



US small business post-crisis

June 16, 2010

Key to a stronger US economic recovery

- US small businesses were hit hard by the 2007-2009 recession and so far have experienced a sluggish recovery relative to larger firms.
- Yet recent survey and employment data point to a pickup in activity.
- Going forward, an improved sales outlook and access to financing will be key to strengthening the nascent US small business recovery.
- German *Mittelstand* is actively engaged in the US market and is in a good position to take advantage of improving economic conditions.

Small businesses are a key source of innovation and new job creation, representing one-half of US private nonfarm employment and GDP. The US economy cannot hope to stage a sustained, robust recovery until small businesses start investing and hiring again.

Not leading the recovery this time

Small businesses (generally defined in the US as firms with less than 500 employees, see page 4, box 3) experienced particularly deep losses in the most recent recession and have been slow to recover. One reason for this is that the construction sector, 86% of which is comprised of small firms, was disproportionately hard hit and has struggled through a protracted downturn. A second reason is that the financial crisis that set off the most recent recession resulted in tighter terms of credit for loans to small businesses, which rely more heavily on traditional bank loans and other forms of credit, as opposed to equity borrowing. As a result, small businesses started shedding jobs earlier than large firms. Very small firms (with less than 20 employees) experienced net job losses already in the second quarter of 2007. Between the beginning of 2008 and mid-2009, these smallest firms accounted for 24% of net job losses, with an additional 36% of net job losses in small businesses with 20-499 employees. Larger firms (more than 500 employees) accounted for 40% of net job losses. This contrasts with the experience of the 2001 recession, when large firms suffered larger job losses than small firms. According to Department of Labor and Census Bureau data, small businesses (in particular very small firms) produced net job gains more quickly than large firms following previous recessions. However, in the current recovery, large firms have thus far recovered faster, while job gains have been slower to accelerate at small firms.

Why have small businesses been slow to recover this time around? Lackluster sales and uncertainty about the economy appear to be the greatest impediments to a small businesses recovery. According to a National Federation of Independent Business (NFIB) report published in February 2010, 51% of small employers cited slow or declining sales as their principal immediate economic problem and 22% cited uncertainty, while 8% cited access to credit. Still, according to the same survey, only 40% of small business owners attempting to borrow in 2009 had all of their credit needs met (against 23% who had none of their credit needs met).

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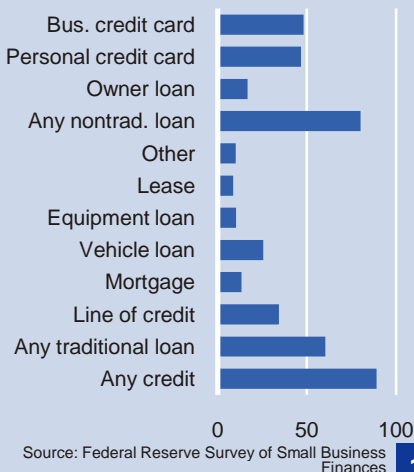
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US small businesses financing

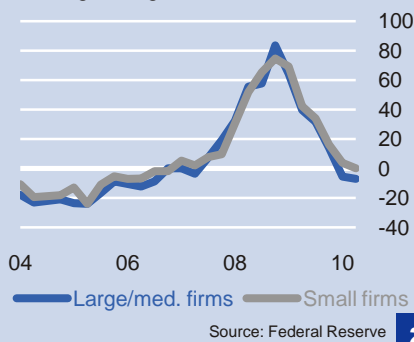
Small businesses primarily obtain funding through commercial banks and non-depository institutions. According to a February 2010 survey from the National Federation of Independent Business, 46% of small business owners cite one of the largest 18 commercial retail banks as their primary financial institution, 34% cite a local bank, and 18% a regional bank.

Small business credit by type



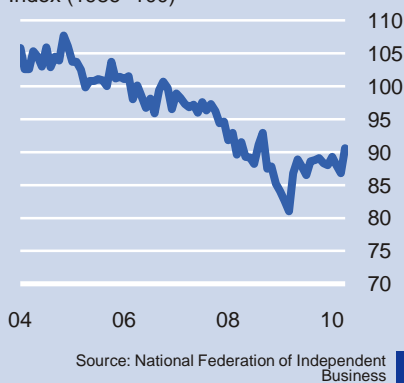
Standards still tight for small business loans

Net percentage of domestic respondents tightening standards for C&I loans



Small business optimism

Index (1986=100)



Falling real estate values have also had a negative impact on small business owners' ability and capacity to borrow. With 95% of small businesses owning real estate and many of these having used it as a source of financing (home equity loan or collateral) during the housing boom, the real estate bust and its tepid recovery has been another factor slowing the recovery of small businesses.

Credit crunch for small business?

Lending to small businesses fell precipitously as a result of the financial crisis and has been slow to recover due to both constrained supply and weaker demand for credit. According to the Federal Reserve, outstanding loans to small businesses decreased from nearly USD 700 bn in Q2 2008 to circa USD 660 bn in Q1 2010. Small businesses, which depend primarily on commercial bank loans for their financing (like in Germany), have been disproportionately affected by the precipitous drop in commercial bank lending, including the decline in commercial and industrial (C&I) loans and commercial real estate and credit card lending. Terms on small business loans tightened considerably during the recession, and interest rate spreads on C&I loans to small businesses increased during 2009 by about 100 basis points, reaching their highest levels in over a decade. Credit conditions for small businesses have also suffered because their finances in many cases are closely linked to the personal finances of small business owners. According to the Federal Reserve, 11% of US households own and manage a small business, 18% of which use personal assets as collateral or guarantee for loans, and a similar percentage have made a loan to the business. The steep fall in home values and related deterioration in household balance sheets has likely limited the access of many small business owners to loans.

Contrary to past recessionary experiences, lending programs guaranteed by the US Small Business Administration (SBA) also declined sharply due to a severe tightening in the secondary market for SBA guaranteed loans. Greater government funding since 2009 has helped increase these loans; still, the results of the most recent Senior Loan Officer Opinion Survey from the Federal Reserve, published in April 2010, show that credit remains tight, particularly for smaller firms. Lending standards for commercial and industrial loans to small businesses (defined for this survey as annual sales of less than USD 50 m) were roughly unchanged, while they were eased for larger firms. Terms on such loans were tightened further in the first quarter of 2010, while on average they were eased for larger firms. Demand for all loan types weakened in comparison to the previous survey. In addition, the survey results showed that banks had continued to tighten terms on business credit card loans to small firms over the past six months.

Survey data starting to pick up

Small business surveys have begun to improve since the beginning of 2010, though they still exhibit some lingering anxiety about economic prospects, concern about poor sales, and hesitancy to hire. The pick up has lagged the recovery of indices such as the Institute for Supply Management (ISM), which are heavily weighted toward large firms and began turning up already in Q3 2009. In May 2010, the monthly Small Business Optimism index of the National Federation of Independent Business (NFIB) rose to over 90 for the first time in 19 months. The NFIB indices for earnings and sales have also risen moderately since the second quarter of 2010. Other

SBA Loan Programs

Banks and other lending institutions offer a number of SBA guaranteed loan programs to assist small businesses. While SBA itself does not make loans, it does guarantee loans made to small businesses by private and other institutions. Participating lenders agree to structure loans according to SBA's requirements, and apply and receive a guaranty from SBA on a portion of this loan. Guarantees on 7(a) and 504 loans were raised to 90% as part of the Recovery Act. SBA offers the following loan programs:

- 7(a) Loan Program for a variety of general business purposes, including working capital, machinery and equipment, furniture and fixtures, land and building, and debt refinancing.
- CDC/504 Loan Program to provide long-term, fixed-rate financing for the purchase of fixed assets (such as real estate or equipment). These loans are delivered by CDCs (Certified Development Companies) – private, non-profit corporations set up to contribute to the economic development of their communities.
- Microloan Program to provide small (up to \$35,000) short-term loans for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment.
- Disaster Assistance Loan Program to provide low-interest loans to repair or replace property, equipment and assets damaged or destroyed in a declared disaster.

Source: SBA

small business surveys, such as American Express, Discover and Intuit, also point to a growing willingness to hire and invest on the part of small business. Moreover, according to Intuit and ADP data, small businesses appear to have started to hire again.

Role of stimulus and other policy initiatives

The Feb 2009 American Recovery and Reinvestment Act (ARRA) increased direct funding for the Small Business Administration by USD 730 m, the bulk of which has been used to raise guarantees and reduce fees for some USD 28 bn in SBA-guaranteed loans. SBA loan volumes are nearly back to their levels before the credit freeze. In addition, the Federal Reserve, in conjunction with the Treasury Department, initiated in late 2008 the Term Asset-Backed Securities Loan Facility (TALF), to promote the issuance of securities backed by loans to households and small businesses, including auto loans, credit card loans, and SBA-guaranteed loans. According to the Federal Reserve, the TALF has helped finance nearly 500,000 loans to small businesses.

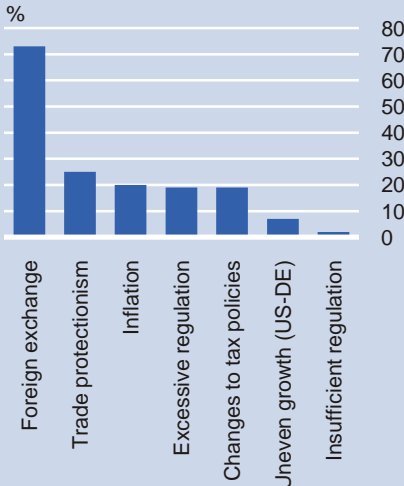
More generally, US fiscal stimulus is helping to support small businesses, particularly through financing for infrastructure projects, which helps the small-business-dominated construction sector. Congress also recently passed a small business hiring tax credit, which provides a payroll tax cut for small businesses that hire new employees this year. While this tax credit could have a temporary effect on small business hiring, it is unlikely to provide a large or prolonged impulse. Small businesses, for whom economic uncertainty and sales prospects are the greatest concerns, are unlikely to hire new workers solely in response to the tax credit. Many of the current sources of stimulus are scheduled to end as early as this year; still, political pressure to support small businesses remains high and will likely result in further extensions of government support (e.g., for SBA programs).

Opportunities for German Mittelstand

The nascent recovery of US small business is also a positive for German *Mittelstand* companies. At the end of 2008, 3,000 German firms, the overwhelming majority of them *Mittelstand*, held USD 212 bn in investment and employed 664,000 people in the US. German firms operating in the US appear to have weathered the economic and financial crisis relatively well, and are in a good position to take advantage of improving economic conditions. The German-American Business Outlook Survey from November 2009 revealed that German firms in the US are moderately optimistic about the prospects for US growth and slightly more optimistic about their own firms' expansion, after having streamlined their businesses in response to the crisis. While 43% of German firms reported having laid off workers during the recession, over 80% planned no additional layoffs, and a significant majority did not consider access to financing a problem.

According to the survey (76% of whose respondents belonged to the classic *Mittelstand* with fewer than 250 employees), foreign exchange fluctuation was the top concern of German firms operating in the United States. The depreciation of the USD in 2008 and 2009 had a negative effect on US subsidiaries of German firms who report their earnings in EUR and/or that have high non-US costs. The recent strengthening of the USD against the EUR has come as a relief to these firms and should increase the attractiveness of the US market to German *Mittelstand* firms – provided they view EUR

German firms' assessment of cross-border risks



Source: German American Business Outlook 2009

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US definition of “small business”

Small business size standards are established by the US Small Business Administration (SBA) on an industry-by-industry basis, but the general SBA definition is a for-profit, independently owned and operated business concern with fewer than 500 employees for manufacturing businesses and less than USD 7 million in annual receipts for most nonmanufacturing businesses. The specific size standards apply to SBA’s financial assistance and to its other programs, as well as to Federal government procurement programs when there is a benefit associated with qualifying as a small business. US ‘small’ businesses are on average larger than in Europe. While 42% of US companies would fall under the European definition of small or medium-sized enterprise (i.e., fewer than 250 employees), the share is at least 50% in Europe and over 60% in Germany.

Source: SBA, OECD

weakness as a longer-term phenomenon rather than just temporary. German firms did not consider themselves either positively or negatively affected by the American stimulus legislation, with small percentages reportedly being either having accessed stimulus funding from the US government or having been adversely affected by the ‘Buy American’ provisions of the American Recovery and Reinvestment Act of 2009. The threat of US trade protectionism was reportedly a concern for one-fourth of German firms operating in the United States.

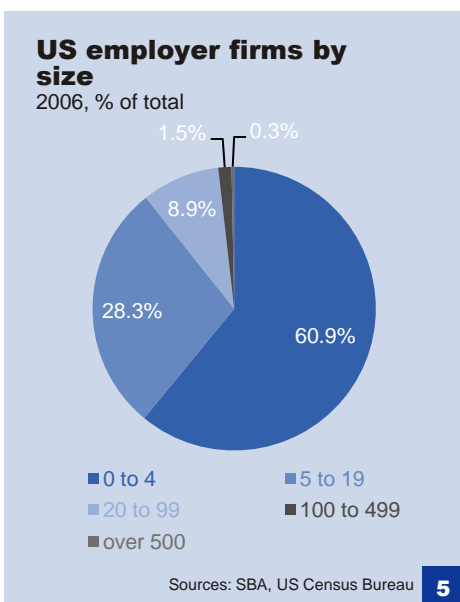
The survey revealed that German firms see the greatest future opportunities for investment in the US in the areas of health care, energy and environmental technology, machine-building and plant engineering, automotive and electrical – all sectors where Germany is strong in terms of technology and innovation. In particular, German firms saw future growth prospects in the US market for renewable energy as well as energy efficiency and infrastructure. With regard to strategies for increasing US sales, the German companies said they planned to focus most on introducing new product lines and entering new customer markets. Many also expressed their intention to expand geographically in the US, as well as to increase marketing initiatives, a particularly important aspect of doing business successfully in the United States.

Confidence and credit crucial for outlook

Going forward, the most important factors for the small business recovery will be a continued strengthening in domestic consumer demand and access to financing. Encouragingly, growth in personal consumption expenditures increased relatively strongly in the first half of 2010, and the ‘jobless recovery’ is slowly beginning to give way to job creation. However, consumers may remain tentative in the face of still-high unemployment and over-stretched household balance sheets. Sustained, strong consumer demand will be necessary to improve the outlook for sales and earnings for small businesses, at which point access to financing will become an essential factor for small businesses to take advantage of increased demand through new investment and hiring.

Longer-term, a number of other factors will play a role, chief among them the availability of affordable health insurance, which was the number one concern of small business owners prior to the crisis. Steeply rising health insurance premiums and high administrative costs for small group insurance plans have made it more costly for small businesses to offer their employees health insurance. As a result, employees at small businesses are nearly twice as likely to be uninsured as employees of larger firms. While the passage of the health care reform legislation in March 2010 should at least help reduce political uncertainty surrounding this issue, the impact of the law on small businesses in practice is not yet clear and will affect firms differently depending on size and other factors. Firms with fewer than 25 employees will benefit from a tax credit to provide health insurance to their employees, but as of 2014 firms with over 50 employees will be fined if they do not provide health insurance.

Other factors that will affect the longer-term health of small businesses include the ability to attract qualified workers, global competition, tax and regulatory policies, and access to government procurement contracts. With respect to procurement, just 22% of federal procurement dollars spent in 2007 went to small businesses. Tax issues which have increased uncertainty for small businesses include the imminent scheduled expiration of tax cuts enacted under





Backbone of the economy

US small businesses ...

- Represent 99.9% of all US businesses (employer and non-employer)
- Employ about half of all private sector employees
- Pay 44% of total US private payroll
- Generated 64% of net new jobs from 1993 to 2008
- Create about half of nonfarm private GDP
- Are 52% home-based and 2 percent franchises
- Produced 30.2% of export value in 2007
- Produce 13 times more patents per employee than large firms.

Source: SBA

the Bush Administration, as well as the future of the Alternative Minimum Tax, which ensnares an increasing number of taxpayers (including many small business owners) each year. Climate legislation, including the establishment of a cap-and-trade system to reduce carbon emissions, represents an additional political uncertainty for small businesses.

On the more positive side, small businesses may soon receive government assistance to boost their exports, under the Obama Administration's new goal to double US exports by 2015. In 2007, small businesses accounted for less than a third of total US goods exports, and less than 2% of small businesses exported goods or services.

Conclusion

The deep US recession forced many US small businesses to streamline their operations, cut expenses (including payroll) and improve their balance sheets. These reactions led to a deeper pullback in activity during the recession and to greater caution on the part of small businesses even as the overall economy started to recover. However, these adjustments have helped to position small business for a healthy, if somewhat delayed, recovery. While access to credit is not cited as a major impediment to small business activity so far in the cycle, standards and terms of credit to small businesses remain tight and will be a key factor as firms seek expansion financing as they become more confident about their business prospects. Consumer demand and spending will also need to continue to improve in order to bolster earnings, sales and confidence that will in turn spur small business investment and hiring.

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Economic indicators

% change yoy

	USA			Eurozone		
	2009	2010F	2011F	2009	2010F	2011F
GDP	-2.4	3.4	3.5	-3.9	1.0	1.1
Private consumption	-0.6	2.5	3	-0.9	0.3	0.6
Investments	-23.2	14.4	10.4	-13.3	1.6	3.8
Exports	-9.6	11.4	7.4	-12.6	5.0	3.0
Imports	-13.9	9.5	7.8	-11.2	4.7	4.1
Inflation	-0.3	2	1.9	0.3	1.3	1.3

Source: DB Research

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