

Bad Lending

Good Lending

A Report on Lending Practices
and
Business Failures



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Executive Summary

Small business failure rates are very often, difficult to properly track. However, in the past few years, considerable research has been conducted to determine the rates and causation of such failures.

It is estimated by a number of US bankers, including Wachovia, Bank of America, Chase, and Wells Fargo that the total volume of bank charge-offs for failures, after SBA and other insurance or guarantees and foreclosures will exceed \$42 Billion in 2007.

Bankruptcies among business owners and the businesses themselves are on the rise, prompted by a number of factors.

It is estimated by SCORE, the Service Core of Retired Executives, a unit of the Small Business Administration that 671,800 businesses are created each year. The number of closures is 544,800 or 81.10%. They are quick to point out that not all the closures mean a business has failed. Yet among the collective group of closures, the majority, we've found, have come from one causative effect or another towards an unplanned closure.

Some of the prime reasons for failure revolve around bank lending practices. We are convinced from the information provided in this report, that if these practices were ended, the failure or closure rate would dramatically be reduced.

Two of the principle reasons businesses suffer unexpected closures are insufficient capitalization and lack of planning. The latter accounting for a key to all other causes of closures. When businesses plan properly, and entrepreneurs spend sufficient time to learn every aspect of the business before they actually enter into it, the restaurant is likely to have planned for every contingency and will survive more than five years.

Conversely, when a business starts or operates without a plan, the principals are not prepared to deal with the slightest problem that could affect their enterprise. Not at all surprising, given the recent bank lending practices in the mortgage arena, few, if any banks require a business plan as part of the lending process. As a result, banks lend money, often SBA guaranteed, without due consideration to the ability of the business to survive to loan maturity or whether the business has sufficient capital to function. Bad planning compounded with bad lending equals impending failure.



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In the venture capital community, we've found that few, if any, VC's invest their funds into any company which does not have a plan and, in point of fact, usually, they require a business plan to begin the investment process. It is largely because of this that companies in VC portfolios have a much higher success rate than those which were financed by banks.

Similarly, when investment banks consider a company, they promptly look at all the planning documents and financial models for the firm before agreeing to handle that firm as a client.

We began to research the motivation and process behind the banking industry's methodology. In doing so, we identified a prime cause which also prompted and will continue to create long-term issues within the banking community. Specifically, banks no longer treat managers as staff, but now treat them as sales personnel, with a considerable change in the payroll model to commissions from salary. This ultimately causes the manager to consider the sale as more important than the effect of the sale on both parties. Their goal is to close a deal, rather than lend to a long-term business venture. There is little or no caring about the longevity of the business because the bank will likely sell the loan to an after-market buyer or can recoup losses on an SBA or other guaranty. Overall, we find this model fails miserably on all fronts.

In regards to the mortgage industry, when the two prime lenders outsourced sales to mortgage brokers, sales were made to many sub-prime borrowers. As sales in the

sub-prime market became a problem, the banks moved a way from third-party sales, brining those sales in-house. Nevertheless, the sales continued.

Similarly, with small to mid-size business loans, the bankers view each prospective loan not as something requiring plans and due diligence, but as an opportunity to earn another commission, hence the sale of loans is made without consideration to the survival of the company.

When a small business owner enters a bank with the intention to obtain a loan, they invariably expect to be told they will need a plan, but surprisingly, they find no such demand. Rather, the bank requires three years of taxes, current proof of any income, a financial statement and, if the company is already operating, financials for the company for at least two years. An application, which never discusses plans, is required as well. Gleeful that the bank is not asking for more work, the applicant complies with as many requirements as they can and usually obtain the loan.

The bank takes a snapshot credit report of the applicant's current economy, with no thought towards the company's ability to bring the loan to maturity. As a result, most bank loans have no plans, and those which do, have only been reviewed by an analyst with no more than 5 minutes study.

Businesses which obtain loans versus VC investment fail at a rate of 11.2 to 1. A ratio that in any other era would be unacceptable by government or bank directors.



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AN UNSCHEDULED CLOSING IS A FAILURE.

Businesses close for many reasons. A 2003 report by the SBA points out that there are significant differences between a business closing and a business failure. While the SBA makes a valid point in every portion of their report, they failed to see that in many cases, a closure can also be a failure. They presume that if a firm does not file for bankruptcy, the closure is not failure. We disagree.

If a proprietor dies, for example, and the company is closed as a result, even if the bills are paid in full out of the estate, the closure is still a failure because there was no plan to cover such a contingency. Had the owner planned properly, in the event of his or her death, key man insurance could have paid any debts. There would be a plan to allow management or heirs to take over the business. No succession planning was in place.

People start businesses for all the wrong reasons. The lack of plans to help them identify what they're getting into makes the risk even higher for banks who do no due diligence effort to determine the worth of the enterprise or the owner's ability to perform. Again, it becomes a case of making and closing a sale that is more important to the bank.

Poor management skills are another cause for failure. While a business may still close its doors without bankruptcy, it may have done so because of poor management. As the banker does not conduct any process

to determine the ability of the owner to actually run the company, the bank may lend on the basis of the owner's credit or collateral assets. Doomed from the outset, such a business should never have been the recipient of any loan until a skilled management team could be put in place.

The location of the business is paramount, they say, and it's true. However, banks rarely look at, and are not skilled analysts to determine whether a location is suited to the business. Often, a business location is well suited to the enterprise when it opens its doors, but shifting demographics may prompt the business to close. If the operator does not have a plan to move the enterprise to a better location, it will fail, but without ever seeing a plan to do so, the banks lend, often knowing a shift in population makeup is underway.

Overexpansion is yet another problem. All too often banks lend to existing concerns that plan to expand beyond management's ability to control the business. Without a secure and sound plan, the rigors of an expansion may adversely affect the ability of the business to survive. Management is overwhelmed and the concern closes. This does not always mean a bankruptcy, but will end up in an unnecessary closing and loss of employment within a community.

We conclude by saying that closings are at all time highs, and no matter what the cause, they would not happen if good planning were in place at the outset.



Plan Evaluation is the Key

After reviewing all sorts of formulæ for determining success, from stochastic models to Martingale and differential equation methods, we found that the one and only solution is a fairly rudimentary one.

If the banks were obligated to follow the VC companies in requiring a business plan, and an independent third party with no interest in either the bank or company were to review the plan, and score it, then several things would happen:

1. The company's management would have all their planning done, in writing and would be in a far better position to reach long term success (defined as five or more years).
2. The management would have a fuller knowledge of how to manage the company.
3. Management would have succession and key man planning in place, as well as a solid exit strategy.
4. Standards for insurance and structure of an organization would become the routine benchmarks for banks.
5. Management standards would become a basic part of lending to small and mid-cap businesses.
6. Loans would have a higher probability of reaching maturity, even if the firm suffers the death or illness of an owner.
7. Banks would tighten credit, only to such an extent that requisites of plans would be met.
8. A scoring method would become the

norm for all banks across the nation and all third-party evaluators.

9. As time goes by, more lending would be available to more successful firms, with deference given to those firms which exceeded their original five-year plans.
10. Business would significantly improve throughout the nation, and many more concerns would be able to expand and grow successfully.
11. Employment would improve.
12. Bank values would rise and share prices increase.
13. After-market value of business loans would also increase.
14. The national economy would see a long-term stable growth as more jobs are created with stability.
15. Social Security would improve with more people keeping long-term jobs.

A new industry would be born, serving the needs of the banks as evaluators. All evaluations would be done by certified evaluators. The International Society of Business Plan Evaluators would certify qualified individuals and help establish equal standards to assure that all plans are given an equal format evaluation.

Bankers, on a side note, would still earn their commissions, while more than \$15 Billion in potential losses would be turned into practical, successful loans by banks across the nation.

A win-win for everyone.



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