Bridging Disparities in Small Business Access to Capital

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Small businesses that need capital may have an equally great need for assistance in building their capacity.

The 2014 "Joint Small Business Credit Survey Report," by the Federal Reserve banks of New York, Atlanta, Cleveland, and Philadelphia, shows that the top challenge for small businesses operating fewer than five years continues to be lack of credit availability. Even as businesses have matured, credit availability has seen only modest growth after years of decline. Small businesses spent, on average, 24 hours in researching and applying for credit, but 45 percent were denied because of low personal credit scores.

Interestingly, although a large percentage of prospective borrowers are not getting credit, lenders contend that they love making loans. According to 25,000 reviews by users of the job site CareerBliss, one of the "10 Happiest Jobs in America for 2015," is the job of loan officer. The reason: "Loan officers often have the pleasure of helping people realize their dreams."

So, why the disparity between the pleasure of making loans and the denial of loan applications?

Tackling the Disparity

The disparity lies, of course, in lenders' need for assurance that they will be paid back according to underwriting standards. So until a struggling business can do well enough to look promising to a traditional lender, it needs an alternative source of capital.

In Massachusetts, the lack of small business access to capital resulted in the state's decision to create Massachusetts Growth Capital Corporation (MGCC) in 2010. MGCC's mission is to provide capital to minority and women-owned businesses, businesses located in smaller postindustrial cities (Massachusetts focuses on a list it calls Gateway Cities), as well as businesses that traditional lenders have turned away.


photo Todd Maki, Photo Op Photography

Gary Webster and Gale Scott of Down Home Cooking and Catering.

During the economic downturn, when credit was scarce for small businesses, MGCC became a critical financing resource, taking measured risk to finance certain businesses that might otherwise have had to lay off employees or close down. Through its revolving loan fund, MGCC has, as of this writing, made $74 million in loans to 224 small businesses that were unable to access financing elsewhere. Those loans affected more than 7,530 jobs, either by preserving employment or creating new jobs.

As MGCC does not rely on collateral to repay its loans, it takes time to assess the ability of borrowers to generate sufficient cash flow to satisfy the obligation. The analysis includes due diligence on the company's historical and projected financials and an evaluation of the character of borrowers, including how they have handled difficult situations in the past.

MGCC also has administered the state's $2 million Small Business Technical Assistance Grant Program, which distributes grants of up to $100,000 on a competitive basis to community development corporations (CDCs) for innovative small business programs. In fiscal year 2015, 81 percent of the 1,806 small business clients that the CDCs served fit into at least one underserved category for technical assistance and loans.

MGCC's role is to demystify the credit process, helping companies ascertain whether there really is a need for capital or whether other issues are impeding success. It's all about getting to the root cause of why the business has not been sustainable and creating tools so that it can build strength.

Many of the MGCC companies survive despite working in very difficult situations and industries. Once they are able to build capacity to improve how they align their offerings with customer demand, they repay their loans. Often they are able to refinance afterward with traditional lending institutions.

According to Gail Scott, principal of Down Home Cooking and Catering in Dorchester, "Not only did MGCC provide business assistance by providing a much needed accounting assessment, but it then put us in a position [to receive] funding for working capital and growth."

And David Slutz, CEO of engineering company Precix, says that MGCC was "a key enabler to our survival and to our thriving today, with headcount of over 400 now. Calm, cool, and collected, they took the time to understand our business, where we were on the demand cycle, and what the future looked like. They got it right, and instead of New Bedford having another empty building, they have an $18 million payroll in the city."

Four Critical Elements

To do this kind of lending successfully, four elements are critical: a good process, strong products, the ability to recognize passion in the prospective borrower, and strong collaborative partners and advisers.

Process

With a site visit to a client's business, a review of the small business's financials, and an interview with the business owner, MGCC is often able to establish quickly whether the prospective borrower has a capital issue or a capacity issue. If it is a capacity issue, technical assistance becomes a prerequisite to any funding. MGCC provides technical assistance of up to $5,000 (for needs related to accounting, financial controls, production scheduling, costing, payroll, IT support, marketing, and the like). The small business contributes half of the consultant's fee.

One thing that sets MGCC apart from traditional lenders is that it can require improvements in business skills and more-active reporting of the business's financial progress. Insisting on solid business practices can only help the company and is likely to provide a road to traditional capital.

Products

In choosing to deploy lines of credit and term loans, traditional lenders are obliged to rely on the borrower's historical results. Traditional loans and even Small Business Administration (SBA) loans take personal credit scores into account, and that can be a barrier in lower-income communities especially.

In contrast, MGCC requires no minimum credit score but instead looks at the borrower's projected working capital and projected profitability, analyzes current personal-debt obligations, provides technical assistance to remedy credit issues, and generally tries to get to yes on the business loan.

Passion

Passion is vital for small business success in lower-income communities. Business owners who are well known within their community and have everything at risk are usually determined to make things work. After all, they may be employing family members, friends, and neighbors who count on them.

Passion is not something revealed by financial statements but in more subtle ways—for example, in an owner's reputation in the community. Passion really can be a measure of future success in business and, if correctly identified, can mitigate some of the financial risk for the lender. Giving tools for success to a passionate entrepreneur can ensure the strength of the company and can help borrowers get beyond a bad credit history. MGCC staff often say when discussing a client, "Do they get it? Do they understand their business and their need for capital?" Small businesses that MGCC serves show that they have earned the capital assistance.

photo Todd Maki, Photo Op Photography

Michael Gonsalves Jr., O-ring press operator, left, and David Slutz, Precix president and CEO.

Making this kind of loan is more of an art than a science. Although one would expect that a portfolio of such loans would be quite risky, MGCC's loss ratio has historically been under 5 percent, and delinquencies have averaged only 2 percent—a tribute to good underwriting and the business owners' passion.

Partners

Partners are vital every step of the way. To help meet the needs of small businesses, an agency like MGCC relies on many players: other government agencies, local CDCs, microfinanciers, small business development centers, the SBA, municipal economic development departments, "Main Street" businesses, banks and credit unions, trade organizations, chambers of commerce, trade unions, and the like.

MGCC's networks are critical for clients because succeeding as a small business is getting more complex every day. Businesses must not only keep up with relevant technology and adapt quickly to industry changes, but in many cases, they must deal with the gentrification of their communities and the associated higher rents and customer expectations.

Lenders, too, must adapt to new technologies, new online competitors, and new constituencies needing loans. Immigrant entrepreneurs, for example, make up the fastest-growing segment of business owners in Massachusetts cities, and that presents lenders with unique demands for training and service. Meanwhile, the need for lenders like MGCC to help strengthen minority, female, and veteran businesses is growing as more corporations encourage veterans, women, and minorities to apply for corporate contracts.

In short, giving small businesses access to capital that they might not otherwise have received may make lending one of the happiest jobs. But lending the capital must go hand in hand with building the capacity of a business. The ultimate goal is equal access to loans. Providing a business with knowledge about the prudent application of capital can help it not only survive but thrive.

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