Small Business Lending Landscape

Opportunity Finance Network
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**Agenda**

- Small Business Financing Initiative Overview
- Today’s Topic and Presenters
- Small Business Lending Landscape
- How can mission-driven small business lenders respond?
- Questions and What’s Next
Goldman Sachs 10,000 Small Businesses is a $500 million investment to help small businesses in the United States create jobs and economic growth by providing entrepreneurs with a practical business education, access to capital and business support services.

The program is based on the broadly held view of leading experts that greater access to this combination of education, capital and support services best addresses barriers to growth.
Small Business Finance Collaborative

- 24 leading mission-driven small business lenders nationally
- Intensive two-year program of peer learning, training, and technical assistance
- Goal: Aggressive growth in small business lending
- Promotion of best practices and collaboration that support scale

Finance Collaborative Participants

[Map showing the locations of the finance collaborative participants across the United States and Mexico]
Today’s Presenters

Nick Elders
Community Reinvestment Fund

Robert Lopez
VEDC

Bryan Doxford
Excelsior Growth Fund

Pam Porter
Opportunity Finance Network

Today’s session: Small Business Lending Landscape

Goals:
- Overview of the rapidly changing small business lending landscape
- What can mission-driven lenders learn?

Agenda:
- Market size and trends
- Traditional lenders
- Alternative sources
- Emerging new entrants
Small Business Market Opportunity

<table>
<thead>
<tr>
<th>Size by Employees</th>
<th>Number of Firms</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 employees</td>
<td>21.3 million</td>
<td>79%</td>
</tr>
<tr>
<td>1-4 employees</td>
<td>3.6 million</td>
<td>13%</td>
</tr>
<tr>
<td>5-9 employees</td>
<td>1.1 million</td>
<td>4%</td>
</tr>
<tr>
<td>10-19 employees</td>
<td>0.6 million</td>
<td>2%</td>
</tr>
<tr>
<td><strong>TOTAL with less than 20 employees</strong></td>
<td><strong>26.6 million firms</strong></td>
<td><strong>98%</strong></td>
</tr>
<tr>
<td><strong>ALL Firms in the US</strong></td>
<td><strong>27.3 million</strong></td>
<td><strong>100%</strong></td>
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</tbody>
</table>

Source: SBA Office of Advocacy, 2014

Businesses need small loans

Data Provided by: Joint Small Business Credit Report, 2014 (Federal Reserve Banks of New York, Atlanta, Cleveland and Philadelphia)
Four Factors Driving Changes in Small Business Lending

- Tighter banking regulations force banks to vacate “small” loans (loans under $1.0M)
- Availability and wide-spread use of “Big Data”, machine learning and data modeling
- Historically low interest rate environment has private equity chasing yield
- Technology and the Internet are transforming banking and lending from physical to virtual

Who is Lending to Small Businesses?

- Banks
- Traditional non-bank lenders
- Emerging lenders
Bank Lenders: Market Size

- Total U.S. small business\(^1\) loan market estimated to be $186 billion\(^2\)
  - 95% of small business\(^2\) loans on bank balance sheets
  - 35 largest bank holding companies held 39% of all small business loans outstanding in 2013.\(^3\)
  - Loans of $100,000 and under account for 90% of small business loans.\(^4\)
- Disintermediation affects banks primarily

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Small Business Loans Represent Declining Percentage of Total Bank Lending

![Graph showing decline in percentage of small business loans as part of total bank lendings]

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\(^1\) loans under $250,000
\(^2\) Goldman Sachs Research *The Future of Finance*, as reported in the WSJ
\(^3\) SBA Annual Report 2014
SBA Lending Growing Faster than Bank Lending

- **Small Business Administration:**
  - SBA 7 (a): $23.6 Billion in 2015 (up 23%)
  - 504/CDC lending: $4.3 billion in FY 2015 (flat)
    - Down 25-30% from highs in 2012-2013
    - But 2016 will see return of 504 refinance program
  - Community Advantage: $100 million in 2015 (up 83%)

Mission-Driven Lenders Serving Low Income Communities

- **Mission-driven lenders demonstrate strong growth in small business lending volume**
  - 198 OFN members: 63,081 loans in 2014 totaling $656 million up 20+%
  - 24 Small Business Finance Collaborative members: 8,356 loans totaling $402 million up 20+%

- **Research demonstrates impact:**
  - CDFI Fund Impact Study: “CDFIs do indeed ‘fill the gap’ that is left by conventional lenders.”
  - SSBCI Study: “States working through mission-oriented lenders have the greatest success in reaching underserved borrowers.”
Many initiatives focus on replicating and scaling small business lender success

- Wells Fargo Diverse Community Capital
  - $75 million debt and grant program to CDFIs that focus on diverse entrepreneurs

- Venturize – sponsored by Sam’s Club and Walmart Foundation
  - Helps minority and women entrepreneurs make sound decisions when borrowing

Emerging Small Business Lenders or “FinTech”

**Definition:** Financial technology companies using digital innovation to disrupt institutional banking systems

**Sectors:** Credit scoring, small business lending, payments, investment management

Three major ways FinTech will reshape finance:

1. Cut costs and improve quality of financial services
2. Develop clever new ways of assessing risk
3. Create a more diverse, and hence stable, credit landscape

Source: Accenture The Future of FinTech and Banking
What are all these companies focused on?

https://www.cbinsights.com/blog/disrupting-banking-fintech-startups

Who are the Emerging Small Business Lenders?
Small Business “FinTech”

Three overarching categories of lenders

- **Balance sheet lenders:** Lenders who raise capital from investors, and then carry the loan risk on their balance sheets
- **Peer to Peer:** Lending platforms which match borrowers with investors, and charge an origination fee
- **Brokers:** Platforms which guide borrowers to different online loan products based on the borrower’s needs and profile

Global FinTech Activity

![Global FinTech Financing Activity](chart.png)

*Source: Accenture and CB Insights*
Market size projections: No definitive estimate...

- PwC: $150 billion+ by 2025
- IOSC: $70bn within next years
- Financial Times: $25 billion by 2019

...except it is growing fast

Recent developments

- U.S. Treasury Report
  - “Opportunities and Challenges in Online Marketplace Lending”
- OCC
  - “Supporting Responsible Innovation in Financial Services
- Legal woes for some marketplace lenders
- Threat of regulation
- Wells Fargo Microloan Product
FinTech Lenders Have a Common Business Model:

1. Relatively high interest rates
   • APRs of 7-200%, unsecured, 1-5% orig. fees
2. Low operating expenses
   • Limited underwriting – driven by technology
   • No brick & mortar presence
3. Higher cost of capital
   • Investor and VC Sources
4. High default rates
   • Default rates of 6 - 10% (vs. <1-3% SBA)
5. Huge Sales and Marketing budgets: unclear if successful
   • Lending Club: $172 million in FY15
   • OnDeck: $60 million (est) in FY15
6. Data and Technology
   • Used to gather and organize information
   • Create more efficient workflow process

How are CRF, VEDC, and EGF responding?
Questions?

Additional Resources
Online innovation promises borrowers unprecedented speed and ease of use:

- Applications typically take very little time to complete
- Process automated with algorithms that access applicant credit histories and social media profiles
- Alternative lenders offer fast turnaround times
  - Loans disbursed within 48 hours or faster
- Search Engine Optimization and Ad Tracking drive marketing

Possible benefits to borrowers

- Higher approval rates mean that those who were previously denied credit can now access it
  - Alternative lenders approved 62% of small business loan requests in Jan 2015. Comparatively, big banks approved just 21%
- Ease of application
- Faster turnaround
- Millennial small business owners are 5x more likely than Boomer owners to consider P2P lending
Risks to borrowers

- Lack of transparency in cost of borrowing
  - A.P.R. is rarely disclosed
- Automated daily ACH payments create cash flow challenges for entrepreneurs
- Lack of reporting to credit bureaus
  - Can lead to “stacking”
  - Limited ability to build credit
- Business model focused on success of lender not borrower
- Brokers impose added costs and increase borrower leverage

What can Mission-Driven Lenders Learn From the Recent Rise of Alternative Lenders?
Current Lending Market
Time Consuming Process

Situation:
- On average, a small business owner spends 24 hours researching and applying for credit.\(^3\)

Solution:
- Create an online loan application.

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Current Lending Market
Ambiguity in Pricing

Situation:
- Some online lending is extremely costly and terms can be unclear to borrowers.

Solution:
- Responsible, mission-based lenders to provide loan capital. Borrowers are informed (educated) on loan terms and conditions upfront.
- Must increase visibility