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The Bright Side

Some small businesses are struggling to get credit, but that's the least of their problems. Those that survive the recession will be stronger for it and lead the economy's recovery

.IMAGE CREDIT: JONATHAN HANSON

IN AFGHANISTAN AND IRAQ, U.S. troops often use ultra-high-tech cameras whose images enable them, at a safe distance, to identify their targets, develop a plan of attack, and, everyone hopes, avoid civilian casualties. Those images are projected on a screen, the better for the entire team to view them. That screen is held steady on a wire stand, which allows for hands-free operation. And that stand is manufactured by Marlin Steel Wire Products.

The Marlin factory sits on Baltimore's outskirts, in a vast brick building that houses a dozen or so companies, from manufacturers to shipping and storage. In fact, Marlin's public face is so unobtrusive that I would never have found it without the exact address.

But behind that blank brick wall is an array of robots, stamping machines, and other equipment marvelous enough to swell the heart of any red-blooded fan of the industrial revolution. On the day I visited, workers in shorts and goggles on one side of the floor were spot-welding baskets to hold components for Honeywell. On the other side, machines were doing work all by themselves. I watched, somewhat awestruck, as one machine put a series of complicated crimps in a piece of wire that was then grabbed by a robot, which rotated the wire, put it back in the machine for a final crimp, and then deposited it onto a rack of identical wire parts—brackets, as it turned out, for telecom cabinets. That day they were going to Singapore, but they could have been going to any of the 29 countries and counting to which Marlin now exports.

These days, a lot of people are anxiously watching operations like this. But they're not watching for enjoyment; they're watching for signs of health, the way old people sometimes compulsively check their blood pressure. Small businesses have become a bellwether for the condition of the American economy. Indeed, to hear politicians talk, small business is—pick your favorite cliché—the lifeblood, the backbone, the thunderously beating heart of the American economy.

Like most clichés, these have some truth. America could truly not survive without operations like Marlin Steel Wire Products. Among other things, they produce specialized parts like that stand, in small production runs that would be uneconomical on the scale of an airplane or automobile plant. Even mighty industrial machines cannot survive without tiny cogs.

Small firms also churn out jobs. Companies with fewer than 500 workers employ roughly half of all American workers, and according to the Census Bureau, more than 70 percent of net new jobs between 1993 and 2006 were created in firms that had fewer than 20 employees at the start of the survey period. But small businesses, which are well down the supply chain, also often find themselves under the greatest pressure from corporate cost-cutting—on the tail end of a particularly vicious game of Crack the Whip. That's why small businesses are also disproportionately where jobs are lost, an effect that downturns greatly magnify.

To add to their woes in the current recession, bank financing seems to have dried up. A survey in April 2010 by the Atlanta branch of the Federal Reserve found that in the previous three months, 40 percent of small-firm applications for credit had been denied, and many of those who were offered credit either got less than they requested, or refused it because of unattractive terms. It's a problem severe enough to have attracted the attention not only of the Obama administration, but also of the Federal Reserve itself, which convened a high-profile conference this July on "Addressing the Financing Needs of Small Businesses."

This combination of factors has triggered the policy-wonk equivalent of the chicken-and-egg debate: which came first, terrible business, or terrible credit? And what can, or should, the government do to help?

Small businesses are clearly hurting: in a survey done in May by the National Federation of Independent Business, less than 10 percent of respondents thought conditions were healthy. The survey also showed that sales and profits had just about recovered to where they were at the very bottom of the 2001 recession.

Bankers say they'd like to lend small businesses more money, but creditworthy firms aren't seeking loans, while too many would-be borrowers need the cash just to stay afloat. (The latter group recalls a bitter adage, popular during the Great Depression: "A banker is someone who lends you an umbrella, then asks for it back as soon as the rain starts.") As Federal Reserve Governor Elizabeth Duke noted during the July conference, "Bankers are predisposed to lending, because without lending there can be no profit." Sheer meanness isn't a very likely explanation of the credit crunch.

As Duke went on to say, of course, the banks are having a few credit troubles of their own. Small-business lending often rests on relationships, and unfortunately, the banking partners of some businesses now have balance sheets impaired by portfolios of bad loans on things like residential and commercial real estate. Others may be worried about concentrating their lending in too few sectors, and may need to diversify by lending less to old customers, perhaps, and more to new ones.

But the problems on the business side are greater still: collapsing collateral values, poor cash flow, and even the personal finance troubles of the owners. Many a successful entrepreneur got his or her seed capital from Visa and MasterCard, and even more-established proprietors tend to have their personal finances heavily entangled with their businesses. A modest dip in sales may leave an owner with a viable business, but an unviable mortgage. The resulting hit to the credit score is hard to explain to already anxious bankers.

We seem to worry more about credit for small businesses than do the firms themselves. The NFIB survey includes questions on finance, and while the results are certainly dismal, with assessments of credit conditions hovering near record lows, just 3 percent of those surveyed report that credit conditions are their largest problem. “What businesses need,” the authors rather tartly conclude, “are customers.”

If a simple shortage of bank capital were a major problem for all small businesses, Drew Greenblatt, the owner of Marlin, might not have had so many high-tech machines to show me. Several of the machines were purchased, and financed, in the past two years. Greenblatt, looking slightly incongruous in a blazer and chinos but clearly in his element, lovingly described the history of each piece of equipment. Three of the machines were of recession-era provenance, including one he managed to buy at a fire-sale price in December 2008, financed 100 percent with a loan from M&T Bank. Another, financed by Wells Fargo, had a space waiting for it and was due to be installed within a few weeks. You expect to see these sorts of devices on a Boeing assembly line, or on the factory floor at GM—in fact, one of them was purchased from a now closed GM plant. Seeing them efficiently stamping out parts on a yeoman scale is more surprising.

Marlin’s specialty is custom work for demanding clients like Toyota, who need precision and quick turnaround. The business that Greenblatt bought 12 years ago used minimum-wage labor to manufacture bagel baskets from rough specifications written out on notepaper and stored in an untidy pile; that business was undercut by Chinese competitors who charged less for a finished basket than he paid for the steel. Greenblatt moved the company from Brooklyn to Baltimore and invested in equipment that was faster and more precise than the old labor-intensive methods of production.

Greenblatt boldly stuck with this strategy when the recession hit. Most firms are staying out of the credit markets entirely, and most of the firms that do seek financing aren’t doing so to make capital investments; according to the Atlanta Fed, the most frequently cited reasons for seeking capital are “Replace an existing loan or line of credit” and “Obtain additional working capital.” Only 20 percent of companies in the NFIB survey said that they plan to make capital improvements in the near future. That’s an increase from the 35-year low of 16 percent, reached in December 2009. But it’s not *much* of an increase.

Taking on new debt in the middle of the worst recession in living memory may seem a little crazy. But for Greenblatt, it has paid off in new business; Marlin is having its best year ever, in terms of both profits and sales. Greenblatt has taken business away from competitors, in part because he now has a staff of mechanical engineers who can work with client companies to custom-design racks to hold delicate parts without damaging them. Those engineers then program the machines to highly exact specifications, a process that can take a day or two. “With the bagel racks,” he said, “it’s a bagel—as long as you’re within a couple of inches, you’re fine.” With a fond glance at his new stamping machine, he added proudly, “I’ve gone from one or two inches, to one-tenth of a millimeter.” Business in this sort of work is so good that on the other side of the factory wall, they’re clearing space to build a desk for the new engineer he’s hiring.

But precision and quick turnaround aren’t the only benefits his investments have yielded. Greenblatt now pays his workers anything from $15 to $30 an hour, plus benefits like health insurance and 401(k) plans; he told me with obvious satisfaction that most of his workers own homes. Nonetheless, he’s actually cutting production costs. Increasingly, he gets clients simply because he can undercut competitors. He’s even managed to take work back from China.

Taking on new debt was not so crazy, then. Besides, hunkering down and hoarding cash isn’t necessarily working out for his competitors. Greenblatt talks about life at the ugly end of the supply chain. “A purchasing manager suddenly realizes he has a warehouse full of stuff, and if he doesn’t reorder, that’s maybe $8 million in cash he saves for his company. But for a guy he buys from—that guy loses $4 million worth of business. People are cutting back staff, hoarding their own cash, keeping it going with their reserves. But how long can they do that? One year? Three years?” He pauses, and the look on his face is anything but triumphant. “I’m guessing it’s not three years.” Several of his competitors have already gone out of business. He expects more to follow.

Greenblatt has seen credit tightening. Like other business owners, he reports that loans are harder to get; loan officers who were once satisfied with a few years of personal and business financial records now want to dig through accounts receivable and profit-and-loss statements. And the time necessary to secure a loan has stretched from 60 days to 90 or more. But interest rates are actually lower, thanks to the recession and the super-loose Fed policy it spawned.

Recessions can actually be good for some firms, even start-ups (or at the very least, can leave their founders with few viable alternatives). General Electric was just getting going during the Panic of 1893. Hewlett and Packard started their business during the Great Depression. The 1974–75 recession gave us Microsoft, and the 1980 slowdown birthed CNN. All of these companies revolutionized their industries, and the American economy.

Joseph Schumpeter's process of "creative destruction"—the cycle of company birth and death that constantly renews the economy—happens fastest at the small-business level, where the competitors are most numerous and the pressures are most intense. And the firms that survive, whether by investing in better equipment, as Marlin has done, or by streamlining their internal costs, will make the economy stronger when we emerge from this mess.

That doesn't mean that the companies that shut their doors, or the workers they lay off, "deserve" their fate. Many of the firms that close, of course, have been mismanaged, but many others are simply victims of fate, or of circumstances beyond their control. But credit is the least of those circumstances. Money is available for firms that can employ it productively; the problem is, too many firms can't.

So why does lending obsess us so feverishly? Why were loans the main focus of the small-business bill the administration was pushing this summer? (When GOP senators opposed it, President Obama responded not with logic, but with a tug at the heartstrings, calling small businesses—you guessed it—"the backbone of our economy," saying that helping them is as "American as apple pie" and that they are "going to lead this recovery." One can only hope that the clichés were manufactured by a proud American small business.)

Small business *will* help lead the recovery: some firms now small will get big, and others, like Marlin, will help make the bigger firms better. And some firms will go out of business, paving the way for better-positioned competitors. We can't do much to improve this process, other than use things like unemployment insurance to ease the suffering of those hurt by it.

Unfortunately, as we found out during the long boom, extending iffy loans is rarely the best way to help those who are suffering. Credit magnifies our fortunes—it helps companies with strong cash flows like Marlin's, but often all it does for those in trouble is provide some extra rope, and maybe help tie the noose.

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