SME: Four Segments Not One
by Charles Wendel

This newsletter begins a series that will focus on defining and differentiating the four key segments that make up a bank's focus on SMEs or small and mid-sized businesses.

Bankers often use the acronym *SME* to describe a business segment that captures a broad range of businesses from "mom and pop"-owned home-based businesses to companies with hundreds of employees and international operations. In reality SMEs involve multiple customer types that banks need to evaluate separately and, then, assess and segment for success.

Small businesses and middle market companies provide different economic opportunities to banks and require distinctively different approaches for banks to build share and profits. Too often financial institutions fail to recognize and act on these differences, melting one segment in with another and, thereby, limiting profits, providing poor customer service, and creating internal organizational frustration.

Four connected but distinct segments comprise SMEs: Microbusinesses, Business Banking, Lower End Middle Market, and Core Middle Market. Because of the unique skills and culture required to meet the needs of each group, our experience is that few, if any, banks succeed at handling all four of these segments. Instead, relatively few excel at the smallest of small businesses while more excel at larger and more complex companies. Some of the best performing banks focus with laser-like intensity on one or two of the groups, avoiding those companies they consider distractions from their essential focus.

Theoretically, a bank with the appropriate resources can serve each of these four groups. However, the reality differs: internal rivalry for resources often occurs (and usually favors larger lending opportunities over smaller companies) and organizational silos pitch one bank group against another. In addition, frequently, top management lacks the patience required to execute on strategy and tactics that can take years to move the bank in as new direction, pulling back from business marketing initiatives that have not been given the time or investment required to succeed.

Many banks have stuck their corporate toes in each of these four segments without understanding the implications of what they have done. Rather than passively continuing to operate in these segments, management needs to proactively assess which segment or segments best match its capabilities, culture, and interests, and deemphasize others. As we will discuss in more detail beginning with our next newsletter, a review of each segment underscores the different customer set each serves and the distinct bank focus on sales, risk management, and customer service, among other areas, each segment demands.

Definitions. Bankers often ask, “How do you define SMEs?” This is a simple question but not so simple to answer. Over the years banks have defined this group by focusing on revenue size, the number of employees, specific product requirements, life cycle stage, and/or psychographics. Because of its relative objectivity and the ability to obtain data, revenues predominate as the initial segmentation tool for most banks.

Revenue cutoff ranges differ substantially from one bank to another. For example, one bank defines small business as including companies from zero to $10 million in its definition while another starts at $3 million and go as high as $30 million in revenues. Additionally, in recent years the revenue range included within the overall small business (both Microbusinesses and Business Banking) has increased substantially as indicated by the bank with the $30 million cap.

Microbusinesses. The number of microbusinesses can total in the tens of millions, if the definition includes part-time business with single employees that operate out of the home (SOHOs). Each microbusiness generates small per company revenue (less than $500k-$1 million) and provides a bank with limited revenue potential. For a bank to be profitable with this group, it needs to follow a number of critical operating principles, including: simple and standardized products, streamlined processing, a simple application process, and an emphasis on self-service and online banking. High tech has to take precedence over the banker “touching” the customer. Other than a call center, the branch has to be the key point of personal contact for microbusinesses. For loans up to $50 thousand, or more, credit scoring has to be relied on.

Business Banking. Business Banking customers usually operate with from five to 20 employees, although that range can differ significantly. Banks focusing on this group often emphasize a revenue size that starts at $1-2 million and goes up to $10 million or more. Some banks have branch managers who can handle at least the customer service component of the relationship, providing important leverage to Business Bankers.

Lower End Middle Market. As banks seek greater productivity and cost efficiencies, many have increased the upper limit of their Business Banking definition to the $20mm or even $30mm revenue limit. Some banks have the same group of relationship managers focusing on all companies from $2 million to $20million or more. In this instance it can be no surprise that smaller companies receive less attention, as bankers focus on whale hunting. This can occur even in instances in which Business Banking provides higher margin opportunities with fewer competitors. Some banks even allow both business bankers and middle market bankers to overlap their sales efforts on this group, creating internal conflict and, potentially, customer confusion.

Core Middle Market. The Middle Market captures larger and generally more sophisticated companies. Beginning with revenues of $10-20 million and in some cases going up to billions in revenues, these clients offer banks the opportunity for extensive cross-sell and per client revenues. This sub-segment may also be the most competitive as it draws the biggest banks and features customers with the sophistication to manage bank relationships aggressively. For this group relationship management capabilities need to be first rate with the relationship manager (RM) playing the role of solutions-oriented diagnostician and sales person, while ensuring quality customer service.

As we will discuss further, each of four segments can provide a sustainable profit stream to banks that pursue the segment with discipline based upon an understanding of the segment's needs and revenue potential. At the same time the bank provider also needs to assess itself to determine which segments both align with its products and services, its cost structure, its banker capabilities, its culture, and its future goals. Misalignment results in lost opportunity and a reduced bottom line. However, as will be discussed in later newsletters, many banks allow pride, their traditional approach to doing business, and inertia to keep them in business lines in which they will never thrive.