

9 Insights (and Takeaways) for SMB Lenders in a Recession

Introduction

Amid market volatility, inflation, and signs of a slowing economy, many economists believe we're poised for an economic downturn or recession. As a result, priorities are shifting for small- to medium-sized businesses (SMBs) – and it's essential that SMB lenders understand and address these changing priorities to make appropriate lending decisions through the challenging times ahead.

With this in mind, we're sharing nine insights on how to navigate SMB lending in a down market – and how data can help you weather the impending storm. In late 2022, Enigma partnered with Fintech Nexus to host a virtual panel discussion with five industry leaders. Now, we've expanded this information to include actionable takeaways you can use as you navigate lending to SMBs during a recession.

But before we dive into the nine insights and takeaways, let's take a deeper look at SMBs in the U.S.

Who are U.S. SMBs and what are their capital needs?

First, let's clarify who we mean by small- to medium-sized businesses (SMBs). While definitions of SMBs differ, they're often determined by headcount and revenue: for example, an SMB could be any company with fewer than 1,000 employees and less than \$1 billion in annual revenue.

SMBs often need access to short-term capital like credit cards, lines of credit, and term loans. They have a lot to deal with in their day-to-day operations and spend the majority of their time focused on running their business – so they need affordable, fast, convenient lending options that meet them where they are.

The pandemic increased SMBs' need for easily accessible capital. It also accelerated their digitization and access to data, which could prove to be a silver lining if we're heading into a downturn that requires more agility and flexibility.

Economic outlook: is a recession looming?

While it's impossible to predict the future, our industry leaders have been monitoring economic indicators closely and drawing upon past experience with the 2008 financial crisis.

You're likely already familiar with the classic signs of an economic downturn, which include a drop in payment rates and uptick in delinquencies.

But the earliest indicators of an economic downturn are changes in spending patterns and levels – especially discretionary spending – among small business owners and consumers. And while this isn't yet occurring across the board, lenders are noticing a trending decrease in non-discretionary spending.

“When things get tight, it's discretionary spending that first gets shut out. Then even non-discretionary spending gets tight, and that translates into things like risk metrics and delinquencies,” says Lakshmi Narain, Managing Vice President of Apollo, a subsidiary of Capital One.

Data will make the difference

Fortunately for SMB lenders, if we are staring down another economic slump, we're bolstered by new access to data and insights that allow us to make more informed, fair, and thoughtful decisions than ever before.

By taking advantage of all the data available to you, you'll be better able to support SMBs through any future financial woes.

9 insights and takeaways for navigating SMB lending in a down market

Industry leaders have been keeping a close eye on the economy, the possibility of a recession, and how the livelihoods of those who work in SMBs might be affected.

From our observations, we have gathered nine insights for SMB lenders as we head into an economic downturn. We'll also share nine key takeaways on how to effectively use data to guide decision-making on SMB lending.

INSIGHT #1:

Consumers keep spending

Despite market turbulence and uncertainty, Mastercard data shows consumers are continuing to spend – but the mix is changing, according to Jane Prokop, Mastercard EVP of Small and Medium Enterprises.

- Retail sales (with the exception of automotive) were up in August 2022, representing a 12% year-over-year increase and up about 20% compared to August 2019
- Perhaps not surprisingly, 2022 online sales grew about 10% compared to 2021, with a dynamic mix across sectors and industries
- Restaurants, airlines, lodging, and other sectors that focus on consumer experiences saw strong, double-digit growth in 2021
- 2022 holiday sales increased 7.6% from the previous year
- Despite predictions of a consumer bias toward in-store spending, ecommerce sales grew 10.6% in 2022. Online sales made up a higher percentage of total holiday shopping (21.6%) than the previous two years (20.9% and 20.6%, respectively)

TAKEAWAY:

Keep engaging with B2C businesses

Many businesses are continuing to see growth in spite of the economic uncertainty, particularly in B2C industries.

Lending capital to consumer-focused businesses can be risky in times of a recession. However, if you're able to successfully engage with these growing businesses, you may find yourself gaining market share from competitors who are hesitant to get involved.

INSIGHT #2:

SMBs continue to spend

Spending by SMBs continues to increase on a global basis, with double-digit, year-over-year growth that's been accelerating since August 2022.

According to Mastercard data shared in our panel, these categories have experienced the most significant growth in spending:

- Food
- Warehousing
- Professional services
- Travel and entertainment

This means that, despite the challenges of the past few years and looming economic uncertainty, SMBs with a B2B focus still need financing options that can help them grow.

TAKEAWAY:

Engage with B2B businesses as well

To benefit from increased spending by SMBs, you'll need to meet them where they are and provide essential capital and other financial support.

It's important that you consider trends by industry and sub-industry when deciding where to direct capital – as some categories grow at a faster rate than others.

INSIGHT #3:

Credit risk is normalizing

Credit risk continues to normalize, although it's still below pre-pandemic levels, according to data from Capital One.

While SMBs are still spending, they're being more cautious given inflation, increasingly price-sensitive customers, and a wariness about passing on increased cost of goods to customers.

Lakshmi sums up lending conditions with this driving analogy: "If you're a typical lender, you still have one foot on the accelerator and the other foot on the brake, holding your steering wheel tight and watching who you're giving a ride to. And if you're a typical borrower, you're asking yourself, 'Can I afford that ride, given it's starting to get expensive and starting to get a bit bumpy along the way?' But overall, conditions still look good."

TAKEAWAY:

Don't get complacent while conditions are good

It's easy to take good conditions, including normalizing credit risk, for granted. But it's essential that you stay vigilant and monitor your data for any early signs of changing trends.

As you continue to engage with SMBs, you'll need timely and accurate data that allows you to make smart decisions and quickly adjust to changing conditions.

INSIGHT #4:

Individual small business performance declined in 2022

While Enigma's data has revealed an increase in spending at the macro level, individual SMB performance is declining.

- At the beginning of 2022, 60% of small businesses were growing (based on monthly card revenue and adjusted for inflation)
- By the end of the third quarter in 2022, this had dropped over ten percentage points, to below 50%

TAKEAWAY:

Takeaway: Take action immediately if you see SMBs struggling

A decline in SMB performance is one of the first indicators that SMBs are starting to struggle – and may continue to do so as the economy dips.

You'll need to collect high-quality data that clearly indicates which businesses are growing and which businesses are declining. This will help your marketing team devote campaign dollars to healthy businesses that are likely to be approved for capital.

Similarly, risk and underwriting teams will need timely and accurate data to demonstrate whether a business's revenue or trajectory have changed in recent months. Gathering this data will help you prepare accordingly and make appropriate lending decisions.

INSIGHT #5:

SMBs are resilient and opportunistic

In the face of many challenges, SMB owners continue to show themselves as a resilient and opportunistic group. They're always ready to take advantage of new opportunities.

- New business launches are still on the rise since the pandemic. In 2020, there was a 23% increase in new business startups – and these launches continue to grow in 2023.
- New businesses emerging today are recognizing rising costs in the market – and taking advantage of opportunities to disrupt the environment.

TAKEAWAY:

Focus on new businesses

A new business has very specific financing and capital needs. It's essential for your team to recognize and tap into high-potential new businesses.

In addition, you must have the right offers in place to attract new business customers – and strategies to reach them before your competitors do.

INSIGHT #6:

Micro-segmentation is becoming essential

The way that lenders model and analyze their potential customers is out of date, according to Chris Scislowicz, Head of Lending at Accenture.

As data continues to evolve, lenders are changing the way they evaluate businesses. This includes micro-segmentation, which will be especially relevant if we head towards a recession.

Micro-segmentation involves dividing larger markets and customer pools into small, actionable groups with common characteristics. It's incredibly helpful for understanding your business, but only if you collect the right kinds of data to inform your segmentation.

Here's an example: If a bank was considering lending to a restaurant in a particular geographic area before the pandemic, it would look at the economics of that area. But when COVID hit, lenders instead needed to know whether a restaurant offered takeout and delivery services. They would also investigate whether a business was considered an essential service.

TAKEAWAY:

Consider all evaluation criteria

All areas of your business, especially risk and underwriting teams, should consistently seek out and evaluate new criteria they can use to assess potential customers.

Takeaway: Risk and underwriting teams should be consistently looking for and considering whether there are new criteria to evaluate businesses or new kinds of data that can provide.

INSIGHT #7:

Greater focus on portfolio monitoring

Between the last quarter of 2022 and the first quarter of 2023, we have observed a significant shift in investments that will strengthen SMB lenders' portfolio monitoring capabilities.

This is especially true among fintech partners: "If the economy is heading the way we expect it to go, we have to ensure portfolio monitoring capabilities are where we need them to be," explains Scott Steinberg, Chief Product Officer at Enigma.

TAKEAWAY:

It's time to invest in greater monitoring

As SMBs shift their priorities and focus on mitigating risk, you should consider ways to improve your portfolio monitoring strategy.

Risk and underwriting teams should consider the monitoring capabilities available to them and whether they can quickly detect or predict a change in a SMB's health.

Similarly, marketing teams will need to explore creative strategies to maximize the ROI of their campaigns and accurately predict when a portfolio is presenting new risks.

INSIGHT #8:

Use all the data

As you prepare for a potential recession, it's essential that you take advantage of all the data you have at your disposal.

It's also critical to consider things like the relative diversity of an SMB's customer base, says Jane Prokop, Mastercard EVP of Small and Medium Enterprises.

"SMBs could have terrific revenue from two customers and then that revenue can disappear practically overnight if they lose one of those customers," she says. "Understanding the details behind the cash flow is really important, particularly as you go into these kinds of periods when there could be severe disruptions in business."

TAKEAWAY:

Use all relevant information when making decisions

As you make lending decisions, you need to identify and assess any internal or first-party data you aren't currently using. How could your team use this information to make more informed decisions?

Third-party data is equally important, especially in volatile times.

- Marketing teams can use first-party and third-party data sources to identify new customer segments and prospects. A recession can actually be an opportunity to gain market share – because if your competitors aren't marketing to their customers, you can take advantage of that untapped opportunity.
- Risk and underwriting teams should identify signals and trends in the shifting economic landscape and use these to make decisions that minimize risk and maximize profit.

INSIGHT #9:

The intention behind data and decisions

Data is immeasurably valuable... but only when used appropriately and effectively.

When gathering data, you should remember that the availability of data needs to go hand in hand with procedural and process maturity. It's critical to consider how to leverage data properly – not just in how you collect it, but in what you do with it.

Try asking:

- What data will be helpful to make an informed decision?
- What data are we legally allowed to use to make a decision?
- What data is morally or ethically appropriate to base a decision on?

TAKEAWAY:

Ensure you use data in an appropriate and compliant way

You need to have a strong understanding of where the data comes from. It's important to work with data providers who are fully transparent about their sources.

Risk teams must be especially careful that any data they are using to make decisions is fully permitted under legal and compliance regulations.

2023 and beyond: The need for speed (and agility)

We believe that the SMB lending industry is better equipped than it was in the “Great Recession” of 2008 to 2009. Thriving through a recession comes down to two things:

1. How quickly you can detect change or insight
2. How quickly you can act on what you detect

Thankfully, technology has given us the ability to better access real-time data as well as use that data to detect patterns, trends, and anomalies – and therefore make better lending decisions.

Generalized credit scores are an incomplete picture of an SMB’s overall “wellness.” Data platforms, like Enigma, that incorporate alternative data sources can safely increase approval rates dramatically.

As we look to the future, clear visibility into card revenues, revenue growth, transaction volumes, and other metrics of financial performance can help you help more small businesses grow and thrive.

Are you concerned about the impact of the economic downturn on your ability to lend to SMBs?
Wondering how new data points could affect your decision-making and help you partner with the best possible customers?

Get in touch for a customized demo of Enigma's data platform.



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