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Banker's Guide to New Small Business Finance

Venture Deals, Crowdfunding, Private Equity, and Technology

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CHARLES H. GREEN

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Banker's Guide to New Small Business Finance

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This book is dedicated to the tireless women and men who perform the detailed tasks required to deliver financing to small businesses. To all those lenders and brokers who engage in countless conversations, answer thousands of questions, and drive hundreds of miles, and whose work takes them to diverse places like dry cleaners, convenience stores, doughnut shops, mills, loading docks, funeral homes, dentist offices, manufacturing plants, highway motels, and every other door on Main Street.

An innovation that is disruptive allows a whole new population of consumers at the bottom of a market access to a product or service that was historically only accessible to consumers with a lot of money or a lot of skill.

—Dr. Clayton Christensen

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Preface

My introduction to the real world of banking, beyond lofty finance courses taken in college, was found on my first bank office desk in a stack of pages filled with columns of blank grids, matched with an adjacent column of accounting terms on the left side of the pages. These papers were spreadsheets, designed to be populated with numbers found in the hundreds of business financial statements collected by the bank from clients as obligated through their loan agreement covenants.

Behind these sheets were musty stacks of file folders of varying age, size, and degree of disorganization, which contained evidence used by the bank previously to decide whether to make each loan. Many of them actually had multiple financial statements inside while many were missing any such information.

My new purpose in life became to open and read every one of these financial statements and transcribe them by hand and pencil, writing every number from every financial account listed into the corresponding grid in every client file's respective spreadsheet. My hand began to ache just thinking about the task ahead. Should I have majored in economics?

These spreadsheets were organized to detail up to four years' balance sheets on the front side and four years' income statements on the back side, with succeeding years listed from left to right. At the bottom of the back side was space for calculating some financial ratios to measure working capital, liquidity, and leverage. Still more impressive was the fifth column on both sides of the page, which was reserved to include the latest year's industry average for each financial account, copiously transcribed from the fine print found in the Robert Morris Associates (now known as the Risk Management Association) Financial Statement Studies (cost = $29.95 in 1979—low whistle).

My boss thought his small-town bank was finally hitting the big leagues, just like the money center banks—*financial analysis*. How sophisticated! But others grumbled that a college kid with no lending or business experience had been hired to second guess or opine about credit decisions already made. They were right, of course, as I discovered in my first loan review discussion with one of the bank's most senior lenders, its chairman, who patiently illuminated how much I had to learn.

And so began my exposure to "the numbers," which today remains the central element of client information required to determine the risk and desirability of a funding transaction. But other than using a digital workbook like Microsoft Excel or other spreadsheet software, little has changed from those early years of my career when even small banks started aggregating more information and exercising more thorough analysis to underwrite credit to businesses.

For many years, technology enabled the commercial banking industry to originate, aggregate, manage, move, and account for cash and non-cash item deposits with dizzying efficiency that dramatically lowered costs, increased productivity, improved security, and saved millions of trees. While in college during the 1970s, a part-time job in the school bursar's office exposed me to check cancellation machines that could imprint "for deposit only" on thousands of student payment checks in a matter of minutes and capture the front and back images of these checks to be reproduced later on microfiche for future reference.

But strangely, applying any technology to its core business—*lending*—has been painstakingly slow for bankers. Other than being able to order credit reports online and access a few financial analysis platforms that still require substantial manual entry, business lending has been the last frontier for banking technology improvement.

Even now, a small business owner approaching a typical bank for a loan will most likely be asked to provide a handwritten application form, personal financial statement, and printed copies of a long list of information. And all these pages are then handled by two or more people who read, analyze, transcribe, copy, file, and retrieve them. As a result, banks frequently waste valuable time and information due to misfiling and losing paper.

Losing information is a byproduct of the overwhelming growth of requirements for more information used to screen potential loans. And since this information is on paper, it aggravates the already problematic system.

Missing at most banks are some of the simplest shortcuts that could manage this arduous process more efficiently, like online portals to gather and interpret much of the required information, digital financial statement forms that could be edited annually, and a centralized digital filing system to store all loan application data in the same way banks have stored checks for decades.

While recovering from the financial crisis that shook the industry in 2008, most banks have hunkered down to repair wounded capital, dealt with large problem loan portfolios, and tried to return to business as usual—that is, business as it was in 2006. The problem is that it's 2014. Part of that focus on recovery also meant deferred consideration of investment in technology assets and system upgrades.

As technology raced forward (recall that Apple's iPad was introduced after the financial crisis) and investors were scouring the Earth for new financial opportunities in the post-CDO period, a funny thing happened: Private equity discovered small business lending. Long the exclusive forte of commercial banks, a new crack appeared in the wall that defined turf of who would finance what.

That crack was widened by banks' reluctance or inability to take on seemingly moderate risks in small business lending since the crisis. Concurrently, the development of funding sources for small companies that could be obtained through fancy technology platforms have made bank applications look like what they are—a thing of the past.

Ironically, the limited number of small companies that have remained very healthy and attractive for bank funding since 2008 have actually fed a feeding frenzy among banks starving for earning assets. Many bankers shared stories with me of intensive negotiations for loans priced at painfully low rates that sometimes even had to include negative loan fees (think of it as a closing cost rebate) just to win the business. The recipient companies must have enjoyed being in funding heaven for a brief while.

Meanwhile, thousands of businesses that had been perfectly fundable for years had to turn to other non-bank lenders and were glad to pay interest rates and fees amounting to annual percentage rates (APR) in the 30 to 70 percent range just to get the growth capital needed. And most interesting is the fact that loan losses for most of these funders have not been much higher than those of the commercial banks, but the revenue sure was.

Literally hundreds of funding companies emerged over the past 10 years that are providing business capital in some very innovative ways. Collectively they have reexamined virtually every convention of traditional bank business lending, such as to whom to lend, how to underwrite risk, how to price risk, how to document credit/funding agreements, how to collect payments, and even where to fund the deal.

And, as with many other new technologies that have emerged in recent years, this sector has its own accompanying support industry of businesses that have popped up to originate and support the prospective borrowers who want to get funding, wherever the source.

Who are these lenders and from where did they come? Some have simply evolved from more seasoned ideas, like merchant cash advance companies, which started in the 1990s and have been much more willing to adapt better technology as it became available.

Some of these lenders are truly cutting edge technologies that have developed proprietary platforms, new underwriting theories, and interesting strategies to manage credit risks. They are funded by a combination of

private equity, loan sales, and in a more limited way, through some bank funding as they begin to scale their early success.

Some of the companies in this space are adapting to evolving ideas, like crowdsourcing, and tapping into smaller investors. The investors under this umbrella have varying motivations (from empathy to fascination) and varying risk appetites (from measured to what-me-worry). The channel growing around the notion of crowdfunding is providing capital to new and old businesses, startups, and some good causes with a profit motive. As the name implies, funding is sourced virtually anonymously through the "crowd."

What do we call lenders that are described in this category? Many insiders, observers, and pundits have been using the tired label of "alternative lenders" to describe this growing list of funders and lenders that are differentiated from each other mainly by the distinctive lending models, client targets, or funding sourcing.

I reject that title because it's been used for two or three decades to describe two much narrower financing categories outside commercial banking known as *asset-based lending* (ABL) and its financial cousin, *factoring*. To me this new sector is definitely distinct from that world, which has shown little appetite for technology, product improvement, or expansion of a rather defined market. That worn category name, alternative, also excludes the support companies that are emerging, which can be an important source of growth for this new category and conventional lending companies as well.

Maybe it's presumptuous of me, but I propose to christen this business funding category as the *innovative funding* sector.

And what has been the banking industry's response to this surging new financial frontier, now labeled "innovative funding"? I would like to describe the reaction as disbelief, disapproval, or dismissal, but curiously, it is overwhelmingly undiscovered. Nobody seems to even know that it's there.

Having been involved in training hundreds of business lenders over the past three years, I asked many participants what they know about technology-driven lenders. I threw out a few company names, like the oldest innovative participant (since 2004!), most publicized company, or largest volume lender. I find there are few who have even heard of these companies or the emerging sector that has racked up about $100 billion of business funding.

Granted, most of that $100 billion would not have been funded by commercial banks anyway and in toto, the sum is not exactly a threat to the $3 trillion of outstanding commercial real estate (CRE) and commercial and industrial (C&I) loans presently held on bank balance sheets around the United States. But it's growing at a rapid pace no one seems to be tracking.

This book is an exercise in my interest and curiosity in this emerging sector and an attempt to chronicle its brief history as a means to understand

its likely trajectory. Drawing from my career as a business banker, Chapter 1 of the book lays down a baseline on how the traditional banking industry has funded small business owners for decades (at least since I entered the business).

Then the challenges to prudently invest in small business loans is examined in Chapter 2, to illuminate how the obstacles banks face give rise to opportunities that are currently being exploited by this rising innovative funding group. Maybe the biggest obstacle is simply the restrictions imposed on all those cheap funding deposits they have to invest that are insured by the FDIC.

Chapter 3 offers my perspective of changes that occurred in the post-2008 capital markets and how we arrived to that point today. Despite concerted efforts of policy makers and the markets, small Main Street businesses are forced to seek funding alternatives due to the lack of viable options in the once-reliable banking sector. And the timing couldn't have been better for the many innovative funders that are described later in the book.

For background, Chapter 4 offers a layman's interpretation of what's happened in the digital marketplace that may shrink the playing field for many banking lenders who seem unaware of a marketing revolution that is threatening their market share. Chapter 5 describes how this perfect storm occurred as private investors began getting squeezed by low interest rates, a terrorized equities market, and the increasing competition in the angel investor marketplace.

In Chapter 6, the environmental changes described earlier are discussed in light of the concurrent emergence of unprecedented data collection, packaging, and distribution. This convergence spawned a flurry of new ideas that began flowing into the marketplace, introducing different ways to distribute capital to individuals and small business owners.

Chapter 7 discusses the new sector of funders and lenders that have begun to provide capital to different niches in the scramble to scale. Donors, innovators, lending peers, and investors are covered in Chapter 8 with the continuing development of crowdfunding, an old idea that has exploded across the globe.

Chapter 9 explores other innovative lenders whose technology may be conventional, but have introduced new ways to deliver funding to specific enterprises and whose growth will impact the increasing migration of capital assets away from commercial banks.

The rising group of service providers that connects funding to borrowers is examined in Chapter 10 with an analysis of what they do (and don't do).

Chapter 11 tries to make sense of all these changes and developments in the banking industry through the lens of a seasoned banker who has

toured the other side. The challenges are real and threatening for some, but will offer many banks opportunities to grow market share, profitability, and other benefits outside lending.

Throughout the book the terms *funder* and *funding* are often used to describe the party that provides small business capital to business owners and the transaction through which it is delivered. Those generic terms are easier to default to rather than constantly having to clarify the differences between gifts, loans, non-loan funding, and equity investment.

Some may ask what the difference is between a non-loan funding and an equity investment. Non-loan funding is an acknowledgment that many companies, particularly the merchant cash advance sector, provide business funding that legally is structured or defined as an advance or purchase of an account receivable, income stream, or other asset. These companies are generally not registered with any state banking or finance regulatory agency or recognized anywhere as a lender and accordingly by law are not able to legally advance loans.

So now read it. This moment is an opportunity for banks large and small to understand this emerging market, take initiative to engage both technology and clients to protect and expand market share, and exploit natural advantages in this brave new world of innovative funding.

Acknowledgments

A lot of collaboration is needed to develop any book project, but even after six earlier titles, this one was most challenging in that it combined the principal business of my career (banking) with the technology cloud we've all been forced to acknowledge.

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Lastly, I want to offer a special tribute to my dad, Joseph Henry Green (1919–2005), who taught me how to count money and the value of entrepreneurship.

About the Author

Charles H. Green is a seasoned finance professional with over 30 years experience as a commercial banker, mostly funding the small business sector. He founded and served as president/CEO of Sunrise Bank of Atlanta. Charles presently advises a broad list of financial service companies.

He has written extensively about business financing through articles and books including *Get Financing Now* (McGraw-Hill, 2012) and the bestselling *The SBA Loan Book*, 3rd Edition (Adams Media, 2011). He earned a BS in finance from the University of Alabama (1979) and a diploma at the Stonier National Graduate School of Banking (2009).

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