CHALLENGES IN SME ACCESS TO CAPITAL

Thought Brief by Richard Swart, PhD

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INTRODUCTION

America was built by courageous entrepreneurs who created industries and technologies that transformed the world. Today, the outsized success of Silicon Valley has led to the widespread misperception that entrepreneurship is alive and well in the United States. Sadly, this is far from the truth. Every month in the United States, more businesses close than are created.[1] The rate of entrepreneurship has been in steady decline for more than a decade and, that decline is steepening; lacking access to finance is a key contributor to this trend. In this thought brief, I outline developing trends in small and medium-sized enterprise (SME) lending and the challenges posed by these trends, and I discuss a few promising paths to improved lending.

The Initial Public Offering (IPO) market—a strong indicator of entrepreneurship—has been stifled by ill-advised regulations. Small IPOs have been essential for American enterprise, providing funds for firms to grow and scale, acting as a bridge from SME to mid-size firm and beyond; small IPOs helped Amazon, eBay, and Yahoo! all become the giants they are today. But since 1997, the number of IPOs has been on the decline in the U.S., and the total number of firms listed on U.S. exchanges has been decreasing, all while exchanges in Asia, the U.K., and Europe have seen substantial growth. We are losing businesses, the capacity for economic growth, and

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stifling our economy. While the Dow Jones Industrial Average soars, the rest of the exchange, which has an average market cap of only $450 million, is slowly dying.

Technological advancement has exacerbated the difficulties of already-challenging SME lending in America. The high cost, high risk, and low reward of underwriting small loans makes small businesses unattractive to banks.1 Small businesses—"Main Street" firms—typically receive their mentoring and services from some combination of three providers: the SBA and subsidiary programs, the local chambers of commerce, and paid consultants, advisors, or service providers. But these resources are not designed to keep up with changes in technology or financing models and do a terrible job of helping clients navigate the changing nature of finance. Most small business owners are literally not aware that new finance options exist.[2] Sadly, data shows even less awareness of new financing models among minority-owned business firms. The mirror image of this problem is that many of the best practices and models come from tech firms, which already experience the easiest access to capital. Creating a system of good, contemporary SME lending is a significant challenge, but one America must rise above if it is to have a healthy economy in the decades to come.

This primer provides a brief overview of some of the factors affecting business creation, business finance, and their impact on job creation and economic growth. It is widely known that smaller firms—especially microenterprises with fewer than five employees—create a majority of the jobs in the United States. With technological advancement, offshoring, and a range of economic factors turning Fortune 500s into net job destroyers, a reassessment of SME financing should be made a top priority.

RISING ROADBLOCKS TO ENTREPRENEURSHIP

Risk and entrepreneurship go hand-in-hand; many leading firms were started during times of great economic and political uncertainty. But as a society we are becoming more risk-averse and less entrepreneurial, and this is to our economic detriment. In part, this results from lacking trust in institutions: Disappearing employment stability and skyrocketing health care costs are just two examples of changing institutions that have estranged Americans. Many would-be entrepreneurs in their 30s and 40s are afraid to launch a business because they fear they could not recover from a failure.

The younger generation is much more accepting of the idea of self-employment, and the rapid growth of co-working, incubators, and other sharing economy mechanisms to support entrepreneurship is highly encouraging. The millennial and post-millennial generations are post-corporatists; they don't believe that larger organizational structures like banks and corporations will play a part in their life.

Generally, there are a number of specific challenges that affect the rate of entrepreneurial activity. They are briefly described below.

There is a social stigma attached to failure that is particularly prevalent within certain cultures. This accounts in part for wide variations in entrepreneurial activity among different racial and ethnic groups.[3] Surveys of small business owners and entrepreneurs reveal that they are under financial burdens imposed by the cost of compliance with an ever-growing body of regulations. There is little support of the argument that entrepreneurs don't start businesses due to the regulatory burden, but data does suggest that the growth rate and viability of firms is being affected by America's increasingly restrictive regulatory environment.[4]

While technology has dramatically decreased the costs to start a business—a web-based business can be started for less than $10,000 with a robust suite of cloud-based technologies that would have cost $1 million to create a generation ago—the decreased cost has allowed large firms to amplify their marketing, advertising, and social media efforts, making it hard for small firms to compete.
The laws of startups have not changed: the vast

majority of new businesses will fail and only 10 to 20 percent of them will earn profit and grow within five years. This churn has always existed and is not improving, suggesting that our spending on small business development and entrepreneur training is not addressing the key challenges of sustaining, rather than merely starting, a small business.

THE FUNDAMENTAL DISCONNECT BETWEEN SMALL BUSINESS SUPPORT SERVICES AND STARTUPS

Most new businesses can be effectively divided between tech-savvy and classical models. Current government-financed small business support services like SBA loans and Small Business Development Centers are designed for the latter, while the former are forced to look to a disaggregated network of meetups, developer meetings, co-working spaces, and web-based tutorials for support.

NEW SUPPORT SERVICES

With the dramatic decrease in the cost of starting a firm and the rise of entrepreneurial culture, new structures have evolved to support entrepreneurship.

INCUBATORS

Incubators are essentially low-cost shared office space. Some provide services, but the essential service is real estate. There is no pressure to leave and the outcome data reflects that most are not profitable and don't provide much meaningful help to firms. [5]

ACCELERATORS

An accelerator is a time-limited intensive process of refining a company's business model to help it prepare for a venture pitch at the end of the acceleration period, which is usually 90 days. They provide a small amount of money—roughly $10,000 per month to a team in order to sustain them during long workweeks leading up to the pitch. Accelerators claim to provide an average of $200,000 worth of services as well.[6] Since the goal is to prepare firms for venture pitches, they select venture-friendly companies. For example, one accelerator, TechStars, focuses on mobile app firms.

In exchange for their services, accelerators take an average 6 percent stake in their firms and receive rights to participate in future funding rounds. There is significant variation in outcomes, with the top 15 percent of accelerators, such as Y Combinator, 500 Startups, and TechStars, dominating the market. Many billion-dollar tech companies have emerged from accelerators, but most firms do not have great success.

CO-WORKING

A variation of incubators is the rise of co-working spaces, in which clients pay monthly rent in exchange for access to flexible offices and supportive infrastructure such as conference rooms and Internet access. Some have a social impact mission, while others focus on providing a wide range of services, including access to insurance and payroll help for freelancers. One such co-working space, WeWork, is now valued at over $5 billion despite having only 18,000 paying members as of this writing. In this model there is no investment or participation in the outcome of the businesses by the center.

One reason for the rise of these low-cost alternative office models is the rise of agile methods of software development and the ability of firms to test a product for only a few thousand dollars. An entrepreneur can use scalable cloud-based technology and literally rent computing cycles that expand instantly to meet demand. Thus, entrepreneurs only need access to a smaller fund of capital to develop minimal viable products and test the market. This has the unintended consequence of encouraging entrepreneurs to launch too early, without sufficient market research.

PROBLEMS IN LENDING

For the last 28 years, the percentage of debt carried by our banks in loans to small businesses has declined every year without exception (Mills and McCarthy 2014). Small business lending is more risky and generally less profitable than consumer lending, so banks have shied away from the market. The days of local community banks investing in their community have gone; instead, smaller financial institutions have shifted their lending to consumer debt that can be securitized.[7] Businesses simply can't get access to debt capital, especially in large parts of the southern United States that totally lack local banking options. Myriad factors contribute to this decline.

Even though some loans are still being made, regulatory barriers make the process prohibitively difficult for many would-be entrepreneurs. The application process is extensive and slow, averaging more than 30 days for a decision. Many businesses don't maintain adequate accounting records, so they are forced to fix or create profit and loss (P&L) and current account statements for the loans. Data also suggests that as many as 30 percent of declined loans to businesses are false negatives, meaning that the business was creditworthy and should have qualified for a loan but was denied anyway.[8]

Government-backed Small Business Administration (SBA) loans are intended to promote lending to small businesses, but qualification requirements limit their impact. SBA loans require collateral, like the founder's house or personal assets, to guarantee the loan. This has the unintended discriminatory consequence of disqualifying many minority business owners who, demographically speaking, possess less personal wealth. Many of these potential entrepreneurs simply have no personal collateral to use and therefore do not quality for SBA loans.

Poor financial literacy among U.S. entrepreneurs exacerbates the aforementioned issues. This is manifested by a lack of understanding of the stages of financing, such as seed, proof-of-concept, angel, venture A, venture B, mezzanine finance, and others. Over 90 percent of first-time entrepreneurs mistakenly believe that a bank will lend money to start a business, when in reality small business loans from banks are made to finance the growth of an established business.[9] Even once started, 82 percent of small business failures can be attributed to poor cash flow management, further highlighting the negative impact of financial illiteracy. SMEs approach banks in time of crisis, when it is already too late, and they are often losing key contracts and going out of business because they have failed to secure debt lines or maintain sufficient cash.

ISSUES WITH ANGELS

Angel investors are high-net-worth individuals who make early-stage investments in firms. The investments are made as individuals, but many angel investors join together in an angel association to pool their efforts, assist with due diligence, and to co-invest. However, unlike a venture capital fund, which has general and limited partners and defined termination dates for its investment funds, angels make a series of investment decisions.

Robust angel investing is uniquely American; no other nation has the U.S.'s amount or depth of angel finance activity, but the system has deep structural challenges that greatly limit angels' ability to contribute to new business growth. Though the United States has more than 1,000 angel investing associations, approximately 80 percent of those are not professionally managed and fail to provide returns to their members. [10]

Though numerous, angel investor organizations are poorly distributed geographically, leading to a surplus of early stage capital in some areas and a total lack in others. Historically, angels have invested within 150 miles of their home. Accordingly, the concentration of angels around Silicon Valley, Boston, Washington, D.C., New York, and Austin, TX, has exacerbated the dearth of borrowing options for entrepreneurs in less metropolitan areas that was created by the disappearance of small banks.

Furthermore, the lack of adequate training and professionalism among angel investors is well documented and lessens their overall effectiveness. A lack of industry standards has led to variations in which the same business plan, team, and financial fundamentals can receive $1.2 million in Salt Lake City, $2.5 million in Boulder, CO, and $4–$5 million in Silicon Valley. Though angels have a right to expect some control over the firms in which they invest, too many over-exert influence, going so far as to design term sheets so that they end up with control over the entire venture if the entrepreneur cannot meet aggressive milestones. This is not the norm, but highlights the variation between very professional angel networks and some of the others.

VENTURE CAPITAL

Venture capital firms emerged in the 1970s and are a partnership managed by a group of general partners, who take investment capital from a series of limited partners and create specific funds with fixed lifespans. Taken as a whole, the returns from venture capital investments are low and unreliable, and many smaller venture capital firms ultimately fail.[11] A number of undesirable industry traits including risk aversion and discrimination seem to distract from the positive impact venture capital could have on new business formation. Since the great financial crisis of 2008, a number of VC firms have closed and the industry as a whole seems to be more risk-averse.

By avoiding healthy risk and seeking unrealistic profits, venture capital firms fail to provide promising new businesses the capital they need. Lately, venture capital firms have looked to invest in more and more mature firms, shrinking the pool of capital available to new firms. Furthermore, venture capitalists demonstrate a strong preference for firms with an addressable market of at least $1 billion, that are projected to scale to $1 billion in revenues, and with very limited scaling costs. Practically, this means they invest primarily in software, technology, and life-science companies where the core value is in intellectual property and the firm's ability to identify new markets. Venture capital fails to fund expansion or growth of 99 percent of all firms.

Another troubling development is venture capital's push for early exits, in which investors want the firms they fund to go public or be acquired within 3–5 years of their development. [12] This forces firms to focus narrowly on one current technology or product that can be scaled rapidly since they cannot afford the time necessary for research. The days of R&D at small firms are over. Research has suffered due to insufficient funding, while risk-averse lenders have pushed most firms toward creating iterative products rather than developing new ones.

Finally, even if a firm is generally compatible with venture capital's stringent standards, research shows that significant gender, race, and cultural biases can obstruct its ability to garner funding. Homophilic behavior—in this case the tendency to fund people with shared characteristics—results in the over-selection of white males, specific industries, and even graduates from a specific pool of 20 elite universities. Women, for example, receive less than 5 percent of venture funding despite having started more than 50 percent of firms in the past decade.[13] Nearly 80 percent of all annual venture capital financing occurs in Silicon Valley.

THE RISE OF NEW FINANCE MODELS

Everything about banking is changing, including money transfers, payment mechanisms and gateways, borrowing practices, lending practices, and wealth management.

Google is providing financing to tens of thousands of small firms.[14] Facebook launched a money transfer system.[15] PayPal is aggressively moving to handle larger transactions traditionally managed by banks. Younger adults, the millennial generation, would prefer to have a root canal than to enter a physical bank branch.[16] This section of the brief will address some of these models with a focus on their use by small businesses.

Led by Prosper and Lending Club, a new marketplace has emerged for consumers to take out non-secured loans, or for smaller investors to purchase fractions of these loans and build diversified loan portfolios. Originally designed as true auction markets, they quickly evolved to service institutional clients such as hedge funds and private equity firms that were looking for yield on cash. These firms are providing *billions* of dollars a quarter in loans to consumers. [17]

For now, at least, these platforms are avoiding sub-prime borrowers, instead focusing on consumers with good income and credit but who are still burdened with high credit card rates. Currently, only about 5 percent of these loans are being made to small businesses, but there is room for expansion in this market. Small banks are panicking; they left the lending market years ago, instead issuing credit cards, but now their consumer customers are choosing to refinance those credit cards at rates between 8 and 12 percent, while non-bank lending institutions can issue loans at 42 percent of the cost of a bank, make lending decisions in hours or days rather than months, and use data to limit risk in ways that banks simply cannot.

GROWTH IN NON-TRADITIONAL LENDING AND SUPPORT

In 1996 Bill Gates was quoted saying, "banking is necessary—banks are not."[18] His insight was that much of the value-added services of banking are based on syndicating pools of resources and evaluating risk. Mr. Gates correctly predicted that technology firms would be able to do many of these services better, cheaper, and faster. Today, the result is a growing industry of high-tech lenders with enormous promise for improving SME lending moving forward.

One advantage of high-tech lending is the rich access to data. Ninety-one percent of small businesses use online banking, and most use some form of online accounting and inventory management; astute lenders can now mine this data in real time and apply advanced algorithms to determine risk. Rather than rely on historical balance sheets and income statements, these lenders require real-time and continuous access to a firm's banking and accounting data to classify borrowers into levels of risk based on factors that would not be apparent using traditional methods. Not only do they require daily access to bank records, but many lenders, especially the Merchant Cash Advance lenders who take a portion of the business's daily credit card receipts to repay the loan,[19] also use ACH technology to withdraw their loan payments on a daily basis. If lenders see a crisis emerging—and sometimes they spot trouble before business owners know they are in trouble—they can raise their concerns to the borrower, demand accelerated repayment, or increase the interest rate based on the new risk profile.

These lenders are transforming underwriting of debt by exploiting big data and using novel sources of data. These firms can tap social information such as customer reviews, web traffic, social media engagement and hundreds of other data points to make nearly instantaneous assessments of a company's health. Loan decisions are algorithmic and can be made in less than 10 minutes.[20] For many small businesses, this speed of decision-making (and their need to know if they will have the money in order to make business decisions) outweighs the higher loan costs, and firms are willing to provide access to their online banking and accounting records in exchange for rapid access to needed capital.

New lenders are, of course, not without risks of their own. Banks must use auditable and accepted accounting methods; these lenders are not required to do so. Banks are required under Sarbanes-Oxley to provide full transparency to auditors on their risk modeling; they can't pass an audit using off-balance sheet or non-standard data sets. These new firms are built on their ability to use data that banks could collect but legally can't use in underwriting. For them, changing business practices with a matter of new code being deployed, whereas the culture of banking sees innovation occurring in decades, not minutes. Banks cannot and will not keep up.

ONLINE BUSINESS LENDING

Hundreds of firms, like Prosper and Lending Club, are entering the business lending market and attempting

to increase their SME loans. Here we outline the numerous subtypes of online peer-to-peer lenders.

MERCHANT CASH ADVANCE LENDERS

MCA lenders use unregulated/unlicensed loan brokers, many of whom are the same individuals who were involved in pushing subprime mortgage loans before the meltdown. Their effective interest rates are 100–200 percent per annum. Not surprisingly, they are becoming seen as the payday lenders of small business lending. However, the industry is attempting to lower rates and eliminate reliance on these questionable loan brokers.

ECOMMERCE-FOCUSED LENDERS

One emerging model is to lend to firms doing business only online. These lenders use metrics from web analytics, online shopping carts, and transactional data sources about online activity to evaluate the health of firms. Based on the very rich and available data about these firms they are able to make lending decisions in less than 15 minutes.

LARGER DEBT PROVIDERS

Firms such as OnDeck (which had a recent large IPO) and Funding Circle can provide much larger loans—essentially alternative to SBA loans. These firms use "off balance sheet measures" in addition to traditional risk models to underwrite loans. One of the most ethical is EquityNet, which expanded from Regulations D filings (essentially small private security offerings) to larger debt security issuances. They can finance several hundred thousand notes, but require exhaustive due diligence and do not have the time advantages of other online lenders.

CROWDFUNDING

Using Crowdfunding sites like Kickstarter and Indiegogo (among hundreds of smaller platforms) is the new normal method of launching new products and companies. These models work very well for product-based businesses, but have shown little success with services-based firms. Contributors have no expectation of ownership; there is no security or equity in these campaigns. Essentially they are a "pre-purchase" of a good before it is manufactured. This is a new form of retailing called "pre-tailing," in which firms offer a product through Kickstarter, Indiegogo, or other sites *before it is manufactured*. This allows for market testing, building customer base, and initial finance to occur *simultaneously.* It is the dominant model followed by most startups today and will soon be a business worth tens of billions a year.

EQUITY CROWDFUNDING

Equity crowdfunding, or offering a security in a business via a crowdfunding portal, is legal through the Provisions of the 2012 JOBS Act.[21] It is the public offering of a security in a private company—something previously illegal until the ban on General Solicitation was removed on October 23, 2013. Firms use equity crowdfunding as an alternative to angel finance or Series A venture finance. Issuer firms can close an equity crowdfunding round in a matter of weeks without the time, expense, or difficulty of making dozens or hundreds of pitches to individual investors. This model is essentially an online marketplace for accredited investors; the general public cannot yet participate. When it is eventually legalized, current legislation caps capital raised at $1 million per year, though this is very likely to change by the summer of 2015.

Given how successful crowdfunding has become for many startups, many angel networks are requiring applicants to demonstrate market acceptance through successful non-equity crowdfunding first. It is changing the model for approaching angel networks. On a more fundamental level, many angel networks are adapting the technology behind crowdfunding or explicitly becoming crowdfunding platforms themselves due to the efficiency offered by this technology. Crowdfunding is leading to a boom in syndicated investing in startups, led by Angellist. Angel investors can now join investor syndicates and invest alongside leading early-stage investors. This level of access used to be open only to extremely high-net-worth individuals investing through private equity firms.

NEW RISK

Alternative Lending presents risks to the businesses and to the market – some of which are not widely understood. The market has matured and dramatically expanded since 2011 but many of these platforms grew out of the great recession of 2007 and 2008. This means that none of these firms have gone through a market correction, let alone a significant shock such as 2008. It is unknown how many of these lenders or platforms will perform in a down market.

Much of the supply of capital has come from institutional lenders who are seeking yield on their cash. When online lenders can provide 12-18% returns with leverage, and T Bills are at historic lows, it is not surprising that there is an incredible demand for access to the marketplace lenders loans. However, with Quantitative Easing coming to an end soon, and interest rates inevitably rising, it is not clear if the level of institutional demand will continue.
There is risk of increased regulation. As these firms continue to capture billions in profits from banks, it is conceivable that traditional financial institutions may push for regulation on these lenders to level the playing field. With increasing securitization and a push from the current administration to impose more regulation to protect consumers, one could anticipate federal scrutiny of these lenders.

This final section will briefly review some of the regulatory issues affecting crowdfunding and discuss the JOBS Act in more detail.

TITLE II: ACCREDITED INVESTOR CROWDFUNDING

Title II rules were released by the SEC in the fall of 2013. They allow equity crowdfunding to accredited investors. The vast majority of firms applying for equity crowdfunding are from Silicon Valley and most investors are from Silicon Valley. Over 75 percent of firms have customers and revenues, suggesting it is an alternative class of capital to traditional Reg D or venture-backed Series A finance. Title II allows firms to advertise the fact they are seeking investors. This relaxing of the ban against general solicitation also forces firms to verify the accredited investor status of potential investors. Firms that fail to take adequate measures can be banned from the capital markets for 12 months.

Title II also allows private firms to have as many as 2,000 owners. The limit used to be 500, which forced Facebook to file for an IPO. It is expected that this will allow firms to stay private longer and will lead to a decrease in IPO filings.

TITLE III: NON-ACCREDITED INVESTOR CROWDFUNDING

Once legalized—and three years after Congress passed the JOBS Act, the SEC has yet to issue enabling rules—Title III will allows average citizens to invest in private firms through purchase of equity. Caps are placed on investments based on the investor's income.

The proposed rules issued by the SEC impose onerous auditing, accounting, and compliance costs on firms that want to use Title III. The costs of capital under Title III are estimated at approximately 20 percent, with some estimates as high as 39 percent cost of capital. Industry insiders believe these high costs are intended to quash the market before it can develop and know that much of the pressure has been coming from the Consumer Federation of America and other groups that are opposed to consumers investing in early-stage companies. In some ways this debate is much ado about nothing. While extensive debate exists about how large the market could be, and what the appetite of the average retail investor will be for relatively illiquid long-term private securities, the experience of the U.K. and Europe demonstrates weak consumer demand for this new asset class.

TITLE IV: MODIFIED REGULATION A PERMITTING SMALL IPOS

Title IV will allow what is called a Reg+ Plus filing: a small IPO up to $50 million. The SEC approved these rules on March 25, 2015, meaning that the new IPO market can begin in early summer 2015. The large-scale IPO markets are so expensive that this act is designed to allow firms to issue IPOs earlier. There is a crisis caused by the excessive costs of going public, and many economists believe growth is hampered by the inability of firms to go public before they reach $500 million in revenue—the current lower threshold.

CONCLUSION

A dramatic shift has occurred, providing SMEs access to online financial opportunities that are faster, easier, and more transparent than the services offered by traditional banks and financial institutions. However, the fees and interest rates can be very high and these additional costs can burden the firms. Additional research is needed to understand the reasons why SMEs adopt these models rather than use traditional financing, but it is clear that financial services and products are being unbundled and that SMEs will have broad access to more finance moving forward.

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