



The Federal Reserve Bank of Richmond

New Alternatives in Small Business Financing

“The U.S. credit crunch that resulted from the worst financial crisis since the 1929 Wall Street Crash is easing, but it’s far from over. Banks started to loosen some lending standards in mid-2010, a year after the recession ended, but loans remain hard to get by historical standards. That’s particularly damaging to small firms, which rely on bank credit for a lot of their funding.”¹

Background

The small business “credit crunch” has been a major media story for the past two years, as illustrated by the above excerpt from the *Wall Street Journal*. Small businesses, typically defined as businesses with less than 500 employees, have historically faced more challenges than most large firms in accessing credit from banks. They seek small loans, often have risky business models, and may lack verifiable financial records. In spite of these issues, small businesses still use banks as their primary source of credit.²

The Small Business Administration (SBA) is mandated to increase small business access to credit and does so primarily by acting as a credit guarantor.³ Three different types of what SBA refers to as non-traditional lending partners are described below, along with examples of the credit products they offer to small businesses.

Superior Financial Group and Wal-Mart
Superior Financial Group (SFG), a federally

licensed SBA 504 lender, and Wal-Mart teamed up in summer 2010 to provide small business loans to Sam’s Club members. For Wal-Mart, the owner of Sam’s Club, this effort was initiated to help support and complement other services they provide for small businesses, including low-rate merchant credit card processing, order-ahead programs and early shopping hours.⁴

Sam’s Club initially examined alternative financing sources that would increase credit availability for their small business members. SFG was chosen as a partner because of their specialization in providing access to credit for underserved borrowers and because they offer free online technical assistance and online training for borrowers.

The initial small business loan pilot program, which was the first of its kind, was introduced on July 6, 2010, to offer loans of up to \$25,000 to small business owners who are also Sam’s Club members. The loans range in size from \$5,000 to \$25,000, but on average most are about \$15,000.⁵ The loans are targeted to start-up, small, or new businesses that are underserved or in need of working capital; this mainly includes minority-owned, women-owned and veteran-owned businesses. The loan amounts are smaller than what banks would normally consider. An online application process offers an automated pre-qualifying option and other tools to educate applicants



on the different types of loans. Applicants can learn about the outcome of their loan application within minutes of applying.

The Sam's Club loan products follow the same guidelines as the SBA Community Express and Patriot Express loan products. These loans require less stringent personal credit requirements than traditional loans and there is no required collateral. Sam's Club loans range in cost from 7.5 percent to 7.75 percent in simple interest, depending on the size of the loan, and have no prepayment penalties or balloon payments. Borrowers are also eligible for a discount of up to 20 percent of the application fee.⁶

Through Sam's Club, SFG and Wal-Mart lend working capital to small businesses in all 50 states. Thus far, business has been brisk. "The demand for these loans is so great that we have exceeded the congressional cap for pilot SBA programs of 200 loans per month," says Sue Malone, SFG's president of strategies for small business and director of marketing.⁷ "We received 4,000 Sam's Club loan requests in the first 10 days of the offering. If you factor in that our loan approval rate falls between 50 - 60 percent, it means that we had almost two years worth of fundable loans in just that first two weeks."⁸

Few of the Sam's Club loans have matured as of this writing, so the performance of these loans has not yet been established. However, SFG's default rate for similar SBA loans stands at 12.1 percent from October 2000 to October 2009, which is lower than the 17.1 percent for SBA lenders during the same period.⁹ "One of the things that makes our process so great is that everyone in our shop was a small business owner at one time or another. We understand how to underwrite these pretty efficiently because of our experience," says Malone.¹⁰

The only downside she sees is the current lending cap, 100 loans per month, set by SBA. "Just today I have spoken to about 30 small businesses trying to stay alive; good businesses, seasoned businesses, viable businesses. But we have to turn some of them down knowing that we could fund them right now if we didn't have the cap."¹¹

Anne Arundel Economic Development Corporation

As part of the federal economic stimulus programs, and in response to small business credit needs, SBA's American Recovery Capital (ARC) loan program was established in 2009.¹² The ARC product was designed for small businesses that had recently been profitable but were having trouble meeting debt payments. The bridge loans were designed to keep otherwise viable companies from sinking because of "immediate financial hardship," offering up to \$35,000 in interest-free financing that could be used to pay short-term debt obligations such as loan payments, business credit cards, leases, and payments to suppliers. Businesses must show evidence of immediate hardship, like a decrease in sales, trouble meeting payroll, or loss of a line of credit.

As initially designed, small businesses would access ARC loans through financial institutions who participated in SBA lending programs. However, in July 2009 Anne Arundel County in Maryland, through the Anne Arundel Economic Development Corporation (AAEDC), worked with a consortium of 16 banks to sponsor its own ARC financing program through September 30, 2010, the end date for the ARC program.¹³ When AAEDC stepped in as an SBA 504 lender, some banks in Maryland had already begun making ARC Loans. However, many businesses found that their lenders were not offering 100 percent SBA-guaranteed loans, according to Mitchell Krebs, senior vice



president at BankAnnapolis, which participated in the ARC program.¹⁴ “AAEDC’s involvement was in part a response when they learned that many businesses were being shut out of this program,” he says.¹⁵

Starting with about 55 interested businesses, 10 businesses completed the application

process and were approved for ARC loans ranging in size from \$9,000 to \$35,000 and averaging \$28,620.¹⁶

In addition to more favorable credit terms, Alexis Henderson, vice president of marketing and communications at AAEDC, explains that, “ARC

loan applicants received assistance from the Small Business Development Center (SBDC) when preparing their ARC Loan applications. After receiving ARC loans, they are also required to meet regularly, one-on-one with an SBDC counselor for additional advice and assistance.”¹⁷

AAEDC borrower Laura Moore, of Laura Moore Designs, found that the ARC loan helped her to free up cash flow to purchase inventory and pay for marketing efforts.¹⁸ It allowed her to move forward with the plans she had laid out for her business.¹⁹ With more than 97 percent of all county businesses being classified as small businesses, Anne Arundel County Executive John Leopold felt that it was vital to do something to address the challenges faced by their business community in this economy.²⁰

The AAEDC leveraged existing support from its consortium of banks, the SBA and the SBDC to approve 10 SBA guaranteed interest-free loans through the ARC Loan program.²¹ The AAEDC continues to operate its small business lending

activities, which involve SBA guarantees and loans up to \$300,000, regularly reviewing its lending activities and modifying those efforts if necessary. The goal is to provide access to capital for small businesses in Anne Arundel County and to increase the AAEDC’s lending, while managing the portfolio to minimize additional risks.²²

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Mountain BizWorks

Mountain BizWorks, a certified community development financial institution based in Asheville, North Carolina, offers a variety of flexible gap financing products to small businesses and entrepreneurs in western

North Carolina. In 2009, Mountain BizWorks approved approximately 50 loans worth a total of \$795,000 for small business owners and entrepreneurs.²³ The average loan is \$15,000. While Mountain BizWorks is partially funded by the SBA, it is not classified as a SBA 504 lender. Its loan pools are disbursed in the form of grants and private loans.

Originally a microlender, Mountain BizWorks has expanded its lending to a wide range of small business sizes and types. Western North Carolina has experienced an increase in the number of entrepreneurs in the region and thus a corresponding increase in the demand for small-business training, coaching and loan capital. This created a need for growth and expansion of Mountain BizWorks’ programs and lending capabilities. According to Mountain BizWorks chief executive officer, Shaw Canale, “The beauty and creativity of what we have to offer is that we can be so flexible. We can provide capital for start-ups, for working capital, for lines of credit, and even commercial real estate projects as long as we



understand how to underwrite it and have the capital.”²⁴

Of all of these types of credit, though, Canale sees revolving credit as the one most needed by small businesses right now. “A line of credit is a powerful tool for a small business. It can be very labor intensive and somewhat capital intensive for us to provide, but a line of credit is so important. We just have to offer them.”²⁵ And while many mainstream lenders are avoiding particular industry sectors, e.g. construction and restaurants, Mountain BizWorks will consider lending to any industry, even a troubled one, as long as the business type falls within SBA guidelines and the individual deal falls within Mountain BizWorks’ lending policies.²⁶

Mountain BizWorks currently bases its rates primarily on the perceived risk of a loan, as opposed to the cost of funds.²⁷ While it still has to consider the cost of funds, Mountain BizWorks is able to blend its capital sources to bring the overall cost of small business borrowing down. Lending terms tend to be tailored to support optimal project cash flow, falling between 10 percent and 12 percent for a term loan ranging between 12 months and 5 years. Loan fees can range from between one and two percent for fees and lines of credit between 12 and 14 percent.²⁸

“We have demonstrated performance over time, so I am comfortable to say that our policies and procedures don’t supersede good sense. Interest rates, terms, and fees — we can adjust any of it, if we think the deal works,” says Canale.²⁹

In the past, Mountain BizWorks default rate reflected its focus on microloans, falling within the typical microloan fund range of nine to ten percent.³⁰ However, since diversifying its lending Mountain BizWorks’ default rate has

drifted downward. “We mitigate our risk by offering technical assistance and consulting. Banks wouldn’t normally do this to the extent that we do, but it really helps improve performance over time.”³¹ Mountain BizWorks meets the needs of their clients through in-depth business planning courses and ongoing technical support in areas such as growth strategies, management tools, and marketing and sales.

Conclusion

The recent recession has highlighted the problems that small businesses face in obtaining credit from financial institutions. As the three examples we highlighted above show, several lending partners have responded to the credit needs of small businesses by offering innovative products and services. Small businesses need to determine the alternative business sources that best match their financial state and funding needs. Identifying alternative financing options and lenders who can provide supportive advice in addition to the product that will best fit or improve a business’ existing business model is key to a successful outcome. ■

Note: A special thanks to Sarah Eckstein, Alexandra Gecker, Courtney Mailey, and Karron Minor for their contributions to this article.

Resources:

Sam’s Club Small Business Loans
www.samsclub.com/sams/pagedetails/content.jsp?pageName=sbaLoanProgram

SBA Small Business Capital Assistance
www.sba.gov/financialassistance/borrowers/index.html

Learn more about Community Development Financial Institutions (CDFIs) offering small business financing in the Southeast United States, in the Richmond Fed’s 2010 *Community Scope* publication.
www.richmondfed.org/publications/community_development/community_scope/2010/vol01_issue01/pdf/full_issue.pdf



Endnotes:

- ¹ Di Leo, Luca, and Alan Zibel. "Bernanke Sees Growth, But Small Firms Key." *Wall Street Journal*, January 4, 2011.
- ² Nash, Betty Joyce and Kimberly Zeuli. "Small Business Lending During the Recession." The Federal Reserve Bank of Richmond, *Economic Brief*, February 2011. www.richmondfed.org/publications/research/economic_brief/2011/pdf/eb_11-02.pdf
- ³ For more information on the Small Business Administration visit, www.sba.gov/.
- ⁴ "Sam's Club Tests Online Small Business Loan Program for Main Street," July 6, 2010. www3.samsclub.com/NewsRoom/Press/734
- ⁵ Ibid.
- ⁶ Ibid.
- ⁷ Malone, Sue, Director of Marketing, Superior Financial Group, phone interview, September 23, 2010.
- ⁸ Ibid.
- ⁹ Ibid.
- ¹⁰ Ibid.
- ¹¹ Ibid.
- ¹² Details about SBA's ARC loan program can be found at www.sba.gov/recovery/arclloanprogram/REC_WHATISARCLOAN.html.
The loans allowed businesses to refinance their existing debt at zero interest, with a period of up to six months to use the loan, followed first by a 12-month moratorium on loan payments and then by a five-year term of repayment.
- ¹³ While the ARC loan program wound down at the end of September 2010, three other ongoing SBA products that are similar to the ARC program include: the Community Express, SBA Express or Patriot Express programs.
- ¹⁴ Krebs, J. Mitchell, Senior Vice President, BankAnnapolis, phone interview, August 4, 2010.
- ¹⁵ Ibid.
- ¹⁶ Henderson, Alexis, Vice President of Marketing & Communications, Anne Arundel Economic Development Corporation, phone interview, September 21, 2010.
- ¹⁷ Ibid.
- ¹⁸ Anne Arundel Economic Development Corporation, "ARC Loan Program." 2010 MEDA Economic Development Award Submission, January 29, 2010.
- ¹⁹ Ibid.
- ²⁰ Ibid.
- ²¹ Ibid.
- ²² Timer, Joseph, Vice President of Financial Services, Anne Arundel Economic Development Corporation, phone interview, March 2, 2011.
- ²³ Canale, Shaw, CEO, Mountain BizWorks, phone interview, September 21, 2010.
- ²⁴ Ibid.
- ²⁵ Ibid.
- ²⁶ Ibid.
- ²⁷ Ibid.
- ²⁸ Ibid.
- ²⁹ Ibid.
- ³⁰ Ibid.
- ³¹ Ibid.

