From the Dallas Business Journal:
https://www.bizjournals.com/dallas/news/2023/05/05/dfw-sba-loans-access.html

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# Cash turns cautious: Bank failures, choppy economy threaten access to small-business loans

*May 5, 2023, 3:26am CDT*


Morgan Reed

Justin Shugrue opened his first store on Mockingbird Lane near SMU in 2020.

Justin Shugrue was running out of options. He needed to raise the rest of the dough, or his dream of a Dallas bagel shop was toast.

With nearly $330,000 from family and friends already secure, the entrepreneur was coming up short. He didn't want to forgo equity control of his new venture, but he needed another source for the rest of the funds – at least an additional $270,000.

“At the end of the day, it’s very hard to get a loan when you’re a non-franchise 22-year-old opening up a bagel shop in Texas,” said Shugrue, who attended Southern Methodist University.

He relied on a Small Business Administration 7(a) loan from Wells Fargo to make up the difference. There was a catch, though: He had to put up his mother’s house as collateral.

“I owe her the world for putting skin in the game,” Shugrue said. “It was a tremendous risk. Those are the types of bottlenecks (you encounter) – and why a lot of young folks don’t open up businesses.”

Fortunately, Shug’s Bagels is thriving. The native of Westchester County in New York opened his first store on Mockingbird Lane near SMU in 2020. He also has plans to open a second location this summer on Lemmon Avenue in the former spot of the Great American Hero sandwich shop.

To finance the second store, Shugrue took out a second SBA loan of $1.2 million with Celtic Bank. This time, he did not have to include his mother’s home.

But other entrepreneurs may not have as much luck as Shugrue.

Even before the failure of Silicon Valley Bank sent shockwaves throughout the banking sector, millions of business owners began bracing for a choppier lending environment in 2023 due to economic uncertainty and elevated interest rates.

With the bank sector in turmoil, business owners now face the prospect of a capital crunch as lenders turn cautious to protect their balance sheets.

The dynamic threatens to limit growth opportunities for entrepreneurs and widen the gap between small businesses and their larger counterparts.

## The Silicon Valley Bank effect

Less than two months after the failures of Silicon Valley Bank and Signature Bank, regulators took control of First Republic Bank and sold the bank’s assets to JPMorgan Chase on May 1.

In the wake of those high-profile failures, experts say banks are likely to experience increased scrutiny from regulators in the months ahead, which could trigger increased caution from lenders and steeper hurdles for businesses.

Small-business loan approval rates at large banks declined for the ninth consecutive month in February, according to the Biz2Credit Small Business Lending Index, landing at 14.2%. The National Federation of Independent Business found the net percentage of small-business owners anticipating easier credit conditions in the next three months hit its lowest point in five years in January.

Rohit Arora, CEO of Biz2Credit, said lending at big banks has stalled. Given the current state of affairs, Arora said small banks are likely to become more cautious, as well.

“There is a real danger small businesses are about to experience a credit crunch,” Arora said.

Ben Johnston, chief operating officer for Kapitus, a New York-based fintech company that provides small business financing, said the banking sector has been tightening since spring 2022 — a trend that accelerated after the failures of Silicon Valley Bank and Signature Bank.

Kapitus has seen an increase in quality applicants seeking growth capital that were unable to obtain the financing they needed from traditional banks.

Interest rate hikes aren’t helping matters — particularly for businesses that depend heavily on the purchase of inventory or raw materials.

“Higher capital costs will make funding growth and taking on new projects riskier and less rewarding, slowing expansion of the economy overall,” Johnston said.

He said nonbank lenders are seeing an influx of applicants, but noted those lenders are often more expensive than banks, making their financing uneconomical in many cases.

Many traditional banks across the U.S. will have to limit their loan growth due to the impact of higher interest rates. While bankers in Dallas-Fort Worth acknowledged their institutions are not immune, they said they remain confident about the opportunity to continue making small business loans in one of the hottest economic regions in the country.

“It’s a lot like real estate,” said Kirk Beason, executive vice president and SBA managing director for Dallas-based Veritex Community Bank. “You’re worried about things like if home values are declining and home starts are declining. Well, real estate is local. Nationally, it may look bad, but there are always pockets that will do well,” he said.

“Whether it’s real estate or small business financing in Texas, we’re a very pro-business state. There are plenty of opportunities for lenders like Veritex to continue to support the small business community.”

Beason said he expects SBA lending to pick up because businesses still need capital.

“Conventional lending has tightened up but during recessionary periods you always see SBA lending become much, much stronger, because there’s still opportunities,” he said. “There are still small business owners that need capital to either expand their business, start up a business or buy a business.”

### Where the SBA fits in

Signature Bank was one of the largest lenders in the secondary market for the SBA’s 7(a) program, purchasing loans from banks and freeing them up to make new loans. Its failure has led some lawmakers, such as Sen. Joni Ernst (R-Iowa), to suggest the industry’s turmoil could deal a blow to small-business lending.

“This will make it very difficult for our lenders to continue to have liquidity to make new loans,” Ernst said. “Especially those non-depository institutions like our small-business lending companies.”

SBA Administrator Isabel Guzman stressed banks should be looking more at 7(a) loans and the government guarantees they offer.

“Right now, 4,000 of the 4,500 community banks who serve so many communities haven’t done an SBA loan in the last two years,” Guzman said. “We need to get them back in, simplify the program and make sure they can use their prudent credit underwriting standards in order to deliver these loans.”

The concern over the program comes as the pandemic, and its billions of dollars in small-business rescue programs, have boosted usage of the SBA’s traditional programs. In 2021, the SBA posted a record $44.8 billion in lending in the 2021 fiscal year across 61,000 loans from its 7(a) and 504 lending programs. Those numbers fell only slightly in 2022.

In Texas, the SBA approved 4,142 loans last year totaling almost $3.43 billion.

Bankers and borrowers have both expressed frustration with the SBA’s processes and regulations over the years.

Shugrue described the SBA loan process as “rigid” – involving going back and forth with the bank and filling out a lot of paperwork to justify how every dollar will be spent.

“I’m certainly looking forward to the day when, if I expand after this, to not do an SBA loan and try something that’s less rigid and gives me more freedom ...and doesn’t take so long,” Shugrue said.

Scott Freeman also received an SBA loan last year for his business, Unicorn Bags.

The Plano-based company manufactures filtered bags used for growing and transporting mushrooms. He said Unicorn Bags' business has surged to more than $1 million in revenue a month due to a "shroom boom." Demand has increased due to a combination of people wanting to eat more organic and healthier foods, as well as decriminalization and legalization efforts for so-called "magic mushrooms" in parts of the U.S.

Freeman, who purchased Unicorn Bags from the company's founders last year, said he decided to get an SBA loan because he felt it offered more flexibility and did not need the financial security of other partners. Like Shugrue, he said the process required a substantial amount of paperwork. He credited Texas Security Bank for making the process easy.

"I never felt like I was frustrated, or they're wasting my time, or this is too much information," Freeman said. "This was a sizable loan at the top end of what you can get through the SBA. I knew what the opportunity was. That's probably the thing. When I really believed that this opportunity was going to be as good as it is, what's another month?"

Some banks, particularly in Texas, choose to forgo SBA lending altogether because they don't want to deal with the regulations and oversight that comes with doing business with a federal agency.

Chris Jones, executive vice president and chief lending officer of Dallas-based Texas Security, said the SBA process takes longer because it involves an additional party, unlike conventional loans. He also said banks must be deliberate in following the SBA's required processes and documentation because if they ever have to call on the SBA's guarantee, they need to be able to provide verification.

Most of Texas Security's underwriting is based on conventional financing, Jones said, and the bank uses the SBA's guaranteed products to fill in gaps.

"We will use SBA when there is some deficiency that would otherwise hinder our ability to finance a company," Jones said. "For instance, if there is proven cash flow, but short on collateral or, conversely, good collateral but maybe a blip in the cash flow history, these would be instances where we may rely on the SBA products."

Other banks, especially in DFW where so many financiers compete for middle-market business, don't offer SBA products because they don't need to do so.

“They drive enough earnings from their middle-market lending that any additional profitability from SBA lending probably wouldn’t move the needle that much,” Beason said. “I think you’ll see more focus on SBA lending at small and mid-sized banks like Veritex, where it can move the needle.”

Beason said small business lending remains a focus for Veritex. He joined Veritex last year to lead a revamp of its SBA lending line of business. About 80% of Veritex’s SBA loan portfolio the past few years has involved real estate financing. Beason said he would like to bring it down to about 50% with the other half of the portfolio involving startups and changes in ownership.

To encourage more participation in SBA lending, Beason said the agency should eliminate redundancies in its regulations and invest in technology improvement to speed up the process.

“Eliminate a lot of the things that have no value and don’t protect anybody,” Beason said. “All that does is add more time to the process and add more cost to the process. It’s kind of like we’re trying to tell the SBA we need to make capital available to small business owners, but it takes so darn long to get it to them it’s almost hilarious.”

Guzman said the agency is working to overhaul its lending and make it easier for small businesses and lenders to participate by streamlining programs and forging partnerships with other agencies to help businesses that have historically had trouble accessing capital.

## Underrepresented on both sides

But the funding landscape for larger small businesses is often just as challenging, with complex needs that require more time and attention. Rohit Mathur has seen it first-hand.

Mathur heads up Bridge, a program from Citi that connects small and midsized businesses with potential lenders across the country to offer loans of up to $10 million.

He said there was a gap for businesses looking to bid for loans and get term sheets in response for loans of $250,000 to $10 million. The process required business owners to go to each bank individually and provide detailed information — often consuming a lot of time for entrepreneurs with little to spare.

“We are talking about Main Street businesses that need access to capital, and we are talking about regional and community banks and CDFIs. Both parties find it hard to find each other,” Mathur said. “There’s underrepresentation on both sides.”

The lenders on the platform include a large number of minority and Black-owned banks across the country, as well as community banks and others that don't have marketing budgets to compete with larger banks. But they have money to lend.

Connecting those dots has long been a challenge and, when capital gets tight, it becomes even harder.

Programs like Bridge aim to address the problem, and the SBA itself is also focusing on ways to connect companies with banks.

## Avoiding lending landmines

Carolina Martinez, CEO of CAMEO, California's statewide micro-business network, said small-business owners searching for funding are often forced to navigate a series of misleading and predatory alternatives. That's especially true when capital tightens up.

Those options often leave business owners saddled with loans with higher-than-advertised interest rates because they have tried and failed to get loans at traditional lenders.

"For a small business, it's really important to ask the right questions before signing anything. It is important for the small-business owner to understand the terms of the product," Martinez said.

CAMEO recently worked on a recent rule in California that would clamp down on predatory lending and require more information about interest rates up front, and in clear print, on any loan documents. Martinez said the goal is a national law.

But federal agencies are also moving ahead with their own efforts.

Lawmakers, Goldman Sachs 10,000 Small Businesses Voices and the Bipartisan Policy Center have each released their own plans for how to modernize the SBA, boost small-business funding and increase access to training and other resources at the agency.

For small-business owners, the upgrades are long overdue. While owners like Shugrue have been able to secure loans, he remembers his first experience.

He realizes not everyone can rely on their mother's house as collateral or have a network of friends and family to rely on to help raise capital.

Shugrue also had a mentor, East Hampton Sandwich Co. Founder Hunter Pond, who helped him learn how to fundraise.

Despite the issues within the SBA's programs, Shugrue said he thinks small business owners should consider SBA loans when they need to raise capital because it costs less than raising equity.

"If you really believe in your idea to a tune that you're willing to put your mom's house up for it, then, debt is always the cheaper, more intelligent answer," Shugrue said. "You don't have to have the passengers on your rocket ship."

*Andy Medici, a senior reporter for The Playbook, contributed to this report.*


**Holden Wilen**
Staff Writer - *Dallas Business Journal*


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