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Financial Crisis Nearly Freezes Small Business Access to Capital

by Steve Tanner, Editor
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Bill Griffiths, owner of Fat Bob's Garage in Ogden, Utah, says his credit score and Dun & Bradstreet rating (used to determine the creditworthiness of a business) have always been strong. Still, he received 30% less from his lender in February of this year than he was promised two years ago. And when he closed the purchase of a new building today, he had to pay a full percentage point more in interest due to the recent crash in financial markets.

Adding insult to injury, Griffiths says he received a call from his lender just three days after being verbally approved for additional loans.

"I received a phone call from the bank telling me that they got a call from a 'higher up' that due to the unstable market, their bank wanted six months payments and my year-end taxes to give me any more loans," he says. Bewildered, he fortunately was able to satisfy the terms.

The story is the same no matter where you go, albeit far worse for many – liquidity, or access to capital, has all but evaporated in the midst of the current financial crisis. Simply stated, small businesses everywhere are much closer to Wall Street than they may realize. And since the passage of the federal bailout package so far has done little to improve matters, now is the time to take stock of what's afoot.

Poorly conceived and risky ventures perhaps should never expect easy credit, but the fear is that even good businesses will be turned away, exacerbating the broader economy.

"That's the big worry right now. I think we'll avoid that problem, but there will be a tightening up of lending for business borrowers," says business consultant Bill Conerly, based in Lake Oswego, Oregon.

Business consultants, executives, bankers, finance experts and other observers agree that the credit crisis is severe and getting worse. This article will explore how the financial meltdown is affecting small businesses. On Thursday, we will explore ways that small businesses can improve their odds of remaining solvent.

The Ten-Thousand-Foot View

There is no shortage of colorful metaphors describing the crisis of confidence in financial markets and its ripple effect across the entire U.S. economy. And since the economy is global in nature, worldwide financial instability affects nearly everyone on earth, Conerly explains.

"The raw materials of your loan might come from China or Saudi Arabia, which is true whether you're borrowing through a traditional loan, leasing equipment or using a credit card," says Conerly, referring to the securitization of loans, often bought by foreign investors. "So you're playing in the big leagues regardless."

Large banks regularly make overnight loans to one another; but those left standing currently do not trust one another's balance sheets, particularly in relation to the questionable value of risky home mortgages. Therefore, the cash spigot has slowed to a trickle. And since embattled banks like Washington Mutual and Wachovia were "extremely large small business lenders," as one observer points out, even good businesses are getting the cold shoulder.

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"I don't see them continuing making small business loans now," says Sam Thacker, small business finance and credit expert for AllBusiness.com Inc. "I don't see their focus being the same; I see them making what I'm going to call loans based strictly on the credit score of the applicant."

A charter bus company that Thacker advises is doing quite well despite the downturn, but its success actually hurts the owner's credit score. Banks check his score each time he seeks capital to purchase a new bus, which has the effect of lowering his score. The credit score wouldn't matter as much if lenders took time to review a complete credit report instead of just the score alone, Thacker says.

"The credit scoring mechanism in our economy penalizes small businesses," Thacker says. "So his credit score – even though he's otherwise credit-worthy – would be higher if he wasn't going out and buying new busses, which prompts a new credit check, which negatively effects the score."

Small business owners who once used their homes as collateral for business loans no longer have that kind of leverage, as the values of home mortgages have yet to reach bottom, says John Arensmeyer, founder and CEO of Small Business Majority, a small business advocacy group based in Sausalito.

Those businesses that are able to secure capital will pay more for it, whether it's through higher-rate credit cards (44% of U.S. small businesses already use credit cards for capital needs, according to the National Small Business Association), asset-based loans (also called factoring) or additional costs such as bank-mandated audited financial statements, sources say.

But for most small businesses in this environment, cash is king.

"Everyone is just cash hungry right now. Many perfectly acceptable credit-worthy companies are seeing their lifeblood of liquidity dry up," says Andy Birol, founder of Birol Growth Consulting in Solon, Ohio.

The Reality on the Ground

Of course not everyone is withering away, as some industries and organizations are better poised for recession than others.

The rule of thumb is to look at which products and services can be considered either essential or contributing to saving money. Most retailers – particularly those in non-essential areas such as dining and entertainment – will feel the pinch and may have the most difficulty securing capital, Stephens and other sources agree. Other industries likely to have problems securing credit include construction and real estate.

And any product or service for which there is a lower-cost alternative might be in trouble. Thacker describes a 30-year-old pest control company that has been consistently strong but is now feeling the strain of recession. "Consumers are saying that instead of having an annual contract [with an exterminator], they'll go to Home Depot, buy a $30 bottle of Raid and do it themselves. So businesses that are heavily consumer-driven are having the most problems, making the case for additional capital," Thacker says.

Any company selling to the medical industry, education or government markets will be fine during the recession and should be able to secure credit better than most, he adds. Secondary and discount markets also tend to do quite well in recessions and may be looked upon more favorably by creditors, says Dave Stephens, co-founder and CEO of San Mateo-based Coupa Software Inc.

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“If you assume things are going to get a whole lot nastier, two growth areas would be pawn shops and auction houses,” says Stephens, whose business operates a Web-based purchasing platform designed to help small businesses save money.

While larger banks are primarily in the process of deleveraging and avoiding additional risk, smaller community banks that didn’t make too many risky investments remain relatively liquid, says Brian Horton, president of Los Angeles-based 1st Enterprise Bank Inc., and are more willing to lend money. He takes pride in having personally met each of his roughly 200 business customers personally. Relationships help minimize risk, he says.

When asked which industries are off limits to his bank’s backing, Horton says it’s all a question of fundamentals, “I don’t care what industry they’re in.”

So far, he claims, the bank has not had to deny a single request for a credit extension since it opened two years ago. Horton says he looks for strong management, reduced leverage on corporate balance sheets and a downside backup plan. Ultimately, he says he’s looking for long-term partnerships.

“You look for owners who are liquid outside of the company, so if they need to they can put some of their own money into the company,” Horton says. “You look for signs of sustained staying power.”

New York-based finance and management consultant Jonathan Gassman says banks that are willing to loan money will do everything they can to minimize risk and make sure they’re paid back. Getting to know your lenders and doing what you can to raise their confidence level, he says, only works in your favor.

“It pays for the owners to go out for lunch with the bankers before they go in cold to put their hands out for money,” says Gassman, partner with Gassman & Golodny Planning Concepts Inc. “Now it’s about proving that you’re not only solvent but you can pay this off.”

The bottom line is that capital – which only works when it’s flowing – has slowed dramatically. Check back Thursday for some expert advice on how to grease the financial skids. ■