The United States' Shift to Reboot Small Businesses

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Table of Contents

Executive Summary

Despite the name, small businesses are huge to the American economy. Their value in job creation as well as the role they play in the United States' economy is enormous.

Importance of Small Businesses of U.S. Economy - Representing about half of the nation's private workforce as well as creating approximately two-thirds of net new jobs in the country, small businesses cannot be overlooked.

2008 Economic Crisis - The 2008 economic crisis was felt by all of America; however, "small businesses were hit harder than larger businesses during the 2008 financial crisis, and have been slower to recover from a recession of unusual depth and duration."[1] Despite being the backbone to the United States economy, traditional lending such as large banks have seemed to ignore small businesses after the financial crisis.

Small Businesses Rely on Lending - Lending from these traditional means were historically vital for the survival and success for small businesses. The capital raised through options such as bank loans were typically the primary source of external financing and it provided working capital for businesses to stay afloat and operate.

New Lenders - With traditional lenders seemingly disregarding the importance of small businesses, new lenders and marketplaces have emerged. These new lenders and marketplaces allow access to the working capital that is vital for small business success. Representing a small portion of a huge industry, these new lenders still have to prove themselves, however new legislation and platforms have emerged to fill this gap and hope to support the small business economy.

These technologies include crowdfunding, "the practice of funding a project or venture by raising many small amounts of money from a large number of people." Peer to Peer Lending, idea of lending capital to an individual or business with the understanding that the capital will be repaid with interest. And finally merchant cash advances.

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[1] Mills, Karen, and Brayden McCarthy. "The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game." Harvard Business School, 22 July 2014. Web. 30 Mar. 2016.

Government Involvement - As these new systems emerge, the government is also changing its policies and legal allowances. There are several acts being passed which are focused on granting more access to capital. This includes the Startup America Initiative as well as the Jobs Act.

This report highlights three possible solutions to the problem caused by the 2008 economic crisis.

Traditional Lenders Open up Lending - Banks and other traditional lenders lower their restrictions regarding obtaining lending.

Traditional Lenders Evolve - Traditional lenders change their methods and evolve to match the shifts in the industry.

Technology Continues to Expand - New entrants continue to grow and are supported by government policies. The industry continues to move towards digital means.

Goals

1. Understand the causes behind the need for the improvements to the financial support systems of small businesses.
2. Gain insight into what the future could hold for small businesses and the support system's surrounding them.

Introduction

This report provides an analysis and examination of the past and potential future of small businesses and the financial support systems built for them. Several solutions exist to solve the issue of accessing financing for small businesses, however this report will only recommend one solution.

Assumptions:

In giving the recommendation, it is assumed that the trends in traditional lending continues, the new technology continues to grow, and finally, that the government policy continue their focus on small businesses. With the patterns of each three of these categories seemly returning consistent results, these assumptions are not far fetched.

Methods:

In order to provide an informed recommendation, much research was done in the making of this report. The entirety of the data is secondary conducted from third parties not involved in the creation of the report. These third parties include prestigious graduate universities such as Harvard Business School as well as corporate analysis from the likes of Goldman Sachs. Additional sources which are provide more qualitative analysis include publishers such as *Forbes Magazine*, *TechCrunch*, etc. In conducting research regarding government policies, the report utilized government pages. The use of this combination of different resources allows the report to view the same topic from several perspectives.

Limitations:

The report is not an all encompassing report on the current state of small business lending. Instead, the report focuses on technology's role in changing the small business financing industry. Topics such as traditional lenders response to this new technology is a lack of information due to the timing of the research done for the report. While certain topics are overlooked, the report covers the most crucial changes affecting the small business financing industry.

Definitions:

Throughout the report, certain terms are used which require additional definition.

<u>Traditional Lenders:</u> Refers to the old systems of accessing finances such as both national and local banks.

<u>Lenders</u>: Those who grant access to capital to small businesses.

<u>Technology:</u> Contrasting the physical entities of traditional lenders, technology in this context includes websites, cell phone applications, and other digital entities.

Problems

The report analyzes one of the largest issues that the small business industry faces. Small businesses require capital in order to to maintain their operational costs. Traditionally, small businesses relied on traditional lenders such as banks in order to gain access to the needed capital. Small business loans were the primary source of capital for decades. However, after the 2008 economic crisis, the traditional means of obtaining capital tightly restricted their lending to small businesses. With how reliant small businesses are on traditional lending, this devastated small businesses. Without the means to fund their operating cost, small businesses are forced to look elsewhere.

Small Businesses are Vital to the United States Economy

Small businesses have historically been a key component to the success of the United States' economy for a multitude of reasons. In no particular order of significance, small businesses allow for innovation, support job creation, and currently represent approximately half of the private workforce.

Beginning with their impact on innovation, small businesses and the individuals behind them have the ability to pursue curiosities in fields of interest. This freedom of choice leads to innovation across a multitude of fields which has kept the United States economy ahead of the competition. A 2011 report from the Small Business Administration stated that, "the difference in patents per employee has now risen to 16 to 1 in favor of small innovative firms versus large innovative firms."[2] With developing nations rapidly catching up to the United States in economic power and speed, this innovation is vital to maintain the United States' position in the global leader boards. Certain reports have shown a clear difference in the different governments' views on small businesses. Reports estimate that the cost of starting a small business is **six times more expensive** in India than in the United States as well as that it takes **38 days to start a business** in China compared to the 6 days it does to in the United States.[3]

Domestically, small businesses are the backbone the economy. Not only in their numerosity and size, but also in their ability to create. According to a 2014 Harvard Business School report, small businesses, "**employ half of the nation**'s private sector workforce - about 120 million people."[4] The impact that they have on the employment rate of the United States is staggering. Equally as important to the employment rate, the ability of small businesses to create private sector jobs is overwhelming important. From 1995 to present day, the small business industry has **accounted for nearly two-thirds of all net new jobs** in the country.[5]

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[2] Breitzman, Anthony, and Patrick Thomas. "Analysis of Small Business Innovation in Green Technologies." *Small Business Administration Advocacy*. Small Business Administration, Oct. 2011. Web. 30 Mar. 2016.
[3] "Interesting Small Business Statistics." *The Latest Updates, Events and Information*. Biz Equity, 12 Dec. 2015. Web. 30 Mar. 2016.
[4] Mills, Karen, and Brayden McCarthy. "The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game." Harvard Business School, 22 July 2014. Web. 30 Mar. 2016.
[5] Mills, Karen, and Brayden McCarthy. "The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game." Harvard Business School, 22 July 2014. Web. 30 Mar. 2016.

Clearly, without the small business industry, the United States economy would be nowhere near as competitive or successful as it currently is. Maintaining the small business industry's health rests on the shoulders of many including traditional lenders, government agencies, and of course, the United States economy as a whole.

The 2008 Global Economic Recession

Felt worldwide, the 2008 global economic recession caused by the housing crisis was an infamous moment in the last century. While businesses of all sizes were affected by the immediate event and following events, small businesses were hit hardest of all. Immediate effects were seen throughout the industry. From 2007 to 2012, the total net job loss of small businesses was staggering with jobs lost as a result of the recession at approximately 11%. **The smaller the business, the harder the affect as well.** "Jobs declined 14.1 percent in establishments with fewer than 50 employees, compared with 9.5 percent in businesses with 50 to 500 employees, while overall employment decreased 8.4 percent."[6]

One of the main factors for this effect on small businesses is their reliance on bank capital. During the economic recession, banks and traditional lenders were hesitant to lend money due to the high instability in the economy and in turn, the high risk of losing the money lent out. Without access to public equity markets or equity for capital markets during the 2008 economic recession, small businesses heavily relied on banks and their lending. With over **81% of small businesses reporting that the capital received from banks was dedicated towards maintaining cash flo**w[7], when the banks decreased their lending, small businesses were affected greatly.

Traditional Lenders Stop Lending

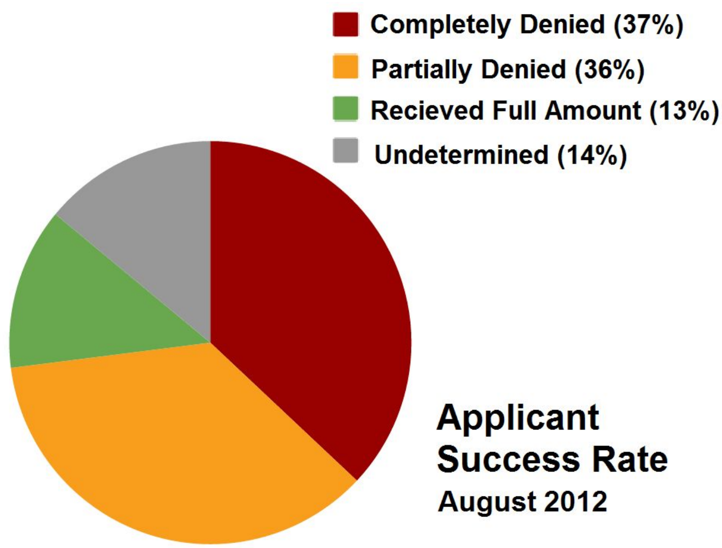
A report from the Small Business Administration released in 2012 reported that from the period of 2008 to 2011, small business lending from banks declined 18%

[6] Mills, Karen, and Brayden McCarthy. "The State of Small Business Lending: Credit Access during the Recovery and How Technology May Change the Game." Harvard Business School, 22 July 2014. Web. 30 Mar. 2016.
[7] "Small Business Borrowers Poll." *Small Business Borrowers Poll*. Federal Reserve Bank of New York, Aug. 2012. Web. 30 Mar. 2016.

"from $659 billion to only $543 billion."[8] Reducing the capital available to small businesses by almost 20% has created a vacuum of financing. While it makes sense for traditional lenders to reduce their lending during and immediately following the economic recession, the fact that **traditional lenders as an aggregate are still lending less** than prior to the 2008 economic crisis is a crucial point to be highlighted. Of course, several reasons exist for this occurrence.

Firstly, banks have tightened their limitations on who is able to receiving funding. A poll done in 2012 found that **37% of applicants were completely denied of capital while an additional 36% only received a partial amount of the capital applied for.**[9] Figure 1 further explains the findings of the 2012 poll.

Figure 1.



An additional reason is that the economic recession hit banks themselves. "During 2009, the FDIC closed more than 100 banks for the first time since 1992; and during 2009 – 2011, a total of 397 banks failed. As of year-end 2011, 813 banks appeared on the FDIC's list of problem institutions, up more than an order of magnitude from a mere 76 as of year-end 2007."[10] Without access to the historical means of access to financing available to small businesses, the United States economy was at high risk. Jobs were at risk and small businesses couldn't stay open due to the fact the typical capital that they used for daily operations was being locked away.

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[8] Cole, Rebel A. "How Did the Financial Crisis Affect Small Business Lending in the United States?" *Www.SBA.gov/advocacy*. Small Business Administration, Nov. 2012. Web. 30 Mar. 2016.
[9] "Small Business Borrowers Poll." *Small Business Borrowers Poll*. Federal Reserve Bank of New York, Aug. 2012. Web. 30 Mar. 2016.
[10] Cole, Rebel A. "How Did the Financial Crisis Affect Small Business Lending in the United States?" *Www.SBA.gov/advocacy*. Small Business Administration, Nov. 2012. Web. 30 Mar. 2016.

New Entrants Emerge to Support Small Businesses

With traditional lenders still not lending to small businesses, t**he century old industry was primed for new innovations to occur.** A Goldman Sachs report titled, "The Future of Finance : The rise of the new shadow bank", estimates that $11 billion annual profit of traditional lenders is at risk due to these new lenders[11]. Lenders of all forms are beginning to emerge. With new and evolving legislation, new forms of lenders once banned due to legal purposes are now emerging. The main forms of lending covered in this report will be crowdfunding, peer-to-peer lending, and merchant cash advances. While we recognize there to be several more forms of lending emerging, data shows that these three forms are the most poised for success in the transition.

Crowdfunding

Crowdfunding is a new trend that has emerged in the financial world that has proven itself as a viable method for obtaining funds. Crowdfunding is defined by *Forbes* as "the practice of funding a project or venture by raising many small amounts of money from a large number of people."[12] Labeled the most disruptive of new models that are replacing traditional methods of financing according to Goldman Sachs, **crowdfunding raised $34.4 billion dollars in 2015**.[13]

Initially, the crowdfunding industry was dominated by reward based platforms such as Kickstarter and Indiegogo which rewarded the crowd by offering physical rewards. Individuals were able to contribute to entrepreneurs and their prototypes in order to help launch the product into the market. With huge successes as well as products which quickly went viral, the most successful project on Kickstarter raised over $20 Million by over 75,000 individuals[14]; reward based crowdfunding received the most amount of press. Because of several of these factors, "crowdfunding" is typically thought of as reward crowdfunding.

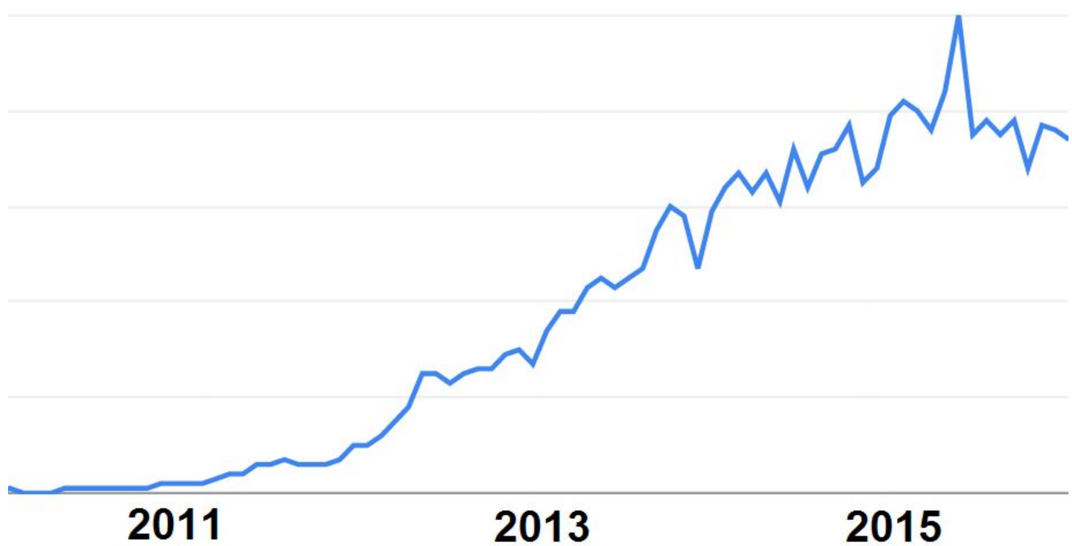
However, new crowdfunding models have arisen in recent years. Figure 2 shows the results of a Google Trends search of "crowdfunding". Before 2011, the term was

[11] Nash, Ryan, and Eric Beardsley. "The Future of Finance: The Rise of the New Shadow Bank." Goldman Sachs, 3 Mar. 2015. Web. 30 Mar. 2016.

[12] Prive, Tanya. "What Is Crowdfunding And How Does It Benefit The Economy." *Forbes*. Forbes Magazine, 27 Nov. 2012. Web. 30 Mar. 2016.
[13] Nash, Ryan, and Eric Beardsley. "The Future of Finance: The Rise of the New Shadow Bank." Goldman Sachs, 3 Mar. 2015. Web. 30 Mar. 2016.
[14] "Kickstarter." *Stats* —. Web. 30 Mar. 2016.

virtually unknown. With the introduction and expansion of platforms such as Kickstarter and Indiegogo circa 2010, the term began to spread like wildfire.

Figure 2.



2010 was the beginning of the introduction of several of well known equity crowdfunding models. Platforms including AngelList, Crowdfunder, Fundable, and CircleUp were launched from 2010 to 2012. These new business crowdfunding models traded a share of the company for funds. Prior to Title III Equity Crowdfunding rules, only accredited investors were able to contribute to crowdfunding platform. More information about Title III Equity Crowdfunding rules will be covered.

Peer to Peer Lending

Also known as lending or marketplace crowdfunding, **this form of lending dominates the overall emerging industry in regards to the total amount of capital funded.** Peer to peer lending is based off of the idea of lending capital to an individual or business with the understanding that the capital will be repaid with interest.

This form of crowdfunding has grown the most rapidly due to the economic crash noted earlier as well as their similarities to traditional lenders. Offering the same form of product to businesses with fixed-rate, term based products that are fully amortizing, peer to peer lenders are seemingly emerging as the go-to source of capital outside of traditional lenders. Several companies are attempting to help occupy this space including the likes of Lending Club and Prosper.

There are differences between the two forms of lending, however. While banks hold the entirety of the capital risk when it comes to lending to small businesses, peer to peer lending groups instead connect businesses to individual investors or investor groups who then choose to put their own finances as risk. In a sense, the risk is shared by many.

With rapid growth and high similarities to the historically successful means of financing for small businesses, peer to peer lending will be a disruptive force to the financial world.

Merchant Cash Advances

With estimates of the merchant cash advance industry ranging from $3 - $5 billion dollars, the MCA industry has cemented itself a foothold in the small business lending industry. With this form of lending, businesses receive a cash advance with little paperwork involved, however the business agrees to pay back the advance, plus a fee and allow the lender to remove a portion of each credit card sales until the total owed amount has been repaid. **One of the main benefits of merchant cash advances is the speed in which businesses receive their funds.** Typically, businesses receive their cash advances approved and funded within a day or two.

Companies such as CanCapital and OnDeck have begun to emerge in this space. But as with any growing industry, more and more companies offering these services will arise and the marketplace surrounding Merchant Cash Advances will begin to develop and evolve.

The Government's Role

Since small businesses are such a vital part of the United States' economy, government policies have begun to shift to support the rebooting of small businesses. From 2008 to present day, the Obama Administration has helped passed several acts in with small businesses in mind.

In January 2011, the Obama Administration launched the **Startup America Initiative, "launched to celebrate, inspire, and accelerate high-growth**

entrepreneurship throughout the nation."[15] As the Obama Administration rolled out policy focused towards rebooting the small businesses of America, five main areas received the most focus.

The first and most pertinent to this report is **unlocking access to capital**. As an innovative method of obtaining lending, crowdfunding received mass volumes of press which jumpstarted the interest and industry in 2011. The four remaining areas in which the Startup America Initiative focused on included connecting mentors and the education available to entrepreneurs, reducing barriers and making government work for entrepreneurs, accelerating innovation of the "lab to market", and finally unleashing market opportunities in industries such as healthcare, clean energy, and education.

In the following year, the Obama Administration also passed the **Jumpstart Our Business Startups (JOBS) Act in 2012. "Containing seven titles, the legislation's intent was, and is, to create cost-effective access to capital for companies of all sizes."**[16] Since certain parts of the act would greatly affect the SEC and the pertaining legality, certain acts were delayed in their passing.

When Title III Equity Crowdfunding rules of the JOBS Act were passed in October 2015, the Security Exchange commission lowered its restrictions and allowed non accredited investors to invest into companies. This greatly unlocked access to capital to small businesses. With the change in the policy being so recent, few reports have been done to show the impact. The reports that do exist show that trends point to equity crowdfunding to continuing to grow with the business owners due to the fact that they are now able to access non accredited capital.

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[15] "Startup America." *The White House*. The White House. Web. 31 Mar. 2016.
[16] Eakin, Rory. "The JOBS Act Is Progress But Much Remains To Be Done."*TechCrunch*. 29 Mar. 2015. Web. 31 Mar. 2016.

Possible Solutions

Due to the fact that traditional lenders such as banks have not rebooted their lending to small businesses, new technology driven entrants to the financial world have begun to emerge to fill the gap. These new entrants are beginning to change the way that small businesses have access to capital, meaning a large shift in the financial world is soon to be expected. With government support through several legislative acts, these new entrants are beginning to pave a path less reliant on traditional lenders. With this in mind, there are several different solutions to the initially posed problem.

Traditional Lenders Start Lending Again

Probably the least likely solution to the problem, traditional lenders begin lending again. Since traditional lenders are only worried about their financial bottom line, it seems unlikely that they will loosen their regulations on lending and put their assets at risk.

Traditional Lenders Evolve

As more and more businesses learn and utilize these new systems, either the traditional lenders will have to adapt to survive or will die out. If they were to adapt, the possibilities could be very similar to these new entrants. With the estimated size of the industry that could be lost being over $10 billion dollars, traditional lenders have a lot to lose. Traditional lenders have begun to utilize technology in similar manners to the new entrants however they are only now starting.

Technology Continues It's Expansion

In the end, technology will most likely emerge as the driving force of change and how businesses obtain funding, whether it be through connecting small businesses to investors or a platform which offers product similar to traditional lenders. Labeled as fin tech or financial tech, the new systems emerging have the potential to change an industry which has remained essentially the same for centuries.

Conclusion and Final Recommendations

After analyzing and compiling research from several different sources, the report recommends the continued support of new emerging technologies. The new technologies present the best opportunity for solving the lack of access to capital. Small businesses also confirm this recommendation as they are beginning to realize the benefits of these new opportunities despite the short length of the industry.

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