Rethinking Small Business Lending…Again

by Charles B. Wendel

A recent report by "a16Z Fintech Team" from Andreessen Horowitz (AH) discusses the need for what they term "better models for SMB lending" and lays out some choices for Fintech lenders. The article presents a valuable assessment of the current state of Fintech lending, although more types of opportunities may exist for lenders than they suggest.

No surprise, the article begins by noting that the pandemic has increased the level of uncertainty around small business lending. Right now, to a substantial degree, other than PPP related activities, little to no loans are available to small business borrowers. One group most impacted by the current environment has been Fintechs with, as the article states, Amex acquiring Kabbage's platform, Enova buying OnDeck, and Stripe Capital creating partnerships to provide Lightspeed and Jobber with POS capabilities for POS.

The report suggests the two acquisitions were distressed sales: "On Deck's delinquency rate went from 11 percent at the end of December to 45 percent by April, and the company was forced to increase its reserve for credit losses and tap an existing credit line." As has been the case since Fintech's started small business lending ten years or so ago, the cost of originating and servicing loans has always been a major challenge. Any small business like my own received frequent and expensive mailings from OnDeck, Funding Circle, Kabbage, and others.

Perhaps worse, many Fintech borrowers went to them because of poor credit quality and lack of borrowing options. A Feds report states "32% percent of online lender applicants chose their lender because they were denied by others, namely community banks." Being an adverse selection lender is never a good thing.

While the mailings have stopped, FIC and others still receive frequent offers by email. In the last month Funding Circle sent us an offer for a term loan of up to $500,000. They even offered the potential for a 60-day payment deferral, in the middle of a pandemic where some small businesses are struggling. It would be fascinating to look at their risk management processes and trend lines. Even if Fintechs want to lend, quality small business borrowers disappear during a downturn as they manage their cash flow and capital conservatively to ensure their survival and the safety of the owner's wealth. Remember, most small businesses do not borrow.

Beyond those mentioned in the AH report, we know several other Fintechs that are considering acquisitions, partnerships, or product extensions, all focused on stabilizing or increasing sustainable revenues and getting out of the origination and servicing cost traps. As the AH report notes, all are addressing similar challenges: "The cost of originating and servicing small loans is comparable to larger loans, but the interest and fee revenue is far less. Plus, the failure rate of SMBs is already high – <u>one in five</u> SMBs go out of business in the first year." That one in five failure occurs in a good year. A walk down a street in New York, Miami, LA, and points between show more and more store vacancies as an indication of the higher failure rate.

The article concludes by providing a view of the future of Fintech lending, It captures two options, but new approaches are being tested all the time.

Embedded- Lending tied to software with an SMB partner, basically a POS model, lowering acquisition costs. More Fintechs are applying their technology to streamline and digitalize POS lending, grabbing the consumer or business customer before they have the chance to take out their credit cards.

"Bank" model- Lending offered through a company like Square that began by offering a POS payments product and then added lending, with data based knowledge of the customer allowing the company to target certain customer types. More companies that service small businesses are open to adding a loan offer. They believe their customer's payment history affords insight and a certain degree of risk protection while strengthening the customer relationship.

In both cases the article notes that term lending will give way to shorter duration loans, with amounts seldom to approach even On Deck's recent average of $55K and 13 months term. However, any shift to shorter duration and smaller loans means the lender needs to continually replenish volumes and perhaps increase reliance on high tech-based decision making. The good news is that short-term loans (the article mentions MCA) should allow a lender to react quicker and operate an enhanced early warning system.

The AH article does not highlight at least two other opportunities for Fintechs, some of which already exist.

Bank and Credit Union "partnerships." Fintechs like Fundation and Numerated Growth Technology have established themselves as leaders in partnering with banks. The banks they target and their operating models differ, based upon their skill base and opportunity assessment. PPP caused many banks to suddenly work with Fintechs and agree to do so at what had previously been an un imaginable speed. The speed of decision making is likely to slow down, however, we hope not to prior levels. Many banks for the first time had their eyes opened to what they can accomplish with a Fintech partner. The best Fintechs will continue to emphasize their areas of expertise while adding on more product capabilities.

Go It Alone Lending. Fintechs can still operate as independent lenders. Today, many lenders are pulling back or highly skeptical about lending to businesses. But, within six months the lending environment may change post-election and, we hope, post pandemic. Now is when Fintechs and start up lenders should be selecting products, segments, technology, and planning an organization for the next growth wave. We see that happening now.

The last paragraph of the AH essay provides a great summary sentence: "So, while it may seem like SMB online lending has been collapsing, it's really being reborn."