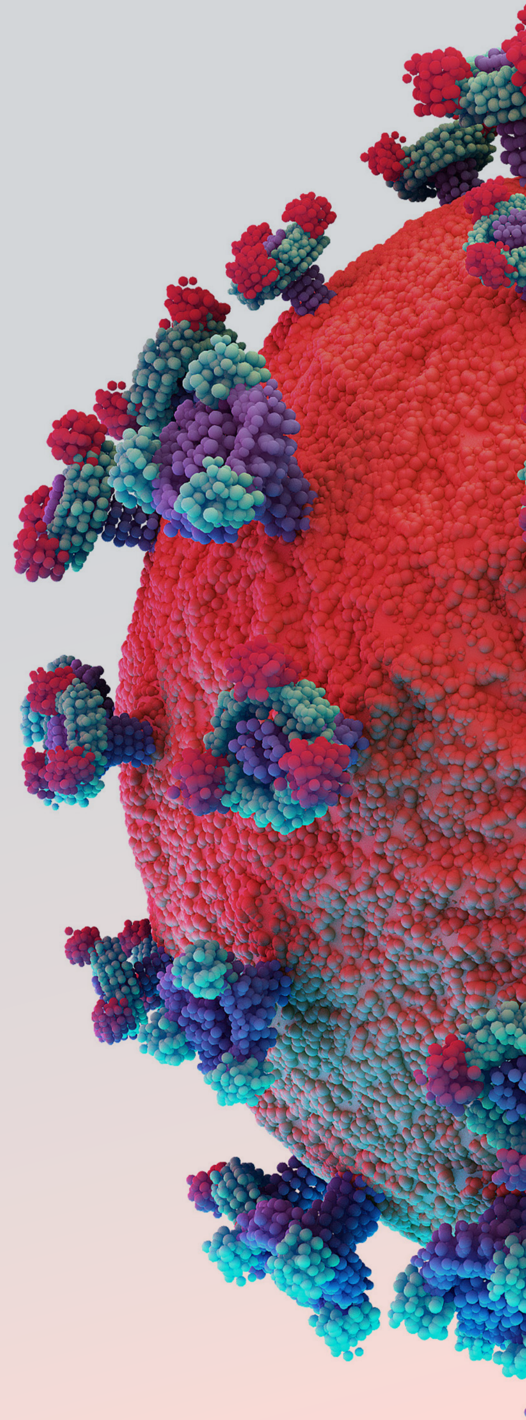
Let's start with a few facts.

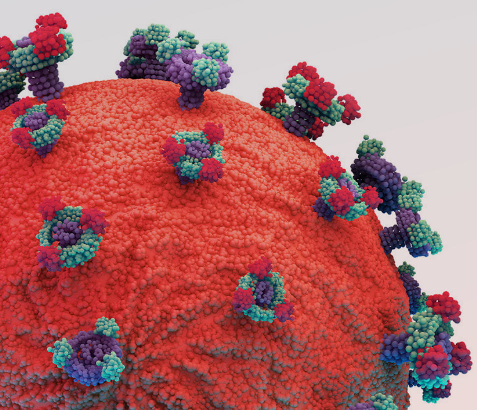
According to the U.S. Federal Reserve's 2019 Small Business Credit Survey:

- 43% of small businesses sought external funding for their businesses in 2018
- And more than half experienced a funding shortfall.

These funds—when small businesses can obtain them—are often used to purchase inventory, replace equipment, finance expansion, and hire new workers.

These needs will persist long after PPP lending has come to an end, yet even in a strong economy, **up to 80% of bank-originated small business loan applications are rejected.**



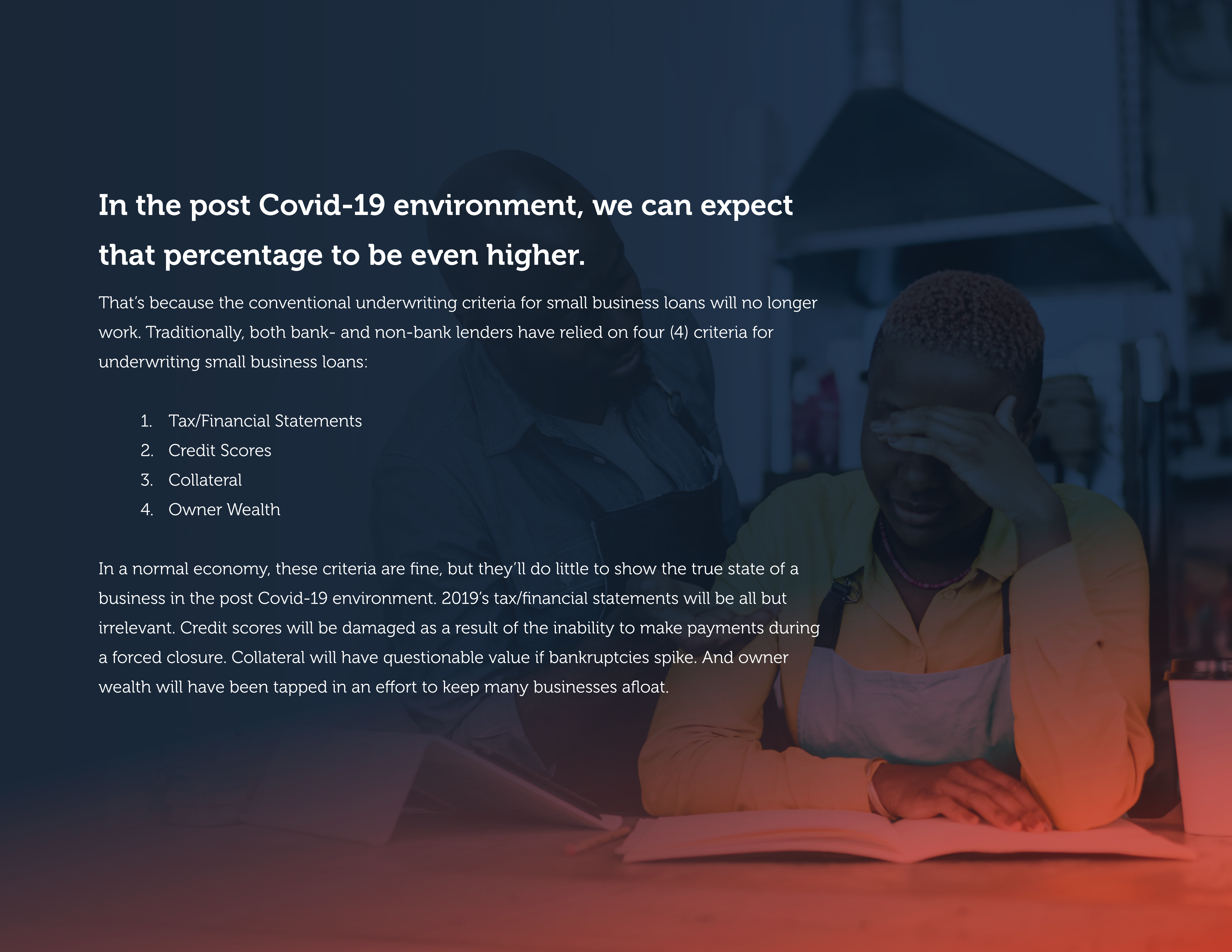


In the post Covid-19 environment, we can expect that percentage to be even higher.

That's because the conventional underwriting criteria for small business loans will no longer work. Traditionally, both bank- and non-bank lenders have relied on four (4) criteria for underwriting small business loans:

1. Tax/Financial Statements
2. Credit Scores
3. Collateral
4. Owner Wealth

In a normal economy, these criteria are fine, but they'll do little to show the true state of a business in the post Covid-19 environment. 2019's tax/financial statements will be all but irrelevant. Credit scores will be damaged as a result of the inability to make payments during a forced closure. Collateral will have questionable value if bankruptcies spike. And owner wealth will have been tapped in an effort to keep many businesses afloat.



Are we headed towards a capital drought?

With traditional underwriting criteria no longer useful, are we headed toward a capital drought? We certainly don't need to, but the answer largely hinges upon lenders doing two things:

1. Adopting new criteria that are more appropriate for the post Covid-19 environment
2. Adopting new product structures that enable the lender to manage risk

New credit criteria include information such as:

- **Real-time Cash Flow**
  Cash flow helps you gauge how quickly the business is recovering from Covid-19. Is it in irreversible decline? Is it struggling but stable? Has it gotten back to normal? Insight into real-time cash flow helps lenders make better decisions about who to lend to along with the terms of any offers.

- **Consumer Sentiment**
  Customers who vote with their reviews also vote with their wallets. Examine reviews from Google, Yelp, and other sources to answer, *Is this a business that customers love?* Businesses that are well-regarded by customers stand a much better chance of recovering than those that had problems before the pandemic shut them down.

New product structures also enable lenders to deliver capital efficiently while managing risk.

Here's how:

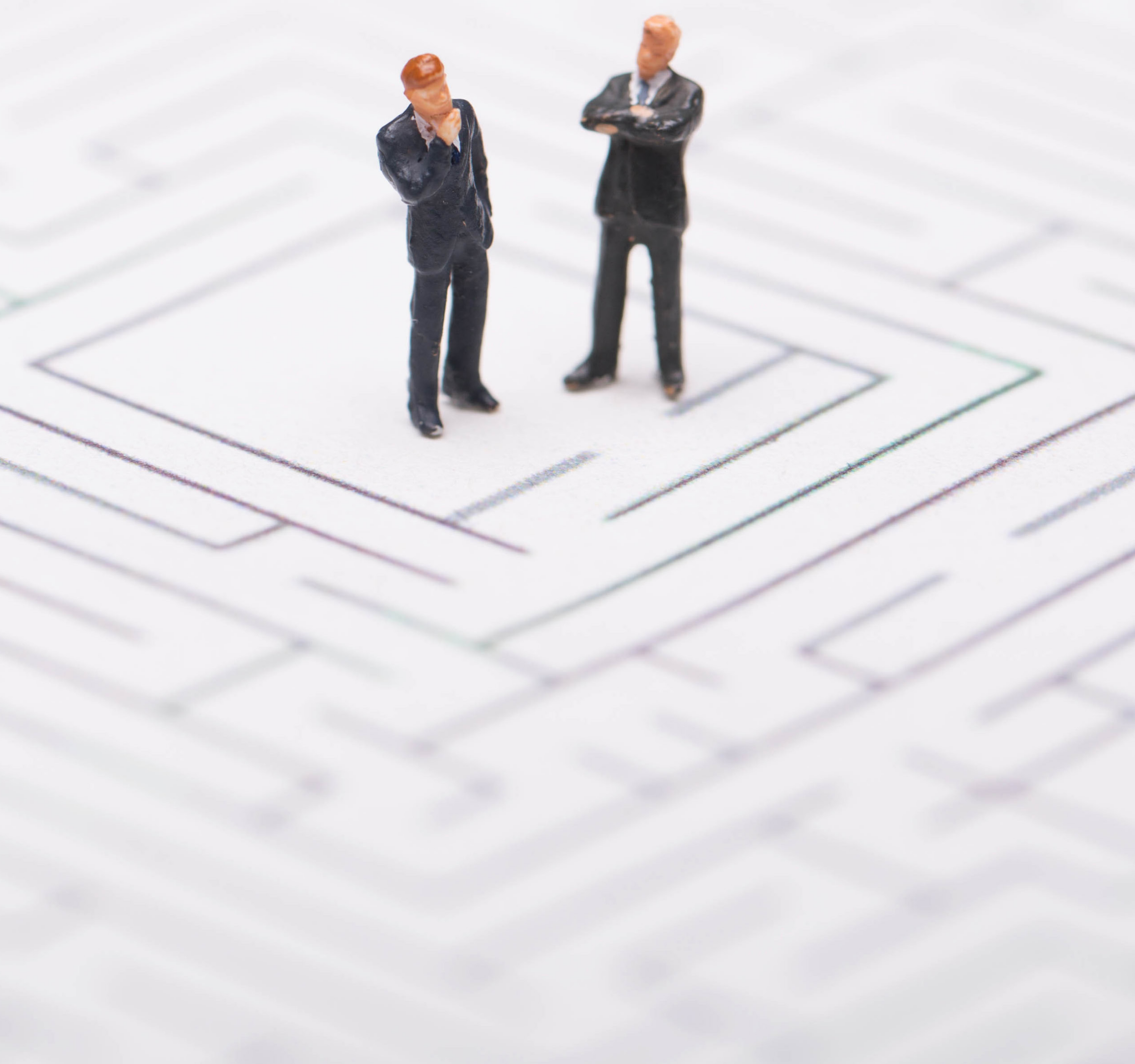
- **Shorter Terms**
  First, lenders should emphasize shorter payback periods in the range of 6-12 months. Shorter terms get the lender paid back faster while enabling the business owner to show that he/she is creditworthy before seeking a larger amount of capital.

- **Daily ACH Payments**
  Second, lenders should collect payments from the borrower on a daily—rather than monthly—basis. Monthly payments introduce unnecessary operational risk. Daily payments are smaller, consistent, and more predictable from the standpoint of the business' cash flow.

- **Tie Payments to Performance**
  Lastly, lenders should tie payment terms to current cash flow performance—and with visibility into cash flow, this is very easy to do.

A new economy needs new rules for lending

If the Great Recession taught us anything, it’s that opportunities exist for lenders to increase their assets, gain market share and, of course, to meet the capital needs of their borrowers. In the post Covid-19 environment, lending is only as risky as the information used to make decisions. With better underwriting criteria and more appropriate product structures, the most forward-thinking lenders will position themselves for success and reap the rewards.



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