EXECUTIVE SUMMARY

The FinTech world is a great dynamo of innovation. Small Business lending is just one area where new entrants are threatening to disrupt the status quo. Early innovators like CAN Capital have been joined by numerous others, including OnDeck, Lending Club, Funding Circle, Kabbage and Fundera. In the United States alone there are at least 100 non-Bank Small Business lenders that have emerged in recent years and more are being launched every month. Traditionalists would call them insane to enter a space dominated by the giant banks with their embedded customer bases and numerous other advantages. Progressives would call them the “Brave 100”, secretly hoping that they win the battle and dethrone the powerful incumbents.

What’s interesting is that players on each side of the battlefield see the world in an identical way but opposite to that of the other side! There’s a profound disconnect that’s fundamental and almost religious in nature. It’s impossible to believe both sides are right given how far apart their first principles are.

Having met dozens of the “Brave 100”, their sales pitches are very similar:

“Small Businesses are 50% of the US economy but they’re starved for credit. Banks are unwilling to lend to Small Businesses or else too difficult to deal with. We’ve designed a product and offer a process that solves this problem. Ha’ooh! Ha’ooh! Ha’ooh!”

Banking executives don’t see what all the hoopla is about:

“These upstarts are trying to stir us up and it doesn’t make any sense. Why is any lender interested in making loans under $250,000 to Small Business owners? There’s no profit to chase and even if there were, we could crush the Brave 100 any time if we so choose.”

And the Brave 100 even taunt the banks...

“In 10 years we want to be facilitating lending of $100 Billion a year”
– Samir Desai, CEO of Funding Circle

“A thousand nations of the Persian empire will descend upon you. Our arrows will blot out the sun!”
– Persian

“Then we will fight in the shade”
– Stelios
“Citi made a pledge to substantially increase our lending to U.S. Small Businesses...the $9.2 BN we lent in 2014 ...is a real shot in the arm to small businesses.”

– CEO of Citi

....which is in stark contrast to the goals of the broad banking community.

Some financial journalists and analysts see this and think alternative Small Business lenders will sweep the field. They’ve started reaching back for their “banks are dinosaurs” quotes from the early days of desktop computing and online banking. Investment banks argue that $176 Billion of outstanding Small Business Bank loans and an associated $1.6 Billion of accounting profit may be “at risk” of shifting away from banks and to these innovators.

There is certainly a huge influx of funding and the high rates of loan growth reported by these innovative firms seem to validate the enthusiasm. But banks would argue that the enthusiasm is misplaced because while the rate of growth is high it’s off a very small base and they have yet to prove competency in the management of a business that has credit risk at its core..

Meanwhile, the banks have started to bestir themselves as they finally push through the wall of new regulation foisted on them by Dodd-Frank and other abstractions to the financial crisis. And perhaps the idea that Small Businesses are starved for credit is an exaggeration.

Will the Brave 100 win or will the Banks continue to dominate the landscape?
WHAT ARE THEY FIGHTING FOR?

It might sound rudimentary, but the first question that needs to be answered is “what are they fighting for?” There’s actually quite a large disagreement about the size of the opportunity and the nature of the Small Business owners’ needs. On the surface it appears to be a very large constituency (according to the US Census there are about 26 million Small Businesses in the country) so it’s easy to make the leap that there’s a large opportunity to be addressed. But it’s dangerous to mischaracterize the opportunity by using an inaccurate stereotype of what a Small Business actually is or what a Small Business Owner actually needs.

For example, most Small Businesses are not just smaller versions of corporations. Definitions vary but a common cut-off to separate Small Businesses from more substantial ones is 100 employees or about $10 MM of annual revenue. Most of these businesses are quite small, with only a handful of employees in a single location. Small Businesses behave differently than their bigger counterparts, and one example of a distinguishing factor that separates a “Small Business” from a “Corporation” is how they’re managed. Most true Small Businesses are led by an Owner-Operator who plays all the roles found in a larger firm’s “C-suite”. He/she sets the strategy, runs the premises, seeks new customers, takes care of existing customers, oversees production, orders supplies, hires & fires employees, and does the banking and payroll.

The absence of a professional finance function is actually quite important because there isn’t someone thinking full time about the performance of the company, its capital needs, and what it would take to grow. Without this person on staff, planning for the current and future financial needs of the business typically happens when the needs are acute. Whether a business has a separate and distinct financial officer is itself a strong function of size and sophistication (Exhibit 1).

“We are with you, sire! For Sparta, for freedom, to the death!”

– Stelios
Small Businesses also differ significantly from corporations and from each other in terms of their aspirations. In a survey, when asked about their aspirations, only 10% of Small Business Owners said they wanted to grow fast and then either go public or sell out (Exhibit 2).

Clearly, the 10% of firms with high growth aspirations are more likely candidates for financing. To them, growth is an important goal and growth usually requires capital. But others, successful Businesses that throw off cash for household income, are less likely candidates for loans. A majority of Small Business owners say their aspiration is to have their Business “...be stable and profitable and provide me and my family with steady, reliable income”. These firms are not typically looking to expand. If a Business is already profitable and the Owner has modest growth ambitions, the Business is not a strong
candidate for much more than short term loans designed to smooth out cash flows.

Another important segment to understand is comprised of Businesses that have revenues of less than $50,000. Many (10%) say their Business is as much a hobby as a commercial enterprise and many others (19%) say they have significant non-business sources of household income. These are factors that suggest either a low need for credit or modest creditworthiness. With such little revenue and without aspirations to grow quickly it’s difficult to understand how the Business is going to be able to support a loan. Exhibit 3 shows a simple segmentation of the 26MM Small Businesses based on some of these factors.

Exhibit 3: Share of Total Small Businesses

BY SB SURVEY SEGMENTS

- **Segment 1**
  - Low Revenue or Hobbyist
  - 50%

- **Segment 2**
  - High Growth/Ambitious
  - 8%

- **Segment 3**
  - Stable Growth, Business is Primary Source of HH Income
  - 19%

- **Segment 4**
  - Stable Growth, Business is Secondary Source of HH Income
  - 23%

**Source:** Oliver Wyman Survey of Small Business Owners (Q2 2014)

And what do these Business Owners say about their use of financial services? Not surprisingly, 100% of them have a primary checking account with a Bank. 100%! That’s important because it means Banks already have a product in the hands of every single Small Business in the country, and they communicate with them a minimum of once-per-month. About 50% also have business savings accounts, 69% have a Small Business credit card, 38% are merchants that accept credit cards as a payment option and 17% have a car loan on a business vehicle. These statistics make it strikingly clear that Banks are serving the Small Business community and already have tangible relationships with them.
But what about non-card, non-auto lending? Is there demand? Are the Banks serving it? Most of the Brave 100 are trying to operate in this space so it’s a very relevant question worth exploring.

The results of an Oliver Wyman survey (Exhibit 4) reveal that only 23% of Small Business Owners say they have any non-card, non-auto credit and two thirds of those who do borrow get their credit from their primary Bank. Most of the rest get their credit from another Bank or a finance company. The most commonly used types of credit are traditional unsecured or secured lines, mortgages and equipment loans (where OEMs and finance firms have a major share).

Exhibit 5 shows how the propensity to use credit varies by segment, with the small “High-growth/Ambitious” segment (unsurprisingly) being the highest user.

Exhibit 4: Small Business Use of Credit is Surprisingly Limited

LOAN PENETRATION

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Penetration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any Non-Card, Non-Auto Debt</td>
<td>23%</td>
</tr>
<tr>
<td>Equipment Loan</td>
<td>14%</td>
</tr>
<tr>
<td>Mortgage</td>
<td>7%</td>
</tr>
<tr>
<td>Other Term Loan</td>
<td>1%</td>
</tr>
<tr>
<td>Secured LOC</td>
<td>8%</td>
</tr>
<tr>
<td>Unsecured LOC</td>
<td>10%</td>
</tr>
<tr>
<td>Cash Advance</td>
<td>1%</td>
</tr>
<tr>
<td>Receivables Financing</td>
<td>1%</td>
</tr>
</tbody>
</table>

Source: Oliver Wyman Survey of Small Business Owners (Q2 2014)
Among the large proportion of Business Owners who do not borrow, 80% say they don’t borrow because they don’t need capital. In an Oliver Wyman survey, only 2% said they applied but were turned down and a further 6% said they didn’t apply because they thought they would be turned down.

Assuming these survey results are directionally correct, it appears that the notion that the Small Business sector is lagging in its duty to drag the US economy out of the ditch because the Banks won’t lend to them is somewhat overstated. Most Small Businesses don’t borrow because they don’t need to and they don’t want to.

Of course, there are exceptions:

START-UPS

People who wish to start an unproven Business often lament that they “cannot get a loan from a bank”. To overstate an opinion to make a point, this is naïve and indicates why such people should almost certainly not be loaned to. What many of them need is equity, not debt. When a business opportunity has a high probabilistic failure rate then debt usually isn’t the right vehicle to finance the opportunity. It’s surprising how often examples of this type of need are used by commentators (frequently journalists) to suggest that Banks have been derelict in their duty.
“Cindy and Ethel wanted to start a business in their basement offering yoga and quilting lessons. But their Bank wouldn’t give them the $50,000 they needed to advertise……”

Cindy and Ethel should tap their personal savings, friends and family, or launch a Kickstarter campaign to help them; but the Banks aren’t the natural solution for their needs.

The exception to this rule is making loans to back a proven business model or one that has significant collateral to tap in case of failure (e.g. – real estate and equipment). Well-run franchises are example of business start-ups that have proven business models with low failure rates (and many are run by seasoned operators); medical practices are examples of businesses that have both real estate and equipment to make loans more secure.

TURN-DOWNS

There almost certainly is a modest segment of the market consisting of established businesses that are technically credit-worthy but who have either been turned down due to conservative lending policies or led to believe that applying to a Bank for a loan is not worth the effort (perhaps by someone else who was turned down). Oliver Wyman research suggests that this missing loan market exists but is modest in total size at about $20 Billion in potential outstandings.

CASH FLOW VOLATILITY MANAGEMENT

Short term lending products are a legitimate answer to a real Small Business problem. Most Small Businesses, including many of the profitable ones with no pressing growth ambitions, report that they experience cash-flow variability that leads to shortfalls multiple times a year. In a research survey, Oliver Wyman asked 1,500 Business Owners questions about their cash flow volatility and how they cope with such shortfalls. Almost half said they experience occasional or frequent shortfalls and their tactics for dealing with them included:

• Transferring money from personal accounts
• Putting new purchases on credit cards to buy some breathing room
• Delaying the payment of other bills
• Calling late-paying customers to accelerate cash inflows
The survey then carefully described a cash-advance product analogous to those offered by CAN Capital and OnDeck. Respondents were then asked a series of questions about the attractiveness of this product and their propensity to use it. Overall findings included the following:

- 52% said it would be either extremely useful, very useful or somewhat useful
- 89% said their preferred source would be their “primary bank”
- Only 4% said the preferred source would be anything other than a bank

Respondents were asked to consider their response to learning that their bank had pre-approved them for such a product:

- 27% said they would either definitely or probably use the product
- 38% were unsure if they would use the product
- Almost all respondents said they would want a line size equal to between 50% and 100% of their average monthly cash flow

The results are highly consistent with the idea of the line as a cash flow volatility management tool rather than working capital or funds for business expansion. And based on these and other responses, Oliver Wyman was able to estimate the total market for such a product if it were offered by banks as a pre-approved feature of their primary Small Business checking account (in essence a structured overdraft facility). The result is a potential market of $20-40 Billion in outstanding loans. This may not sound like that much relative to the ~$800 Billion Small Business credit market today (including non-bank lenders) but because these advances are both small and short term, outstanding balances tend to understate the real significance.

For instance, total ‘advances’ would be about two to three times this number based on the typical draw and pay down of a cash advance product while outstanding balances might be lower but draws more frequent with an invoice factoring product. The conclusion is still the same: There’s significant need for short-term lending products to help Small Business Owners address their cash flow volatility challenges.

OWNERS WITH GROWTH ASPIRATIONS

And while it’s a small segment of the overall Small Business community, only 8% have growth aspirations and could potentially make good use of longer term capital. This is the battleground that’s least understood for an obvious reason: The debt will be used
for investment purposes which are projected to have payoff in the future. Since then, no lenders are simply not willing to underwrite a loan that requires an increase in cash flows to support the loan payments the amount of capital available to a Business Owner is based on the business’s current results, not his/her aspirations. Speculative growth investment is best left for equity investors.

Many of the Innovators have structured their suite of products with the belief that this is a big market opportunity. The typical loan being made by these players has a 3 year term, is about $100K in size, and is attached to an interest rate in the “teens”. It only takes 10,000 customers to qualify for and accept these loans to generate $1 Billion in originations volume, so it’s not difficult to believe the Innovators have plenty of room to grow. But it would take 1 million Small Business customers to generate $100 Billion of loan originations volume and it’s debatable whether or not the market opportunity is this large or how much of it can be wrested from banks.
THE INNOVATORS

Most people who follow the sector have heard of OnDeck, CAN Capital, Funding Circle and Kabbage. Fewer people have heard of Dealstruck, Fundera, ApplePie Capital, Taulia or FastPay. And not everyone may be aware that firms like Amazon, PayPal, Square and Intuit are scaling quickly in this space.

Exhibit 6: Sample of the Alt-Lending Players

<table>
<thead>
<tr>
<th>LENDERS</th>
<th>AGGREGATORS</th>
<th>B2B INVOICING</th>
<th>PAYMENTS NETWORKS</th>
<th>E-COMMERCE PLATFORMS</th>
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</thead>
<tbody>
<tr>
<td>Balance sheet lenders</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>OnDeck</td>
<td>Fundera</td>
<td>taulia</td>
<td>Taulia</td>
<td>Square</td>
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<tr>
<td>Kabbage</td>
<td>lendio</td>
<td>davidxchange</td>
<td>BEHALF</td>
<td>PayPal</td>
</tr>
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<td>borro</td>
<td>Biz2Credit</td>
<td>FUNDBOX</td>
<td>viewpost</td>
<td>Amazon</td>
</tr>
<tr>
<td>BONG STREET</td>
<td>BoeFly</td>
<td>H&amp;R BLOCK</td>
<td>FASTPAY</td>
<td>Alibaba.com</td>
</tr>
<tr>
<td>CAN CAPITAL</td>
<td>bolstr</td>
<td>QuickBooks</td>
<td>BlueTarp</td>
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<tr>
<td>swift</td>
<td>ApplePie</td>
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<tr>
<td>Marketplaces</td>
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<tr>
<td>F2Binvestor</td>
<td>Lendio</td>
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<td>YOB</td>
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<tr>
<td>Funding Circle</td>
<td>LendingClub</td>
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<tr>
<td>PROSPER</td>
<td>STREETSHARES</td>
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<tr>
<td>LiftForward</td>
<td>Dealstruck</td>
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<td>Crowd-source</td>
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<td>Kickstarter</td>
<td>seedInvest</td>
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<tr>
<td>CircleUp</td>
<td>EquityNet</td>
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Small Business lending more important to core business

Note: Only intended to be representative, not collectively exhaustive

A few of these firms are traditional balance sheet lenders. Others are “marketplaces” that match lenders and borrowers, adding value partly by the match-making process and partly by facilitating risk assessment, pricing and payment processing. And getting capital in advance of shipping product as well as facilitating equity investments is becoming available through some of the emerging “crowdsourced” platforms.

There are “aggregators” like Lendio and Fundera - destination websites that attract prospective borrowers. They add value throughout the entire process: education about funding options, curation of high quality lenders, management of a unified

“This is where we hold them! This is where we fight! This is where they die!”

– King Leonidas
application form, collection of necessary documentation, advice received offers, and negotiation of the offers on behalf of the Small Business borrower.

“B2B invoicers” are starting to enter the lending space traditionally served by factoring companies and factoring companies themselves are experiencing significant growth. At their core, companies like AvidXchange, Bill.com, Tradeshift and Viewpost are focused on helping Small Businesses with their accounts payable, accounts receivable and associated payments & record-keeping. But to the extent they are successful, it puts them in an enviable position to understand a Business’s cash flow patterns and its suitability for short-term loans. Accordingly, many of them are now adding lending to their offering.

Other firms occupy a similarly fortuitous position whereby their main business gives them privileged access to information about a firm’s cash flow and hence a strong basis for offering finance. American Express Merchant Financing has been successful for Amex, extending short-term financing to businesses that accept American Express cards and that have significant Amex-specific charge volumes. PayPal and Square enjoy a similar position and have offered financing products to many of their customers. It would not be surprising to see other merchant acquirers bring similar offers to market, and indeed some ISOs already do. Amazon is in a somewhat similar position, with the finance product being an add-on for smaller merchants who sell on the Amazon platform.

The innovations that underpin these firms’ lending businesses are similarly varied. This could be one of the key reasons why the Innovators are succeeding. New business models require systems capabilities that the banks don’t have and are not able to quickly build. The DNA of the Innovators is steeped in the design of beautiful user interfaces, product customization around specific user needs and ultimately their ability to ship code. Traditional Banks typically fail on many of these dimensions or at the very least are slow in their delivery.

NEW PRODUCT FORMATS

Banks have implemented systems that allow them to do a very specific set of things and offer a very specific set of products to their customers. New product formats have emerged that require functionality not available in traditional Banking systems. One example is the “merchant cash advance” product which in its classic form requires a daily remittance platform and connections directly
into the Business’s merchant account so that daily payments can be automatically drawn. Another new format is the extension of the “P2P” platform innovation from consumer loans into the Small Business space. The management of “fractional loan ownership” and “whole loan sales” is complex but powerful in its ability to unlock sources of capital willing to lend to Small Business owners. And “invoice factoring” requires the re-direction of invoices to a unique lockbox for each Business being served.

Representative players: CAN Capital, Funding Circle, Lending Club, Fundbox, Blue Vine

SUPERIOR USER EXPERIENCE

One of the biggest distinctions between the Banks and the Innovators is in the design of their application processes. Many of the Innovators have been founded by experienced technology entrepreneurs and the companies have tech DNA in every corner of their organizations while the Banks typically struggle to hire the same quality of tech talent. Instead of designing user experiences with modern tech stacks and mobile use cases in mind, the banks mostly use third party software providers or internally managed code bases that are over a decade old. The Innovators obsess about creating clean, simple and friction-free application processes that allow applicants to apply on any device at any time with much of the data collection being automated. When faced with a long-form bank application that requires the submission of lots of documentation and a multi-day/multi-week decision timeframe or the streamlined processes of the Innovators, many Small Business Owners are choosing the later

NEW DATA AND A NEW APPROACH TO UNDERWRITING

Some Innovators have been relentless in their attempts to find new types of data to assess credit risk. Traditional Bank underwriting methods based on financial statements are widely recognised to be costly, slow and not particularly effective at differentiating risk. The use of checking account information to assess risk, at least for loans of short duration, has been a powerful breakthrough. These players have also explored other data sources for insight into credit and fraud risk, including the use of selected social media data, UPS activity and historical e-commerce sales data.

Representative players: Kabbage, OnDeck
PRIVILEGED CHANNELS FOR FINDING POTENTIAL BORROWERS

Most Banks and alternative Small Business lenders have a relatively high all-in cost of finding and underwriting successful loan applicants. The combination of the high cost of channels like direct mail and Adwords, modest response rates, and low approval rates means the cost per successful applicant typically ends up quite high. This “marketing tax” ultimately ends up passed on to the borrower in terms of a higher price which has led to certain businesses attempting to find qualified applicants by tapping into exclusive and/or free channels. Products can be tailored to reflect the distinct needs of the customer base in any given channel. If done right, the net result is a very efficient business with attractive products and pricing for borrowers.

Representative players: Amazon, ApplePie Capital, Square Capital

COMPLETE SUITE OF PRODUCTS

Some of the Innovators are targeting the reported frustration of prospective Borrowers who don’t understand their funding options nor know who the best lenders are for their type of business need. Applying with a single lender will typically provide a Small Business Owner with no more than a few options, and it’s very possible they end up with no loan at all. Aggregators have designed their sites with the goal of simplifying and demystifying the online application experience as well as providing every credible funding option in a single location. As a result of their value proposition, they are typically able to attract prospective Borrowers at a lower price than any individual lender can which in turn makes them a great source of volume for the lender community.

Representative players: Fundera, Lendio, Biz2Credit, Boefly

The obvious question is: Are the Innovators succeeding? The headlines suggest that the new players have gained a foothold in the marketplace and are gearing up to steal significant market share from the banks.

“PayPal’s Small Business Lending ‘Accelerating’ On The Way To $1 Billion”

“Every year for the past three years we’ve signed up as many customers as the prior years combined”

– Taulia
“CAN Capital Hits $5 Billion Milestone”

“Marketplace lenders are expected to provide $7.9 billion in Small Business loans this year, up 68% from last year, according to research from Morgan Stanley. That is only 3.3% of the total, but marketplace lenders’ share could reach 16% by 2020”

– Morgan Stanley

And the investor community seems to be placing its bets in the space. Debt and equity capital is flowing freely into the hands of these alternative Small Business lenders

“Funding Circle Raises $65 Million for Peer-to-Peer Small Business Loans”

“Loan Platform Kabbage Raises $135M at a $1B Valuation, Grows Credit Line to $900M”

“Fundbox Secures $50 Million in Funding, With Investment by Jeff Bezos”

“Square Raises More Money To Make Small Business Loans”

How dominant these players will be in a few years remains to be seen but it’s clear that the Brave 100 are prepared to fight.
THE BANKS

And then there are the banks. As we have seen, every single Small Business has a relationship with a bank in the form of a primary checking account. Banks (and bank branches) are extremely important to Small Business Owners because of their need to deposit cash and checks regularly. Banks are invariably selected based on locational convenience and like consumers, Small Business Owners rarely change their primary bank.

With the gradual concentration of US retail banking that has occurred, the top 10 Banks now hold approximately a 50% share of Small Business Banking and the top 25 banks hold around a 60% share.

Exhibit 7: Bank lending to SBs

BY LOAN SIZE AND TYPE

Even though the majority of Small Businesses do not have any non-card, non-auto debt, those that do borrow overwhelmingly borrow from banks. Only in equipment finance (and auto lending) do non-banks make up a significant percentage of the supply. Non-banks currently make up only about 25% of the total $800BN in outstanding Small Business loans.

“Unlike the cruel Leonidas, who demanded that you stand, I require only that you kneel.”

–Xerxes
Half of all Business Owners say that their Bank has assigned them a “Relationship Manager” and half of those owners (28% overall) say they speak with their RM three or more times a year. One can legitimately debate the merits and benefits (to either party) of RM assignment by Banks but clearly Banks occupy a privileged position in the lives of most Small Business Owners.

When it comes to lending, Banks therefore enjoy many latent advantages over alternative lenders:

**ACCESS & SHARE-OF-MIND**

Business owners generally know their banker and the bank is in regular communication with them, albeit often in relatively superficial ways. The marginal cost of initiating contact and communicating with a customer is very low - near zero.

**DATA**

Almost all Small Businesses have only one checking account and their banks have electronic access to all the data in those checking accounts. The cost to a bank of estimating creditworthiness based on the transaction and balance data in a Small Business’s checking account should be near zero (the operative word being “should”).

**COST OF FUNDS**

In today’s data environment a bank’s cost of funds for a line of credit will typically be in the range of 50-60 basis points—a fraction of the 600-1,200 basis points marginal cost for non-Bank lenders.

Despite these advantages, Banks have not yet responded to the threat posed by the Innovators. There are many possible reasons for this that include inertia, old technology and mis-aligned incentive structures, but one factor worth discussing is the effect of regulatory change.

Before the financial crisis, regulation of banks’ capital adequacy was prescribed under Basel rules. Under these rules, banks learned to relate the profit they earned from each business line (and product) to its riskiness and the proper amount of capital needed as a buffer against that risk. The Basel framework was extremely useful to banks because it showed them for the first time the risk-adjusted rate of return on their scarce capital (RAROC).
One revelation of RAROC metrics was that Small Business Banking is usually immensely profitable in economic terms. A further revelation was that the profit was mostly attributable to three products:

1. High-balance checking accounts
2. Small Business credit cards
3. Merchant services (i.e. processing Small Business Merchants’ credit card transactions)

And a final revelation was that, very often, card lending was profitable while non-card lending to Small Businesses was actually unprofitable. Under Basel, a bank would typically find that its Small Business loan portfolio generated an accounting profit but not necessarily an “economic profit” - i.e. it did not generate an adequate return on the capital required to support the loans. Card portfolios on the other hand were able to generate “economic profits” due to interchange and fee revenue and the relatively fast churn of transactions through the product. Cards were seen as “good” while loans were seen as “bad”.

It’s worth noting that two of the three products that generate most profit do not carry appreciable credit risk (and hence require limited capital backing). The third product, Small Business credit cards, does carry risk and has a significant capital need but it also has very high yield and fees.

Under RAROC, the reason Small Business lending is insufficiently profitable for banks is only partly because of the capital requirements. Surprisingly, it isn’t because of high credit losses either: Small Business lending by banks has produced historical default rates that are quite low (generally in the 0.75% to 1.5% range outside of a recession). The major reason for poor profitability is that for loans of under $250,000 (and especially for those under $100,000 which are the vast majority by number of Small Business loans) the operating costs of finding the Borrower, processing the loan application and of loan administration/review, are all very high.

Banks’ response to this revelation was to kick off credit process redesign projects, a big part of which involved the semi-automation of Small Business loan underwriting. The idea was to emulate consumer lending practices within Small Business lending through the use of credit scores and automated decisioning. In practice, this usually meant using a scorecard matrix to judge the credit risk of an applicant: one score for the Business itself and another for the Business Owner (his or her consumer score).
This approach was less successful than had been hoped, partly because Small Business risk prediction is simply a tougher challenge than consumer risk prediction. Generic Small Business credit scores are not as good at predicting default as consumer scores like FICO or VantageScore are for consumer loans. The key to underwriting most Small Business loans is the data that describe the cash flows of the Business and none of the off-the-shelf scores have had access to their data. For the banks to succeed they would have to develop their own scores based on their own data and for most banks this was a task that took a back seat in priority to stress testing and other Regulatory concerns.

Understanding the seasonality of a Business’ cash flows, the performance of each business vertical in stressed economic times, and the affordability of loan payments based on the loan structure were all difficult analytical challenges that the banks weren’t yet prepared to address.

In practice, automated underwriting often also meant automating only a certain percentage of applicants (the “very good” and the “very bad”) and manually underwriting the rest. Meanwhile, in order to preserve the Small Business Banking relationship, many automatic rejects were appealed to the manual system. This left banks with limited improvement with as much as 80% of application volume still handled manually. Banks only saved a little money on the modest percentage of loans that were 100% underwritten automatically and their risk assessment accuracy didn’t really improve.

Then came the financial crisis, the ‘great recession’ and the Dodd-Frank Wall Street Reform and Consumer Financial Protection Act. It was signed into law in July 2010, and since then US banks have been consumed with the task of meeting its extensive provisions. The larger banks in particular, have been under enormous pressure to satisfy their regulators on capital adequacy and capital planning procedures.

“Basel” has been superseded by the concept of “stress testing”. Passing the Fed’s stress test (Comprehensive Capital Analysis & Review) and satisfying their liquidity coverage ratio (“LCR”) have been the major preoccupations of these banks.
When the crisis hit, followed by the great recession, Small Business Banking units hunkered down and focused on the most profitable products. Most banks tightened their underwriting criteria; they also scaled back or completely abandoned their automated underwriting of Small Business credit. One banker recently shared that the reason his firm returned to manual underwriting was not because they thought it was more accurate, but because they had so few loan applications that the handful of human underwriters they still had on staff were more than enough to underwrite all of the loan applications --- it was a good way to keep them busy.

As a result of these changes, banks cut back their lending overall by almost 15%.

So while the alternative lenders have flourished and brought their innovations into the Small Business arena, the banks have been quite distracted. But it could be argued that their distraction may be about to end.

In the current regulatory environment, banks representing 80% of US Banking assets are subject to mandatory stress testing. These processes have been in place now for five complete cycles and all but a handful of banks have now passed their stress tests. The process has been hugely time-intensive, and several banks initially struggled, but most banks have now satisfied the regulators and are able to return their attention to their core businesses, to growth and to profitability.

As banks begin to reassert themselves in Small Business Banking, they will certainly look closely at the Innovators, most likely focusing on the following areas:

- Re-establishing an automated underwriting approach for all or most Small Business loans
- Integrating checking account and other relationship data into their risk models
- Making better use of credit bureau and other third-party data sources to improve risk models
- Exploring the potential for a short-term cash-advance product as a mainstream offering to their Small Business customers
- Exploring collaboration with the Innovators to bring added-value services to their Small Business customers
But even as banks move to reassert themselves in Small Business lending, it may be some time before the Innovators feel squeezed out. A bank CEO recently said that he was not overly impressed with the performance of the leading alternative lenders. Their combined volumes, he said, amounted to a mere rounding error for his bank. Innovation in Small Business is not exactly flashing on his radar screen!

Nevertheless, lower down in the hierarchy, his bank is indeed looking at products like the cash advance loan and running pilot analyses to see what predictive power lies in the bank’s own DDA data for existing Small Business customers. Their early analyses confirm that DDA data elements enhance their current “champion” Small Business credit risk scores significantly. Maybe this is a precursor to bigger changes...
“His helmet was stifling, it narrowed his vision. And he must see far. His shield was heavy. It threw him off balance. And his target is far away.”

–Dilios

Exhibit 8: Areas of competitive differentiation

<table>
<thead>
<tr>
<th>Finding applicants</th>
<th>Applicant mix</th>
<th>Underwriting cost</th>
<th>User experience</th>
<th>Cost of funds</th>
<th>Pricing</th>
<th>Account maintenance costs</th>
</tr>
</thead>
</table>

FINDING APPLICANTS

It can’t be stressed enough how important it is in the Small Business lending space not to start with a huge sunk cost simply to find applicants. The “cost per 100 applicants” is a critical performance metric and many of the Innovators are struggling to drive this cost down. Alternative lenders start with the challenge of finding significant numbers of applicants, and despite frequent claims made that banks are systematically starving Small Business of the credit they need, it turns out to be surprisingly costly to find applicants. Using Google AdWords, search terms like “Small Business Credit” and “Credit for Business” cost $30-50 and with modest click-through, application, approval and close rates the final cost per booked loan ends up well into the thousands of dollars for some lenders. The cost to the Aggregators, though, is typically less than that of the direct lenders.

Do the banks have an advantage? Relative to all but the lenders with access to a privileged source of customers the answer is YES. Small Business customers walk into their branches on a regular basis with little to no prompting and campaigns that are designed to drive them into the branches are quite effective. Banks don’t have to generate demand or awareness for their products. It exists naturally.

ADVANTAGE – BANKS, AGGREGATORS AND CHANNEL ORIENTED LENDERS
APPLICANT MIX

It’s critical to keep the unit cost of finding applicants low but the mix of those loan applicants can be just as important. If a lender is looking for pristine borrowers and most of their applicants have poor credit, they won’t be able to approve many which will raise the cost per approved loan significantly. Similarly, if a lender offers cash advances and the applicants are actually looking for traditional equipment loans, term loans or lines of credit, then few will follow through or close.

Using the web or direct mail to surface applicants has the tendency to generate an applicant mix that is shifted towards the credit-needy. The approve/decline process that many of the non-Bank lenders go through can be quite costly but is a necessary part of keeping their loss rates under control. The exception to this rule comes once again from lenders with access to a privileged source of customers or those that have the ability to pre-approve a set of customers based on robust cash flow data.

Banks rely on their own customers to proactively raise their hands when they’re interested in funding, and typically the risk profile of these customers is skewed in a positive direction. Many marginal or poor Businesses flock to the internet or other “faceless” channels because they’re scared of being declined. As a result, the banks don’t see as many of these customers as the alternative lenders do and it should therefore be an area in which they hold a strong advantage.

It should also be noted that the Aggregators have a distinct advantage on this dimension because they have a complete set of products which means that they aren't as sensitive to applicant mix as the other models.

ADVANTAGE – BANKS AND AGGREGATORS

UNDERWRITING COST

If a lender can achieve the same degree of credit risk discrimination with an automated credit score as they could with manual underwriting, the former will confer a cost advantage over others who opt for the latter. But if two underwriting approaches have different intrinsic costs, yet the more costly one is better at separating “goods” from “bads”, it may easily pay for itself in reduced errors.

As discussed earlier, banks have largely abandoned automated underwriting and reverted to manual underwriting using financial
statements and other documented sources of information about a Business. Alternative lenders typically automate much of the underwriting process. This is partly for reasons of cost and partly legitimate innovation. The innovation is the use of cash flow analysis to gain insight into credit-worthiness with much of the data coming directly from sources like a merchant statement or a Small Business’s checking account, or even from Quickbooks. The idea of interpreting cash flow data to infer credit-worthiness is a significant innovation and one that banks have only recently started to realise could be important. The banks have not yet caught up with alternative lenders and are still in the experimental stage of analysing DDA data for underwriting purposes.

But if they ever figure this trick out, it could confer a doubly important advantage. First, since Banks already have the DDA data in electronic form, the cost to a Bank of accessing and analysing all that data on a single Small Business customer will be near-zero. This will enable a Bank to rank-order all of their Small Business customers by creditworthiness. Second, by assessing credit-worthiness using this powerful source of free internal data, Banks could pre-approve a high percentage of their customers for a short term lending product. Not all Small Business Owners would accept these offers, but for the customers that do, the banks would have found, underwritten and booked these loans at near-zero cost—a massive advantage over the non-Banking players.

Contrast this to their current underwriting costs and the magnitude of the transformation will become apparent. In a recent Consumer Bankers Associations research publication, larger banks reported an average cost per new loan of $1,600 (marginal) and $3,200 (fully loaded). The highest reported costs were $5,000 (marginal) and $7,000 (fully loaded). Where are these costs coming from?

Banks vary a lot in productivity but the applications handled per full-time employee range around a mid-point of about 100-125 loans/year. If the all-in cost is $100,000 for such an employee, the costs translate to around $1,000/loan just for marginal employment cost. These larger banks report approval rates in the 40-75% range, and net booked rates (on approved loans) in the 50-80% range. These approval and final close rates for Banks raise the net cost per booked loan significantly.

So if banks can automate their underwriting process through the use of pre-existing DDA data the advantage would be theirs, but for now the edge is probably with the innovators.
USER EXPERIENCE

Lenders aren’t exempt from the “shopping-cart dilemma” that’s faced e-commerce retailers since the dawn of the internet. If the checkout process is too complex or has too many steps, customers tend to abandon their shopping carts. The same is true with lenders. If an application process requires too many fields, asks the applicant to find and submit many pieces of documentation, and delivers an answer back to the applicant in an unknown period of time, there’s a good chance that many customers will abandon the process.

Banks have very little digital DNA having come from a world where branches and personal contact with customers was the norm. But in today’s world of smart phones, tablets and computers, many Small Business Owners expect a more streamlined user experience. The Innovators understand this and have designed their systems and processes accordingly.

ADVANTAGE – INNOVATORS

COST OF FUNDS

All business models that involve making loans that are held to maturity need to minimize their cost of funds. This is another area where the Banks have a massive structural advantage. The cost of funds for any alternative lender managing a balance sheet is multiples of the costs at any major bank. Banks’ cost of funds for short-term loans are around 1% while even the more established alternative lenders have effective costs of funds in the 5%-8% range. The less established alternative lenders have costs that are often much higher, sometimes even in the teens. Because many of the alternative lenders are relatively unproven and not yet profitable, they also generally carry higher equity/total assets ratios than the banks.

Marketplace model originators and Aggregators don’t have a direct cost of funds disadvantage because they aren’t funding any loans themselves. But, they have an effective disadvantage because most of the purchasers of their loans have a higher cost of funds than the Banks. This results in higher pricing for the Small Business Borrower which in turn makes them more difficult to find, approve and close.

The processors and E-commerce platforms aren’t as disadvantaged as the other alternative lending players because many of them are sitting on piles of cash that have a low return profile if unused. Putting idle capital to work is a good way for a giant cash machine to make money.
ADVANTAGE – BANKS, PROCESSORS AND LARGE, WELL-ESTABLISHED E-COMMERCE PLATFORMS

PRICING

In theory, if a lender can produce accurate credit risk ratings and understand its costs, it should always be possible to price so as to meet or exceed a hurdle rate of return. In reality there are pricing caps that limit the approvable population, but the concept of pricing for risk is powerful even when bound by this constraint. This means a lender can construct a loan portfolio with returns that are at, or above, the required rate of return on capital. While this is generally true with all the Innovators (based on marginal costs), this does not seem to happen with the Banks. Analysis of Bank pricing of individual loans tends to reveal:

- Inconsistency, with a wide range of rates at any given risk grade
- Inaccuracy, with a tendency to over-price good borrowers and under-price weaker ones

This may be cultural but it also may be the result of wanting to protect the holistic Small Business Banking relationship even at the expense of the loan economics. The Innovators don’t think this way and don’t have the same worries.

ADVANTAGE – INNOVATORS

ACCOUNT MAINTENANCE COSTS

Once a loan has been booked, the cost of administration, monitoring, and payment processing/collections can be significant. For Banks, the cost of ongoing loan monitoring and collections can be high due to regulation and compliance as well as the lack of an automated payment system (i.e. – daily remit). For the Innovators, lack of scale is a major factor in their costs. As an example, one of the bigger short-term lenders spends tens of millions of dollars annually on systems and people to support a portfolio of around 20,000 active loans. The net cost per loan runs well into the thousands of dollars per customer.

This means that many of the Innovators have a CURRENT disadvantage that should lessen over time and eventually disappear if they can scale their businesses into the hundreds of thousands of customers or manage their tech stack frugally. And, there are Innovators that have nearly no incremental servicing costs because their customers are already on-boarded, monitored and serviced through their core systems (i.e. – Amazon, AvidXchange, Square, etc).
So, while both sides have major disadvantages, the Bank disadvantage is structural and is unlikely to go away anytime soon.

**ADVANTAGE – INNOVATORS**

So, what conclusions can we draw from this analysis of competitive advantage? The clearest insight is that on paper the banks have a few structural advantages (like cost of funds) and many more potential advantages. If they were to borrow more from the Innovators’ playbooks, the Banks could hold an advantage across the entire activity chain and many Innovators would struggle to compete.

Even if this were to happen it appears certain innovator business models would fare quite well. The Aggregators are more than happy to source volume to the banks, as they to alternative lenders, and their value proposition doesn’t change if the banks turn their potential advantages into kinetic advantages. The Channel Oriented Lenders will also fare well because they are able to proactively reach out to customers without running into other lenders as well as source customers specifically looking for their suite of products.

Whether the banks evolve is the key determinant of the Small Business lending landscape of the future, but one can only speculate as to the probability of this happening.

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### Exhibit 9: Areas of competitive differentiation

<table>
<thead>
<tr>
<th>Finding applicants</th>
<th>Applicant mix</th>
<th>Underwriting cost</th>
<th>User experience</th>
<th>Cost of funds</th>
<th>Pricing</th>
<th>Account maintenance costs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Banks</strong></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Captive customer base</td>
<td>“Mature”, stable businesses</td>
<td>Limited use of DDA data</td>
<td>Legacy code and software</td>
<td>“Cheap” funding from deposits</td>
<td>Not often risk-based</td>
<td>Saddled by compliance and regulatory burden</td>
</tr>
<tr>
<td>Owns relationship</td>
<td>Positive selection</td>
<td>Manual processes</td>
<td>Potentially onerous document processes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Innovators</strong></td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Severe “marketing tax”</td>
<td>Potential for adverse selection</td>
<td>Alternative data like cash flow</td>
<td>UX built for all devices, speed and removal of friction</td>
<td>Dependent on lender maturity</td>
<td>Risk-based pricing designed to deliver economic returns</td>
<td>Currently subscale</td>
</tr>
<tr>
<td>Exception: Channel lenders</td>
<td>Exception: Aggregators and channel lenders</td>
<td>Automation yields productivity</td>
<td>Can’t compete with bank funding cost</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

✓ Competitive advantage  
✗ Competitive disadvantage
"Leonidas, my compliments and congratulations. You surely have turned calamity to victory. Despite your insufferable arrogance, the god-king has come to admire Spartan valour and fighting skill. You will make a mighty ally."

-Persian General

OBSERVATIONS AND MUSINGS

An energetic group of highly motivated innovators is targeting a huge sector of the economy, trying to meet what they feel is a major need for financing that is being ignored by the incumbents. The incumbents - banks - enjoy substantial profits from their services to members of that huge sector but do not actually make much, if any, profit from lending to them. How is this going to end?

OBSERVATION #1: BANKS HAVE STARTED TALKING TO THE INNOVATORS

The Banks have certainly become aware of the Innovators and have started to engage in open dialogue with them. We have seen notable public exchanges, and behind the scenes almost all of the largest US banks have had discussions with the leading cash advance and platform players to explore different forms of cooperation.

“FinTech on The Move: Regions Financial Partners With Startup Online Lender Fundation”

“BBVA Compass Teams With OnDeck to Bolster Bank’s Small Business Offerings”

“Lending Club and Union Bank Enter Into Strategic Alliance”

“H&R Block Small Business Clients Can Access Capital Through New Partnership With Funding Circle”

Exhibit 10: Areas of competitive differentiation

<table>
<thead>
<tr>
<th>BANK</th>
<th>ALT LENDER PARTNERSHIPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regions</td>
<td>FUNDATION</td>
</tr>
<tr>
<td>BBVA Compass</td>
<td>OnDeck</td>
</tr>
<tr>
<td>First Tennessee</td>
<td>OnDeck</td>
</tr>
<tr>
<td>KeyBank</td>
<td>avidxchange</td>
</tr>
<tr>
<td>UnionBank</td>
<td>LendingClub</td>
</tr>
<tr>
<td>BancAlliance</td>
<td>LendingClub</td>
</tr>
<tr>
<td>citibank</td>
<td>LendingClub</td>
</tr>
</tbody>
</table>
A typical discussion has the bank acting as a marketing channel for Small Business loans to its existing Small Business customers. With help from the partner, the bank underwrites the loans and classifies them as “keepers” or “pass-throughs”. A “keeper” would be a low-risk borrower who would qualify for a loan using the bank’s existing credit policy. A “pass through” would be an applicant that fails the bank’s risk cut-offs and as a turn-down gets passed through to the partner for further consideration. The partner can either find a home for the loan (with themselves or with a lender in their network in the case of an Aggregator) or reject the applicant outright.

In theory, this type of arrangement leverages the strengths of both parties and works to avoid their weaknesses. The banks have low-cost access to existing customers, low cost of funds and ready access to the businesses’ DDA data in electronic form. But the alternative lenders provide the new credit risk analysis expertise and platforms that can handle various loan structures. They also allow the banks to make balance sheet loans to their higher quality borrowers while reducing the sting of rejection for their turn-downs by offering further consideration.

In practice, not a huge amount of progress has been made and history teaches us that these relationships rarely work out. Execution and alignment are the keys to a good partnership arrangement and banks often struggle with both. Systems integration projects never get completed as promised, and as a result the customer and data hand-off processes suffer. And within the banking organization there is rarely a champion who will stake their career (or even annual bonus) on the success of the program.

But almost all the banks are eyeing the Small Lending space and partnerships with the Innovators are being penned. The banks are quite sensitive to the potential public relations nightmare (as they see it) of being called out for making loans with very high annual percentage rates, but many of the newer lenders in the space have products with pricing that would pass these banks’ internal “rep risk” tests. To date, several such relationships have been struck but very few (if any) have grown into major new-loan volumes. The low volumes aren’t due to lack of opportunity but rather due to the cultural issues within the banking system. The last few years have been a big shock for banks and the organizational metabolism of banks has always had a lower resting pulse than that of start-ups. Decisions are made slowly and the outcomes are pale reflections of what the energetic start-ups would prefer to see happen.
But this type of Bank/Innovator conversation underlines a couple of things. First, the Innovators have realized that the banks have access to their target audience and invaluable data on them. Reducing friction and costs is a big theme in the world of the Innovators and Bank partnerships can help achieve both. Second, in partnership conversations with Banks, the Innovators are essentially ceding the highest-quality borrowers to the Banks. This is a de facto acknowledgement that while the Innovators bring some, the banks are in the driver’s seat and can write the rules.

The Bank/Innovator combination has massive potential so it’s a trend to watch closely.

OBSERVATION #2: CHANNEL ORIENTED LENDERS DON’T CARE ABOUT THE BANKS EXCEPT AS A SOURCE OF DEBT FUNDING

For the Innovators that have access to customers and data through their invoicing products, their payment networks or their e-Commerce platforms, the Banks are seen as irrelevant. Going direct to the Small Business Owners with pre-approved offers based on historical payment and relationship data is their main strategy, and as a result they don’t feel like they’re competing with the banks. Being able to lend against a specific invoice or against future sales within an e-commerce platform is a killer capability. The “taxes” in the system are reduced dramatically which in turn allows them to offer fantastic products and pricing to their customers. They don’t have to find the customers. They don’t have to spend much time or money underwriting them. They don’t have to on-board them. They don’t have to build a sophisticated account monitoring and collections system. Waste in their system is negligible compared to that of a typical lender so pricing should theoretically collapse to the cost of capital plus an acceptable margin.

The only intersection these Innovators have with the Banks is on the debt side of the house. Not all of the players are sitting on piles of excess cash that can be used to make loans on-balance sheet, so the Banks play a critical role in lending to these Innovators. There’s plenty of room for Banks to make money purchasing loans or putting debt facilities in place for these players but this is a very different relationship than that sought by many of the Innovators. And, because of the massive reduction in costs across the entire value chain, the Channel Oriented Lenders should be able to dominate the small-dollar lending space.
OBSERVATION #3: THE AGGREGATORS ARE SCRATCHING AN ITCH

It might come as a shock to some of you (who may be reading this on a stone tablet) but Small Business Owners are increasingly going on-line to educate themselves about their borrowing options. While some of them set up face-to-face meetings with the relationship manager assigned to them by their bank, more and more Small Business Owners are turning to the internet to learn, search, apply and accept. Many of the marketplace and direct lenders are capitalizing on this trend, but the big beneficiaries are the Aggregators.

The reason for this is simple – the Aggregators are neutral parties who want to educate and expose potential Borrowers to all their options which makes them natural destinations. Any given lender is biased in their advice because they’re motivated to share the benefits of their suite of products to a potential Borrower even if there are better options for them in the broader market. Being the “Champion of the Small Business Owner” is a distinction that could fall on the backs of the Aggregators and attract droves of potential Borrowers.

But the key to owning this distinction and living up to the “Champion” title is to be squeaky clean in one’s practices. “Brokers” in many industries have been painted as evil due to bad actors who chased personal compensation at the expense of the customer. The introduction of Regulation inevitably follows complaints because where there’s smoke there’s typically fire. To prevent a similar meltdown in the Small Business Lending space, a Small Business Borrowers’ Bill of Rights has been created by a consortium of Innovators that defines “True North” and new Lenders and Small Business organizations are endorsing it regularly.

At its core, the Bill defines 6 major Rights that Small Business Owners should be afforded:

1. Transparent Pricing and Terms
2. Non-Abusive Products
3. Responsible Underwriting
4. Fair Treatment from Brokers
5. Inclusive Credit Access
6. Fair Collection Practices
With these 6 Rights as a guidepost, the Aggregators have the potential to carve out a valuable position in the marketplace and become a major, trusted source of volume for direct lenders and banks.

**OBSERVATION #4: A DISGUISED BANK ADVANTAGE IS DISGUISED NO MORE**

No discussion on Small Business Lending would be complete without exploring the role of the government in supporting Small Businesses in the US. It’s a constituency everyone is supportive of as we hear countless political candidates talk about Small Businesses being the “job creators” and “main street backbone of the economy”. The way the government directly helps their lending needs is through the SBA program. The majority of this total represents loans made by banks.

Under the various SBA loan programs, owners typically borrow money for equipment or inventory, working capital, refinancing debt, or buying another business or real estate. SBA loans are made through intermediaries/partners that include banks, Credit Unions and other originators that are willing to adhere to the government’s SBA process. To encourage these partners to do so, the SBA provides a government-backed guarantee on part of the loan that ranges between 75-90% of the losses incurred. These programs are significant. Between 2009 and 2013, SBA loan programs measured almost $95 Billion.

SBA loans can be viewed as an alternative to the products that many of the Brave 100 offer. The SBA itself describes the program as such: “Large Bank institutions... generate the bulk of their SBA loan volume by loans, especially the express loan and line of credit, offered to those who would be declined for ‘normal’ bank credit due to factors such as length of time in business or slightly more conservative underwriting factors”. This is a clue as to why owners might turn to the SBA program: what appears to be a higher chance of being approved.

However, since the SBA program is essentially a government subsidy that has historically been run almost exclusively through banks, it has created a disguised advantage that the banks have become accustomed to. While there are significant disadvantages to the SBA application and approval process (lengthy, costly and difficult to navigate), the presence of the guarantee provides banks with enough loss protection to offer very competitive rates to a population that would otherwise be difficult to lend to. Some Small
Business Owners are willing to trade off a higher interest rate or other less advantageous loan terms for a faster approval process and/or a quicker funding cycle but many are not.

But recently even the SBA product has come under attack by a few Innovators and it’s not difficult to imagine more doing the same. In response to the consistent negative feedback about the traditional SBA process, the government designed a streamlined version that had slightly different features. The SBAExpress product is more limited than the traditional SBA product in many ways, but it features an accelerated turnaround time for SBA review (within 36 hours) and reduced collateral requirements for very small loans. The guarantee has also been reduced from 90% to 50% which does increase the need for intelligent underwriting by the lender.

Innovators like Better Finance with their SmartBiz product have built an entire business around the SBAExpress process, and to-date they’ve processed over $1 Billion of applications on behalf of their partners want to own the loans. Is this a sign that the disguised advantage is finally out in the open? Will other Innovators step into the space? The answer is likely “yes”.

OBSERVATION #5: THE CROWD IS STEPPING UP

Many Entrepreneurs are starting and scaling Businesses that have speculative and/or unproven business models at their core. Some of them are trying to bring a new product to market and others are trying to offer a service to their community with no real sense of demand. These Businesses are inherently risky and require creative sources of financing until such time as the business model is better understood. Debt is rarely the right vehicle for financing these Businesses with the historical method of choice being “savings” and “friends and family” money.

But, a category of match-makers has emerged that exposes early stage Businesses to “the crowd”, and trends suggest that the crowd is responding.

“Since our launch, on April 28, 2009, 9.7 million people have backed a project, $2 billion has been pledged, and 94,203 projects have been successfully funded.”

– Kickstarter
At its core, Crowdfunding has become the ideal way to test consumer demand for a product. Companies like Kickstarter and Indiegogo are really helping Businesses “pre-sell” goods and services before they’re created. If successful, the Business Owner will understand much better what the demand for his/her product is and from there a more refined business plan can be created. For some Businesses there will be enough obvious demand that equity and lending capital will become available.

Other Crowdfunding platforms like CircleUp are helping a very specific type of business jump immediately to the equity side of the capital equation. Their target audience is U.S. consumer products companies that have more than $1 million in revenue for the current fiscal year with a tangible product or retail outlet that can be touched, tasted, used, or visited.

“CircleUp Raises $22MM To Invest In Consumer Brands On Its Crowdfunding Platform”

Over time CircleUp plans on pairing the equity investments with debt which will open up funding for these Businesses that banks have been unable to provide in the past.

Are Crowdfunding sites competitive with the Banks? Not in the least. Are they helping Small Business Owners gain access to sources of funding that they’re seeking? More and more every day.

Will the Brave 100 win the Battle for Supremacy or will the Banks blot out the sun with their superior forces? Will they ignore each other and farm their own lands in peace or can they find a way to co-exist in the same territories? The answer isn’t obvious. But if we use history as our guide the following are likely outcomes:

1. Banks will continue to loan hundreds of billions of dollars a year to their Small Business banking customers. Many banks will see a gradual decline in their Small Business loan portfolios but a few banks will figure out how to use their inherent data and cost of funds advantages to grow their portfolios.

2. Banks and Innovators are going to try hard to make partnership arrangements work. Many will sputter out but there is the possibility that a few become substantial in size.

3. Channel Oriented lenders have massive structural advantages over the other lenders in the space and will find ways to unlock financing solutions for their existing customers and create substantial profit centers for their organizations.
4. Aggregators and lenders with full product suites that focus on the user experience will continue to grow rapidly and steal share from the banks and from more narrowly focused lenders.

5. The biggest battle between the Innovators and Banks will take place in the $100K-$250K, 3-5 year term loan, sub-20% APR space. Banks will cede the smaller loans to the Innovators and the Innovators will cede the very large loans to the Banks. Neither side dominates the other in terms of advantages so it will be a fun battle to watch.

HA’OOH! HA’OOH! HA’OOH!
ADDENDUM

DATA SOURCES

General citations in this report include company press releases and other public news. Research cited in this report includes:

1. Oliver Wyman survey of 5,000 Small Business owners conducted (Q2 2014), exploring financial services use, business characteristics and aspiration

2. Oliver Wyman survey of 1,500 Small Business owners (Q2 2013), focused on credit product use and interest in bank-supplied cash-advance products

3. Consumer Bankers Association and Oliver Wyman (2014), “Partnering with Main Street: Opportunities for Growth in Small Business Lending”. Includes a joint survey conducted for the report that focused on the Small Business lending practices of ~25 large and medium-sized US banks


For more information on the Oliver Wyman research, please contact Peter Carroll at peter.carroll@oliverwyman.com

DIFFERENT INCENTIVES

One immense difference between Banks and the Innovators is the nature of their incentive structures. If you run a bank’s Small Business Banking unit and you successfully grow your loan portfolio profitably by 100% over 5 years what would be your likely reward? You would likely make a decent bonus and possibly be promoted to the next level in the corporate hierarchy.

But if you are one of the early hires or a Founder at an Innovator that grows rapidly and achieves a market value of $1 Billion, you should have enough money to retire comfortably.

In a completely rational world, the difference in these payoffs is neatly balanced by the relative degrees of risk in the two situations. The Innovator may commit years of time and energy and eventually flame out with nothing to show for his/her efforts while the banker may fail yet still keep his/her reasonably well-paid job. But it’s easy to see why the Innovators are so driven and Entrepreneurship is on the rise.
ABOUT THE FIRMS

QED INVESTORS

QED Investors actively supports high-growth businesses that use information to compete and win. While our support is tailored to the specific needs of each portfolio company, we typically provide a combination of both capital and capability. With operationally-oriented skills that we believe are both fundamentally applicable and broadly transferable, we enjoy working closely with a small set of carefully selected companies that range in size and style. But common to all of our partnerships is a shared conviction that information plays a decisive role in the success of the company, a mutual desire for a high degree of direct engagement, and a shared enthusiasm for experimentation and learning. For more information, visit www.qedinvestors.com.

OLIVER WYMAN

Oliver Wyman is a global leader in management consulting. With offices in 50+ cities across 26 countries, Oliver Wyman combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation. The firm’s 3,700 professionals help clients optimize their business, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities. Oliver Wyman is a wholly owned subsidiary of Marsh & McLennan Companies [NYSE: MMC]. For more information, visit www.oliverwyman.com.
ABOUT THE AUTHORS

FRANK ROTMAN
Founding Partner, QED Investors
frank@qedinvestors.com

Frank Rotman is a Founding Partner of QED Investors. His investments are typically focused on financial services and financial technology companies that are credit oriented or have data analytics foundations at their core. His portfolio of 20+ investments includes many of the emerging next-generation companies in the financial services eco-system such as Credit Karma, Prosper, Avant Credit, SoFi, GreenSky, LendUp, ApplePie Capital, and CAN Capital. Look for further writings from Frank in his blog at www.fintechjunkie.com and learn more about QED Investors at www.qedinvestors.com.

PETER CARROLL
Senior Partner, Oliver Wyman
peter.carroll@oliverwyman.com

Peter Carroll is a Senior Partner in the Financial Services practice at Oliver Wyman, the leading management consulting company. He and his colleagues have conducted extensive original research into small businesses and their owners, and their use of banking products. His clients have included many large and medium banks, where he has helped them to improve their overall small business banking strategies, including changes to their traditional lending methods.

JONATHAN LIU
Associate, Oliver Wyman
jonathan.liu@oliverwyman.com