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CAN SMALL FIRMS WEATHER THE ECONOMIC EFFECTS OF COVID-19?

With each day that passes, the far-reaching economic implications of the COVID-19 pandemic become increasingly apparent. Of particular concern are the effects the pandemic is having and will continue to have on small businesses as they endure the direct impacts of social distancing directives, including temporary closures and modified operations. With declining revenues, many small firms have had to lay off employees. Governments have begun offering small business loans with attractive interest rates and repayment terms in order to help smooth cash flow and retain employees.[1] While we do not have real-time data on the quickly changing small business conditions, the 2019 Small Business Credit Survey sheds light on how firms are likely to remain afloat during this uncertain time.

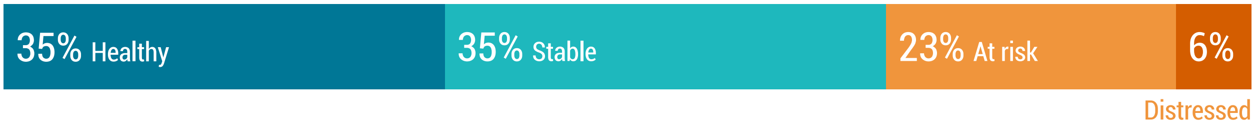
Overall, we find:

- Even in late 2019, a period characterized by positive economic growth and low unemployment, small businesses exhibited varying degrees of financial health. Smaller firms, younger firms, and firms helmed by black or Latino owners were more likely to be classified as “at risk” or “distressed.”
- Only one in five healthy firms (and even fewer less-healthy firms) had sufficient cash reserves to continue normal operations if they experienced a two-month revenue loss. A majority of small businesses would be likely to reduce their workforce and operations, or delay payments. Many firms would rely on personal funds or debt to bridge the gap.

UNDERLYING FINANCIAL HEALTH

First, we looked at firms’ financial health in 2019, focusing on profitability, credit risk, and business funding. Among these three facets, we categorized “healthy” firms as those that are profitable, have higher credit scores (low credit risk),[2] and use retained business earnings[3] to fund the business. Firms that meet only two of these criteria are “stable,” one of these criteria are “at risk,” and none of these criteria are “distressed.” Figure 1 shows aggregate percentages.

FIGURE 1 FINANCIAL HEALTH SPECTRUM[4] N=3,267



1 See for example: https://www1.nyc.gov/site/sbs/businesses/covid19-business-outreach.page; https://portal.ct.gov/DECD/Content/Business-Development/05_Funding_Opportunities/Small-Business-Express; https://www.sba.gov/about-sba/sba-newsroom/press-releases-media-advisories/sba-provide-disaster-assistance-loans-small-businesses-impacted-coronavirus-covid-19.

2 Credit risk is based on the self-reported business credit score or personal credit score, depending on which is used. If the firm uses both, the lower credit score is used. “Low credit risk” is a 80–100 business credit score or 720+ personal credit score.

3 Primary source of business funding is retained earnings, rather than external financing or personal funds.

4 Percentages may not sum to 100 due to rounding.

Source: Federal Reserve Banks, 2019 Small Business Credit Survey

However, the aggregate numbers mask variation in the small business population. As shown in Figure 2, some firms tended to be financially healthier than others, including larger and more mature firms. In contrast, smaller firms, younger firms, and firms with black or Latino owners were more likely to show signs of limited financial health. It is important to note that firms helmed by black or Latino owners face structural barriers that influence their business' financial health.[4]

FIGURE 2 FINANCIAL HEALTH SPECTRUM BY FIRM CHARACTERISTICS[5]

		Healthy	Stable	At risk	Distressed
	All firms N=3,267	35%	35%	23%	6%
Annual revenue	$100K or less N=287	8%	30%	45%	17%
	$100K-$1M N=1,169	30%	39%	23%	8%
	More than $1M N=1,626	45%	34%	18%	3%
Number of employees	1-4 employees N=1,207	32%	36%	25%	8%
	5-19 employees N=1,416	35%	36%	23%	6%
	20-499 employees N=644	47%	32%	17%	4%
Age of firm	0-5 years N=890	23%	37%	31%	8%
	>5 years N=2,377	41%	35%	19%	5%
Industry	Non-manufacturing goods production & associated services N=647	33%	36%	25%	6%
	Retail N=362	34%	37%	25%	5%
	Leisure & hospitality N=325	27%	37%	28%	8%
	Healthcare & education N=286	38%	35%	22%	5%
Race/ethnicity of ownership[6]	Non-Hispanic White N=2,486	37%	36%	22%	5%
	Non-Hispanic Black or African American N=335	17%	26%	37%	21%
	Non-Hispanic Asian N=127	29%	40%	23%	8%
	Hispanic N=269	22%	29%	31%	18%

DEALING WITH FINANCIAL LOSS

A new question in the 2019 survey asked business owners how they would respond to a potential financial loss equal to two months of their revenues. Unfortunately, the scenario posed in this question no longer represents a hypothetical situation for firms facing the effects of COVID-19.

As shown in Figure 3, we find that responses differ across the financial health spectrum. Only one in five healthy firms reported they could continue business as usual with their cash reserves; this number falls to less than one in ten among stable, at-risk, and distressed firms. Further, there are clear work-force implications, as two of the most common responses include reducing salaries and laying off workers, especially among the healthiest firms. To bridge funding gaps, firms in all four categories said they would rely on the owners' personal funds, but this tactic was more common among at-risk and distressed firms. In addition, at-risk and distressed firms were more likely to report an inclination to take out debt than were healthier firms. This may have an impact on the types of recovery programs and loans that could work best for different types of small businesses.

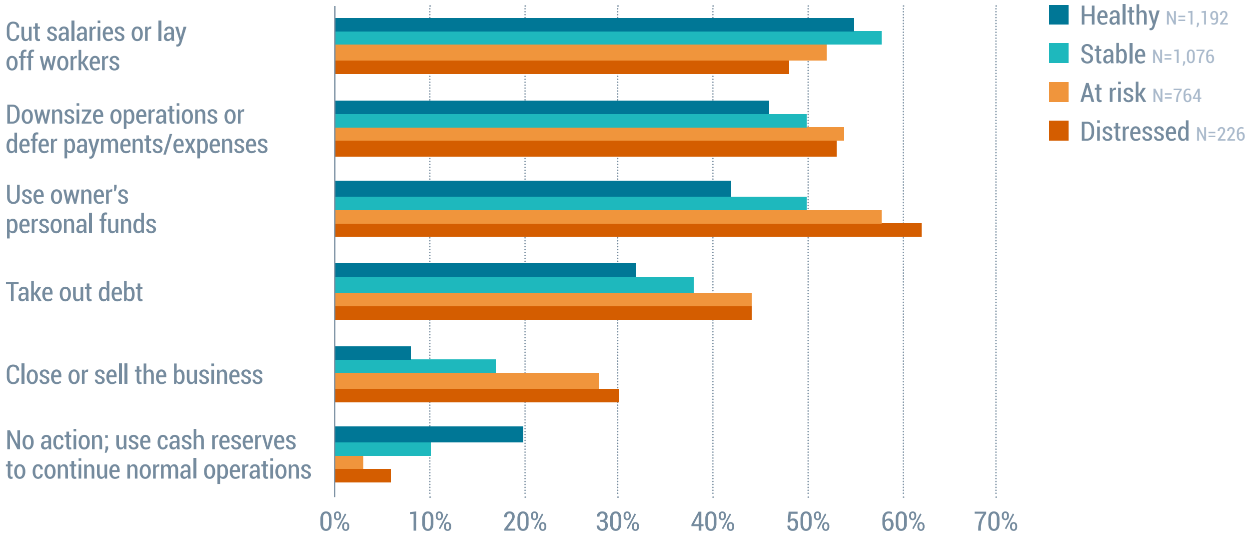
4 For example, black- and Latino-owned firms are more likely to report higher credit risk ratings than white-owned firms. For more information, see: https://www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2019/20191211-ced-minority-owned-firms-report.pdf.

5 Percentages may not sum to 100 due to rounding.

6 This table uses Census-defined categories of race and ethnicity. In the text of this paper, we use "Latino" instead of "Hispanic."

Source: Federal Reserve Banks, 2019 Small Business Credit Survey

FIGURE 3 **ACTIONS FIRMS WOULD TAKE TO RESPOND TO A 2-MONTH REVENUE LOSS**[7]



CONCLUSION AND IMPLICATIONS

Understanding the financial position of small firms prior to the onset of the COVID-19 pandemic can help inform efforts to support those businesses through these challenging times. As demonstrated in the survey responses, small businesses vary greatly in their financial strength and resilience in the face of significant financial challenges. The data presented here provide insights on firms' planned responses to a particularly relevant hypothetical scenario of revenue losses. This preview of firms' expected actions can provide policymakers with important information as they determine the most effective responses to the current crisis.

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7 Respondents could select multiple options. Some response options have been combined for readability.

Source: Federal Reserve Banks, 2019 Small Business Credit Survey