Chapter 12 Sources of Financing: Debt and Equity

If you don't know who the fool is in a deal, it's you.
—Michael Wolff

There's many a pessimist who got that way by financing an optimist.
—Anonymous

LEARNING OBJECTIVES

Upon completion of this chapter, you will be able to:

1. **EXPLAIN** the differences in the three types of capital small businesses require: fixed, working, and growth.
2. **DESCRIBE** the differences in equity capital and debt capital and the advantages and disadvantages of each.
3. **DISCUSS** the various sources of equity capital available to entrepreneurs, including personal savings, friends and relatives, angels, partners, corporations, venture capital, and public stock offerings.
4. **DESCRIBE** the process of "going public," as well as its advantages and disadvantages and the various simplified registrations and exemptions from registration available to small businesses wanting to sell securities to investors.
5. **DESCRIBE** the various sources of debt capital and the advantages and disadvantages of each: banks, asset-based lenders, vendors (trade credit), equipment suppliers, commercial finance companies, savings and loan associations, stockbrokers, insurance companies, credit unions, bonds, private placements, Small Business Investment Companies (SBICs), and Small Business Lending Companies (SBLCs).
6. **IDENTIFY** the various federal loan programs aimed at small businesses.
7. **DESCRIBE** the various loan programs available from the Small Business Administration.
8. **DISCUSS** valuable methods of financing growth and expansion internally.

Raising the money to launch a new business venture has always been a challenge for entrepreneurs. Capital markets rise and fall with the stock market, overall economic conditions, and investors' fortunes. These swells and troughs in the availability of capital make the search for financing look like a wild rollercoaster ride. For instance, during the late 1990s, founders of dot-com companies were able to attract mountains of cash from private and professional investors, even if their businesses existed only on paper! Investors flocked to initial public offerings from practically any dot-com company. The market for capital became bipolar: easy-money times for dot-coms and tight-money times for "not-coms." Even established, profitable companies in "old economy" industries such as manufacturing, distribution, real estate, and brick-and-mortar retail could not raise the capital they needed to grow. Then, early in 2000, the dot-com bubble burst, and financing an Internet business also became extremely challenging.

Today, the challenge of attracting capital to start or to expand a business remains. Most entrepreneurs, especially those in less glamorous industries or those just starting out, face difficulty finding outside sources of financing. Many banks shy away from making loans to start-ups, venture capitalists have become more risk averse, private investors have grown cautious, and making a public stock offering remains a viable option for only a handful of promising companies with good track records and fast-growth futures. The result has been a credit crunch for entrepreneurs looking for small to moderate amounts of start-up capital. Entrepreneurs and business owners needing between $100,000 and $3 million are especially hard hit because of the vacuum that exists at that level of financing.

In the face of this capital crunch, business's need for capital has never been greater. Experts estimate the small business financing market to be $170 billion a year; yet, that still is not enough to satisfy the capital appetites of entrepreneurs and their cash-hungry businesses.[1] When searching for the capital to launch their companies, entrepreneurs must remember the following "secrets" to successful financing:

- *Choosing the right sources of capital for a business can be just as important as choosing the right form of ownership or the right location.* It is a decision that will influence a company for a lifetime, so entrepreneurs must weigh their options carefully before committing to a particular funding source. "It is important that companies in need of capital align themselves with sources that best fit their needs," says one financial consultant. "The success of a company often depends on the success of that relationship."[2]
- *The money is out there; the key is knowing where to look.* Entrepreneurs must do their homework *before* they set out to raise money for their ventures. Understanding which sources of funding are best suited for the various stages of a company's growth and then taking the time to learn how those sources work are essential to success.
- *Raising money takes time and effort.* Sometimes entrepreneurs are surprised at the energy and the time required to raise the capital needed to feed their cash-hungry, growing businesses. The process usually includes lots of promising leads, most of which turn out to be dead ends. Meetings with and presentations to lots of potential investors and lenders can crowd out the time needed to manage a growing company. Entrepreneurs also discover that raising capital is an ongoing job. "The fund-raising game is a marathon, not a sprint," says Jerusha Stewart, founder of iSpiritus Soul Spa, a store selling personal growth and well-being products.[3]
- *Creativity counts.* Although some traditional sources of funds now play a lesser role in small business finance than in the past, other sources—from large corporations and customers to international venture capitalists and state or local programs—are taking up the slack. To find the financing their businesses demand, entrepreneurs must use as much creativity in attracting financing as they did in generating the ideas for their products and services. For instance, after striking out with traditional sources of funding, EZConserve, a company that makes software that provides energy management tools for large PC networks, turned to the nonprofit group Northwest Energy Efficiency Alliance and received a sizable grant as well as marketing assistance that fueled its growth.[4]
- *The World Wide Web puts at entrepreneurs' fingertips vast resources of information that can lead to financing; use it.* The Web often offers entrepreneurs, especially those looking for relatively small amounts of money, the opportunity to discover sources of funds that they otherwise might miss. The Web site created for this book (www.prenhall.com/zimmerer) provides links to many useful sites related to raising both start-up and growth capital. The Web also provides a low-cost, convenient way for entrepreneurs to get their business plans into potential investors' hands anywhere in the world. When searching for sources of capital, entrepreneurs must not overlook this valuable tool!

- *Be thoroughly prepared before approaching potential lenders and investors.* In the hunt for capital, tracking down leads is tough enough; don't blow a potential deal by failing to be ready to present your business idea to potential lenders and investors in a clear, concise, convincing way. That, of course, requires a solid business plan.
- *Entrepreneurs cannot overestimate the importance of making sure that the "chemistry" among themselves, their companies, and their funding sources is a good one.* Too many entrepreneurs get into financial deals because they needed the money to keep their businesses growing only to discover that their plans do not match those of their financial partners.

Rather than rely primarily on a single source of funds as they have in the past, entrepreneurs must piece together capital from multiple sources, a method known as **layered financing.** They have discovered that raising capital successfully requires them to cast a wide net to capture the financing they need to launch their businesses.

layered financing—*the technique of raising capital from multiple sources.*

A Company Example

The founders of ***Med-Channel****, an Internet-based company that focuses on the medical supply industry, demonstrate the "patchwork" of start-up financing that has become so common. In addition to the initial capital the founders provided, the company raised $42 million in its early stages from 11 private investors. Then Med-Channel received a cash infusion from two venture capital firms. As the company grew, it turned to two investment banks and large corporations, including Johnson & Johnson and an Italian pharmaceutical company, to satisfy its capital requirements.*[5]

This chapter will guide you through the myriad of financing options available to entrepreneurs, focusing on both sources of equity (ownership) and debt (borrowed) financing.

PLANNING FOR CAPITAL NEEDS

Learning Objective

Becoming a successful entrepreneur requires one to become a skilled fund-raiser, a job that usually requires more time and energy than most business founders think. In start-up companies, raising capital can easily consume as much as one-half of the entrepreneur's time and can take many months to complete. Most entrepreneurs are seeking less than $1 million (indeed, most need less than $100,000), which may be the toughest money to secure. Where to find this seed money depends, in part, on the nature of the proposed business and on the amount of money required. For example, the originator of a computer software firm would have different capital requirements than the founder of a coal mining operation. Although both entrepreneurs might approach some of the same types of lenders or investors, each would be more successful targeting specific sources of funds best suited to their particular financial needs.

Capital is any form of wealth employed to produce more wealth. It exists in many forms in a typical business, including cash, inventory, plant, and equipment. Entrepreneurs need three different types of capital:

capital—*any form of wealth employed to produce more wealth.*

Fixed Capital

Fixed capital is needed to purchase a company's permanent or fixed assets such as buildings, land, computers, and equipment. Money invested in these fixed assets tends to be frozen because it cannot be used for any other purpose. Typically, large sums of money are involved in purchasing fixed assets, and credit terms usually are lengthy. Lenders of fixed capital expect the assets purchased to improve the efficiency and, thus, the profitability of the business and to create improved cash flows that ensure repayment.

fixed capital—*capital needed to purchase a company's permanent or fixed assets such as land, buildings, computers, and equipment.*

Working Capital

Working capital represents a business's temporary funds; it is the capital used to support a company's normal short-term operations. Accountants define working capital as current assets minus current liabilities. The need for working capital arises because of the uneven flow of cash into and out of the business due to normal seasonal fluctuations. Credit sales, seasonal sales swings, or unforeseeable changes in demand will create fluctuations in *any* small company's cash flow. Working capital normally is used to buy inventory, pay bills, finance credit

working capital—*capital needed to support a business's short-term operations; it represents a company's temporary funds.*

sales, pay wages and salaries, and take care of any unexpected emergencies. Lenders of working capital expect it to produce higher cash flows to ensure repayment at the end of the production/sales cycle.

Growth Capital

growth capital—*capital needed to finance a company's growth or its expansion in a new direction.*

Growth capital, unlike working capital, is not related to the seasonal fluctuations of a small business. Instead, growth capital requirements surface when an existing business is expanding or changing its primary direction. For example, a small manufacturer of silicon microchips for computers saw his business skyrocket in a short time period. With orders for chips rushing in, the growing business needed a sizable cash infusion to increase plant size, expand its sales and production workforce, and buy more equipment. During times of such rapid expansion, a growing company's capital requirements are similar to those of a business start-up. Like lenders of fixed capital, growth capital lenders expect the funds to improve a company's profitability and cash flow position, thus ensuring repayment.

Although these three types of capital are interdependent, each has certain sources, characteristics, and effects on the business and its long-term growth that entrepreneurs must recognize.

2. Describe the differences between equity capital and debt capital and the advantages and disadvantages of each.

EQUITY CAPITAL VERSUS DEBT CAPITAL

Equity capital represents the personal investment of the owner (or owners) in a business and is sometimes called *risk capital* because these investors assume the primary risk of losing their funds if the business fails.

A Company Example

*For instance, private investor Victor Lombardi lost the $3.5 million he invested in a start-up called **NetFax**, a company that was developing the technology to send faxes over the Internet. When NetFax's patent application stalled, the company foundered. Just three years after its launch, NetFax ceased operations, leaving Lombardi's investment worthless.*[6]

equity capital—*represents the personal investment of the owner(s) in a business and is sometimes called risk capital.*

If a venture succeeds, however, founders and investors share in the benefits, which can be quite substantial. The founders of and early investors in Yahoo, Sun Microsystems, Federal Express, Intel, and Microsoft became multimillionaires when the companies went public and their equity investments finally paid off. To entrepreneurs, the primary advantage of equity capital is that it does not have to be repaid like a loan does. Equity investors are entitled to share in the company's earnings (if there are any) and usually to have a voice in the company's future direction.

The primary disadvantage of equity capital is that the entrepreneur must give up some—perhaps *most*—of the ownership in the business to outsiders. Although 50 percent of something is better than 100 percent of nothing, giving up control of your company can be disconcerting and dangerous.

A Company Example

*For instance, when Gary Hoover launched **Bookstop Inc.**, a book superstore, he relied on equity financing so much that he was left with just 6 percent of his company's stock. Seven years after start-up, the venture capitalists who owned most of the stock fired Hoover from the company he founded!*[7]

Entrepreneurs are more likely to give up significant amounts of equity in their businesses in the start-up phase than in any other.

debt capital—*the financing that a small business owner has borrowed and must repay with interest.*

Debt capital is the financing that a small business owner has borrowed and must repay with interest. Very few entrepreneurs have adequate personal savings to finance the complete start-up costs of a small business; many of them must rely on some form of debt capital to launch their companies. Lenders of capital are more numerous than investors, although small business loans can be just as difficult (if not more difficult) to obtain. Although borrowed capital allows entrepreneurs to maintain complete ownership of their businesses, it must be carried as a liability on the balance sheet as well as be repaid with interest at some point in the future. In addition, because lenders consider small businesses to be greater risks than bigger corporate customers, they require higher interest rates on loans to small companies because of the risk-return trade-off—the higher the risk, the greater the return demanded. Most small firms pay the prime rate—the interest rate banks charge their most creditworthy customers—*plus* a few percentage points. Still, the cost of debt financing often is lower than that of equity financing. Because of the higher risks associated with providing equity capital to small companies, investors demand greater returns than lenders. Also, unlike equity financing, debt financing does not require an entrepreneur to dilute her ownership interest in the company. We now turn our attention to nine common sources of equity capital.

SOURCES OF EQUITY FINANCING

Learning Objective

Personal Savings

The *first* place entrepreneurs should look for start-up money is in their own pockets. It's the least expensive source of funds available! "The sooner you take outside money, the more ownership in your company you'll have to surrender," warns one small business expert.[8] Entrepreneurs apparently see the benefits of self-sufficiency; the most common source of equity funds used to start a small business is the entrepreneur's pool of personal savings.

A Company Example

In 1979, when Robert MacLeod and Stephen Byckiewicz launched ***Kiss My Face****, a company that sells a line of soaps and shampoos, they could not persuade a bank to lend them any money, so they pooled all they had—just $10,000—and invested it in the business. Sales were thin in the early years, but they climbed steadily with the help of creative marketing and the strategic partnerships with larger companies that MacLeod and Byckiewicz forged. The entrepreneurs financed their company's growth with retained earnings and some debt but retained 100 percent ownership. Today, Kiss My Face is debt free and tallies sales of more than $18 million. "We're very happy to have maintained complete control of our business," says MacLeod.*[9]

Lenders and investors *expect* entrepreneurs to put their own money into a business start-up. If an entrepreneur is not willing to risk his own money, potential investors are not likely to risk their money in the business either. Furthermore, failing to put up sufficient capital of their own means that entrepreneurs must either borrow an excessive amount of capital or give up a significant portion of ownership to outsiders to fund the business properly. Excessive borrowing in the early days of a business puts intense pressure on its cash flow, and becoming a minority shareholder may dampen a founder's enthusiasm for making a business successful. Neither outcome presents a bright future for the company involved.

Friends and Family Members

Although most entrepreneurs look to their own bank accounts first to finance a business, few have sufficient resources to launch their businesses alone. In fact, three out of four people who start businesses do so with capital from outside sources.[10] After emptying their own pockets, where should entrepreneurs turn for capital? The second place most entrepreneurs look is to friends and family members who might be willing to invest in a business venture. Because of their relationships with the founder, these people are most likely to invest. Often they are more patient than other outside investors and are less meddlesome in a business's affairs than many other types of investors. "Most of our relatives just told us to pay them back when we could," says an entrepreneur who used $30,000 from family members to launch a gourmet coffee business.[11]

Investments from family and friends are an excellent source of seed capital and can get a start-up far enough along to attract money from private investors or venture capital companies. Inherent dangers lurk in family business investments, however. Unrealistic expectations or misunderstood risks have destroyed many friendships and have ruined many family reunions. To avoid such problems, an entrepreneur must honestly present the investment opportunity and the nature of the risks involved to avoid alienating friends and family members if the business fails. On the other hand, some investments return more than friends and family members ever could have imagined. In 1995, Mike and Jackie Bezos invested $300,000 in their son Jeff's start-up business, Amazon.com. Today, Mike and Jackie own 6 percent of Amazon.com's stock, and their shares are worth billions of dollars![12]

Angels

angels—*wealthy individuals, often entrepreneurs themselves, who invest in business start-ups in exchange for equity stakes in the companies.*

After dipping into their own pockets and convincing friends and relatives to invest in their business ventures, many entrepreneurs still find themselves short of the seed capital they need. Frequently, the next stop on the road to business financing is private investors. These private investors or **"angels"** are wealthy individuals, often entrepreneurs themselves, who invest in business start-ups in exchange for equity stakes in the companies. Angel investors have provided much-needed capital to entrepreneurs for many years. In 1938, when World War I flying ace Eddie Rickenbacker needed money to launch Eastern Airlines, millionaire Laurance Rockefeller provided it.[13] Alexander Graham Bell, inventor of the telephone, used angel capital to start Bell Telephone in 1877.

In many cases, angels invest in businesses for more than purely economic reasons (for instance, because they have a personal interest in the industry), and they are willing to put money into companies in the earliest stages, long before venture capital firms and institutional investors jump in. Angel financing, the fastest-growing segment of the small business capital market, is ideal for companies that have outgrown the capacity of investments from friends and family but are still too small to attract the interest of venture capital companies. For instance, after raising the money to launch Amazon.com from family and friends, Jeff Bezos turned to angels because venture capital firms were not interested in a business start-up. Bezos attracted $1.2 million from a dozen angels before landing $8 million from venture capital firms a year later.[14]

Angels are a primary source of start-up capital for companies in the embryonic stage through the growth stage, and their role in financing small businesses is significant. Experts estimate that 400,000 angels invest $50 billion a year in 30,000 to 60,000 small companies, most of them in the start-up phase.[15] Because the angel market is so fragmented and disorganized, we may never get a completely accurate estimate of its investment in business start-ups. Although they may disagree on the exact amount of angel investments, experts concur on one fact: Angels are the largest single source of external equity capital for small businesses. Their investments in young companies dwarf those of professional venture capitalists, providing at least two to five times more capital to 20 to 30 times as many companies.

Angels fill a significant gap in the seed capital market. They are most likely to finance start-ups with capital requirements in the $10,000 to $2 million range, well below the $3 million to $10 million minimum investments most professional venture capitalists prefer. Because a $500,000 deal requires about as much of a venture capitalist's time to research and evaluate as a $5 million deal does, venture capitalists tend to focus on big deals, where their returns are bigger. Angels also tolerate risk levels that would make venture capitalists shudder; as much as 80 percent of angel-backed companies fail.[16] One angel investor, a former executive at Oracle Corporation, says that of the 10 companies he has invested in, seven have flopped. Three of the start-ups, however, have produced fifty-fold returns![17] Because of the inherent risks in start-up companies, many venture capitalists have shifted their investment portfolios away from start-ups toward more established firms. That's why angel financing is so important: Angels often finance deals that no venture capitalist will consider.

The typical angel invests in companies at the start-up or infant growth stage and accepts 24 percent of the investment opportunities presented, makes an average of two investments every three years, and has invested an average of $80,000 of equity in 3.5 firms. Ninety percent say they're satisfied with their investment decisions.[18] When evaluating a proposal, angels look for qualified managers, a business with a clearly defined niche, market potential, and a competitive advantage. They also want to see market research that proves the existence of a sizable customer base.

Entrepreneurs in search of capital quickly learn that the real challenge lies in *finding* angels. Most angels have substantial business and financial experience, and many of them are entrepreneurs or former entrepreneurs. Because most angels frown on "cold calls" from entrepreneurs they don't know, locating them boils down to making the right contacts. Networking is the key. Asking friends, attorneys, bankers, stockbrokers, accountants, other business owners, and consultants for suggestions and introductions is a good way to start. Angels almost always invest their money locally, so entrepreneurs should look close to home for them—typically within a 50- to 100-mile radius. Angels also look for businesses they know something about, and most expect to invest their knowledge, experience, and energy as well as their money in a company. In fact, the advice and the network of contacts that angels bring to a deal can sometimes be as valuable as their money!

A Company Example

John McCallum, founder of ***VetExchange****, an Internet-based service provider for veterinarians, found that the contacts and the advice angel investors brought to his company were invaluable. "Our angels are networked across the country," says McCallum. "They have relationships you can't imagine." One angel, a former entrepreneur, gave McCallum valuable advice on a key strategic issue recently. "He's dealt with the same issue five times before," he says.*[19]

Angels tend to invest in clusters as well, many of them through one of the nation's 170 angel capital networks. With the right approach, an entrepreneur can attract an angel who might share the deal with some of his cronies.

A Company Example

In 1995, Hans Severiens, a professional investor, created the ***Band of Angels****, a group of about 150 angels (mostly Silicon Valley millionaires, many of whom are retired entrepreneurs) who meet monthly in Portola Valley, California, to listen to entrepreneurs pitch their business plans. The Band of Angels reviews about 30 proposals each month before inviting three entrepreneurs to make 20-minute presentations at their monthly meeting. Interested members often team up with one another to invest in the businesses they consider most promising. Over the years, the Band of Angels has invested a total of more than $90 million in promising young companies. The average investment is $600,000, which usually nets the angels between 15 percent and 20 percent of a company's stock. At one meeting, Craig McMullen, CEO of Cardiac Focus, a company that is developing a disposable vest to help doctors map patients' cardiac arrythmias without surgery, made a pitch for $2 million. Cardiac Focus needed the money to complete its management team, perform clinical trials, and file for approval from the FDA. Within weeks of the presentation, 14 members of the Band of Angels decided to invest, giving Cardiac Focus the capital it needed to reach the next phase of growth.*[20]

The Internet has expanded greatly the ability of entrepreneurs in search of capital and angels in search of businesses to find one another. Dozens of angel networks have opened on the World Wide Web, including AngelMoney.com, Business Angels International, Garage.com, the Capital Network, JumpStart Investments, the Capital Connection, WomenAngels.net, and many others. The Small Business Administration's Access to Capital Electronic Network, ACE-Net, is a Web-based listing service that provides a marketplace for entrepreneurs seeking between $250,000 and $5 million in capital and angels looking to invest in promising businesses. Entrepreneurs pay $450 a year to list information about their companies on the site, which potential angels can access at any time.

Angels are an excellent source of "patient money," often willing to wait seven years or longer to cash out their investments. They earn their returns through the increased value of the business, not through dividends and interest. For example, more than 1,000 early investors in Microsoft Inc. are now multimillionaires. Members of the Tech Coast Angels, a network of angel investors in California, purchased stock in a fledgling computer networking company called Sandpiper Networks at 70 cents a share, which they later sold for $97 a share![21] Angels' return-on-investment targets tend to be lower than those of professional venture capitalists. Although venture capitalists shoot for 60 percent to 75 percent returns annually, private investors usually settle for 20 percent to 50 percent (depending on the level of risk involved in the venture). Private investors typically take less than 50 percent ownership leaving the majority ownership to the company founder(s). The lesson: If an entrepreneur needs relatively small amounts of money to launch a company, angels are a primary source.

Partners

As we saw in Chapter 4, entrepreneurs can take on partners to expand the capital foundation of a business.

A Company Example

When Lou Bucelli and Tim Crouse were searching for the money to launch ***CME Conference Video****, a company that produces and distributes videotapes of educational conferences for physicians, they found an angel willing to put up $250,000 for 40 percent of the business. Unfortunately, their investor backed out when some of his real estate investments went bad, leaving the partners with commitments for several conferences but no cash to produce and distribute the videos. With little time to spare, Bucelli and Crouse decided to form a series of limited partnerships with people they knew, one for each videotape they would produce. Six limited partnerships produced $400,000 in financing, and the tapes generated $9.1 million in sales for the year. As the general partners, Bucelli and Crouse retained 80 percent of each partnership. The limited partners earned returns of up to 80 percent in just six months. Within two years, their company was so successful that venture capitalists started calling. To finance their next round of growth, Bucelli and Crouse sold 35 percent of their company to a venture capital firm for $1.3 million.*[22]

Before entering into any partnership arrangement, however, entrepreneurs must consider the impact of giving up some personal control over operations and of sharing profits with others. Whenever entrepreneurs give up equity in their businesses (through whatever mechanism), they run the risk of losing control over it. As the founder's ownership in a company becomes increasingly diluted, the probability of losing control of its future direction and the entire decision-making process increases.

A Company Example

At age 19, Scott Olson started a company that manufactured in-line skates—a company that he had big dreams for. ***Rollerblades Inc.*** *grew quickly but soon ran into the problem that plagues so many fast-growing companies—insufficient cash flow. Through a series of unfortunate incidents, Olsen began selling shares of ownership in the company for the money he desperately needed to bring his innovative skate designs to market. Ultimately, investors ended up with 95 percent of the company, leaving Olson with the remaining scant 5 percent. Frustrated at not being able to determine the company's direction, Olson soon left to start another company. "It's tough to keep control," he says. "For every penny you get in the door, you have to give something up."*[23]

Corporate Venture Capital

Large corporations have gotten into the business of financing small companies. Today, about 300 large corporations across the globe, including Intel, Motorola, Cisco Systems, UPS, and Johnson & Johnson, invest in fledgling companies, most often those in the product development and sales growth stages. Today, 20 percent of all venture capital invested comes from corporations.[24] Young companies not only get a boost from the capital injections large companies give them, but they also stand to gain many other benefits from the relationship. The right corporate partner may share technical expertise, distribution channels, marketing know-how, and provide introductions to important customers and suppliers. Another intangible yet highly important advantage an investment from a large corporate partner gives a small company is credibility. Doors that otherwise would be closed to a small company magically open when the right corporation becomes a strategic partner.

A Company Example

When Keith Brown launched ***BuildSoft Inc.****, a company that links residential builders, suppliers, and subcontractors over the Internet, he began looking for corporate investors who would also serve as partners, giving BuildSoft the tools it needed to gain a competitive advantage. Within seven months, Brown had negotiated a $104 million dollar deal with 12 giants in the construction industry, including Lennar and Owens Corning. Not only did the corporations supply valuable capital to the growing company, but they also attracted customers and provided access to products and marketing and distribution expertise.*[25]

Foreign corporations such as Nestle S.A., the Swiss food giant, Hitachi, a Japanese maker of electronics, and Orange S.A., one of France's largest companies, are also interested in investing in small U.S. businesses. Often these corporations are seeking strategic partnerships to gain access to new technology, new products, or access to lucrative U.S. markets. In return, the small companies they invest in benefit from the capital infusion as well as from their partners' international experience and connections. In other cases, small companies are turning to their customers for the resources they need to fuel their rapid growth. Recognizing how interwoven their success is with that of their suppliers, corporate giants such as AT&T, ChevronTexaco, and Ford now offer financial support to many of the small businesses they buy from.

A Company Example

*Jeff Brown, CEO of **RadioFrame Networks**, found not only a customer in France's wireless technology giant Orange S.A. but also an investor. RadioFrame's technology improves the performance of wireless networks inside buildings, making it a perfect fit with Orange's primary business. Through its venture capital division, Orange invested $1.5 million in the 55-person company, giving it enough fuel to feed its growth.*[26]

Venture Capital Companies

venture capital companies—*private, for-profit organizations that purchase equity positions in young businesses they believe have high-growth and high-profit potential.*

Venture capital companies are private, for-profit organizations that assemble pools of capital and then use them to purchase equity positions in young businesses they believe have high-growth and high-profit potential, producing annual returns of 300 to 500 percent within five to seven years. More than 1,300 venture capital firms operate across the United States today, investing billions of dollars (see Figure 12.1) in promising small companies in a wide variety of industries. *Pratt's Guide to Venture Capital Sources*, published by Venture Economics, is a valuable resource for entrepreneurs looking for venture capital. The guide, available in most libraries, includes contact information as well as investment preferences for hundreds of venture capital firms.

Colleges and universities have entered the venture capital business; more than 100 colleges across the nation now have venture funds designed to invest in promising businesses started by their students, alumni, and faculty.[27] Even the Central Intelligence Agency (CIA) has launched a venture capital firm called In-Q-Tel that invests in companies that are developing new technologies that could benefit the CIA. One of In-Q-Tel's investments is in a company that is developing a three-dimensional Web browser that allows users to see "live" versions of the Web sites they visit.[28]

Venture capital firms, which provide about 7 percent of all funding for private companies, have invested billions of dollars in high-potential small companies over the years, including such notable businesses as Apple Computer, FedEx, Microsoft Inc., Intel, and Genentech.[29] In many of these deals, several venture capital companies invested money, experience, and advice across several stages of growth. Table 12.1 offers a humorous look at how venture capitalists decipher the language of sometimes overly optimistic entrepreneurs.

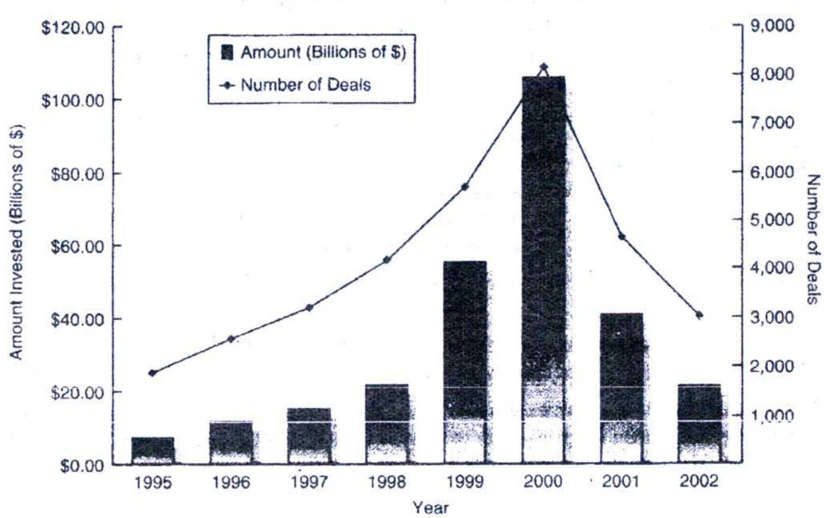


FIGURE 12.1 Venture Capital Financing

Source: PriceWaterhouseCoopers MoneyTree Survey, 2003, www.pwcmoneytree.com/moneytree/nav.jsp?page=historical.

TABLE 12.1

Deciphering the Language of the Venture Capital Industry

Sources: Adapted from Suzanne McGee, "A Devil's Dictionary of Financing," *Wall Street Journal*, June 12, 2000, p. C13; John F. Budd Jr., "Cracking the CEO's Code," *Wall Street Journal*, March 27, 1995, p. A20; "Venture-Speak Defined," *Teleconnect*, October 1990, p. 42; Cynthia E. Griffin, "Figuratively Speaking," *Entrepreneur*, August 1999, p. 26.

By nature, entrepreneurs tend to be optimistic. When screening business plans, venture capitalists must make an allowance for entrepreneurial enthusiasm. Here's a dictionary of phrases commonly found in business plans and their accompanying venture capital translations.

Exploring an acquisition strategy—Our current products have no market.

We're on a clear P2P (pathway to profitability)—We're still years away from earning a profit.

Basically on plan—We're expecting a revenue shortfall of 25 percent.

Internet business model—Potentially-bigger fools have been identified.

A challenging year—Competitors are eating our lunch.

Considerably ahead of plan—Hit our plan in one of the last three months.

Company's underlying strength and resilience—We still lost money, but look how we cut our losses.

Core business—Our product line is obsolete.

Currently revising budget—The financial plan is in total chaos.

Cyclical industry—We posted a huge loss last year.

Entrepreneurial CEO—He is totally uncontrollable, bordering on maniacal.

Facing unprecedented economic, political, and structural shifts—It's a tough world out there, but we're coping the best we can.

Highly leverageable network—No longer works but has friends who do.

Ingredients are there—Given two years, we might find a workable strategy.

Investing heavily in R&D—We're trying desperately to catch the competition.

Limited downside—Things can't get much worse.

Long sales cycle—Yet to find a customer who likes the product enough to buy it.

Major opportunity—It's our last chance.

Niche strategy—A small-time player.

On a manufacturing learning curve—We can't make the product with positive margins.

Passive investor—She phones once a year to see if we're still in business.

Positive results—Our losses were less than last year.

Repositioning the business—We've recently written off a multimillion-dollar investment.

Selective investment strategy—The board is spending more time on yachts than on planes.

Solid operating performance in a difficult year—Yes, we lost money and market share, but look how hard we tried.

Somewhat below plan—We expect a revenue shortfall of 75 percent.

Expenses were unexpectedly high—We grossly overestimated our profit margins.

Strategic investor—One who will pay a preposterous price for an equity share in the business.

Strongest fourth quarter ever—Don't quibble over the losses in the first three quarters.

Sufficient opportunity to market this product no longer exists—Nobody will buy the thing.

Too early to tell—Results to date have been grim.

A team of skilled, motivated, and dedicated people—We've laid off most of our staff, and those who are left should be glad they still have jobs.

Turnaround opportunity—It's a lost cause.

Unique—We have no more than six strong competitors.

Volume sensitive—Our company has massive fixed costs.

Window of opportunity—Without more money fast, this company is dead.

Work closely with the management—We talk to them on the phone once a month.

A year in which we confronted challenges—At least we know the questions even if we haven't got the answers.

POLICIES AND INVESTMENT STRATEGIES. Venture capital firms usually establish stringent policies to implement their overall investment strategies.

INVESTMENT SIZE AND SCREENING. Most venture capital firms seek investments in the \$3 million to \$10 million range to justify the cost of investigating the large number of proposals they receive. The venture capital screening process is *extremely* rigorous. The typical venture capital company invests in less than 1 percent of the applications it receives! For example, the average venture capital firm screens about 1,200 proposals a year, but more than 90 percent are rejected immediately because they do not match the firm's investment criteria. The remaining 10 percent are investigated more thoroughly at a cost ranging from $2,000 to $3,000 per proposal. At this time, approximately 10 to 15 proposals will have passed the screening process, and these are subjected to comprehensive review. The venture capital firm will invest in three to six of these remaining proposals.

OWNERSHIP AND CONTROL. Most venture capitalists prefer to purchase ownership in a small business through common stock or convertible preferred stock. Typically, a venture capital company seeks to purchase 20 percent to 40 percent of a business, but in some cases, a venture capitalist may buy 70 percent or more of a company's stock, leaving its founders with a minority share of ownership.

Most venture capitalists prefer to let the founding team of managers employ its skills to operate a business *if* they are capable of managing its growth. However, it is quite common for venture capitalists to join the boards of directors of the companies they invest in or to send in new managers or a new management team to protect their investments. "We change management in the companies we fund about 40 percent of the time," says Janet Effland, a partner in the venture capital firm Apax Partners.[30] In other words, venture capitalists are *not* passive investors! Some serve only as financial and managerial advisors, whereas others take an active role in managing the company—recruiting employees, providing sales leads, choosing attorneys and advertising agencies, and making daily decisions. The majority of these active venture capitalists say they are forced to step in because the existing management team lacked the talent and experience to achieve growth targets.

STAGE OF INVESTMENT. Most venture capital firms invest in companies that are either in the early stages of development (called early stage investing) or in the rapid-growth phase (called expansion stage investing). Others specialize in acquisitions, providing the financing for managers and employees of a business to buy it out. On average, 91 percent of all venture capital goes to businesses in these stages, although some venture capital firms are showing more interest in companies in the start-up phase because of the tremendous returns that are possible by investing then.[31] Most venture capital firms do not make just a single investment in a company. Instead, they invest in a company over time across several stages, where their investments often total $10 to $15 million.

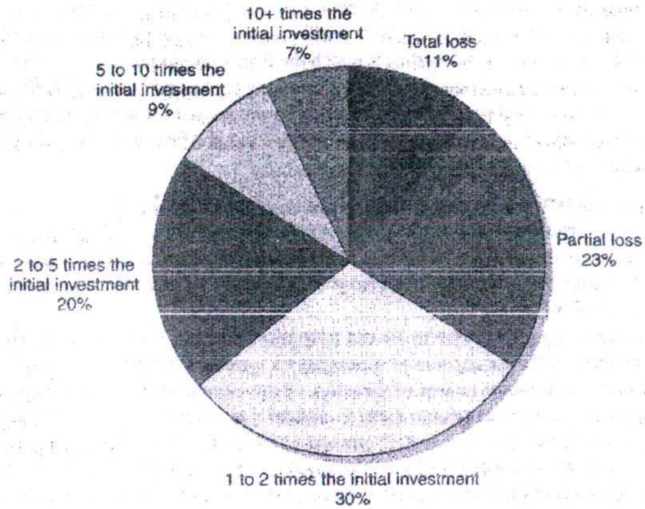
INVESTMENT PREFERENCES. The venture capital industry has undergone important changes over the past decade. Venture capital funds now are larger and more specialized. As the industry matures, venture capital funds increasingly are focusing their investments in niches—everything from low-calorie custards to the Internet. Some will invest in almost any industry but prefer companies in particular stages, from start-up to expansion. Traditionally, however, only 9 percent of venture capital financing goes to companies in the start-up (seed) stage, when entrepreneurs are forming a company or developing a product or service. Most of the start-up businesses that attract venture capital are technology companies—software, biotechnology, telecommunications, and networking.[32]

WHAT VENTURE CAPITALISTS LOOK FOR. Small business owners must realize that it is very difficult for any small business, especially fledgling or struggling firms, to pass the intense screening process of a venture capital company and qualify for an investment. Venture capital firms finance only about 3,600 deals in a typical year. Two factors make a deal attractive to venture capitalists: high returns and a convenient (and profitable) exit strategy. When evaluating potential investments, venture capitalists look for the following features:

COMPETENT MANAGEMENT. The most important ingredient in the success of any business is the ability of the management team, and venture capitalists recognize this. To venture capitalists, the ideal management team has experience, managerial skills, commitment, and the ability to build teams. One financing expert explains, "Venture capitalists are really buying into the management of your company. If the light isn't on at the top, it's dim all the way down."[33]

FIGURE 12.2 Average Returns on Venture Capital Investments

Source: Paul Keaton, "The Reality of Venture Capital," Small Business Forum, Arkansas Small Business Development Center, http://asbdc.ualr.edu/bizfacts/-501.asp?print=Y, p. 8.



A Company Example

FurnitureFind.com, an online furniture retailer that not only survived but also thrived in the dot-com fallout, recently attracted a multimillion-dollar investment from HQ Venture Capital in Austin, Texas. Because its founders had been in the bricks-and-mortar retail furniture business for many years and understood the industry, FurnitureFind.com emerged as one of the online market leaders. "We were impressed by the strength of the management team," says HQ Venture Capital's CEO. The founder's experience and the company's proven business model convinced venture capitalists that FurnitureFind.com will become "the dominant online franchise in the category."[34]

COMPETITIVE EDGE. Investors are searching for some factor that will enable a small business to set itself apart from its competitors. This distinctive competence may range from an innovative product or service that satisfies unmet customer needs to a unique marketing or R&D approach. It must be something with the potential to create a sustainable competitive edge, making the company a leader in its industry.

GROWTH INDUSTRY. Hot industries attract profits—and venture capital. Most venture capital firms focus their searches on prospects in rapidly expanding fields because they believe the profit potential is greater in these areas. Venture capital firms are most interested in young companies that have enough growth potential to become at least $100 million businesses within three to five years. Venture capitalists know that most of the businesses they invest in will flop, so their winners have to be *big* winners (see Figure 12.2). One venture capital investor says, "If you want to get really good returns, your hits generally have to earn 10 times your investment in three to five years."[35]

VIABLE EXIT STRATEGY. Venture capitalists not only look for promising companies with the ability to dominate a market, but they also want to see a plan for a feasible exit strategy, typically to be executed within three to five years. Venture capital firms realize the return on their investments when the companies they invest in either make an initial public offering or are acquired by or merged into another business.

INTANGIBLE FACTORS. Some other important factors considered in the screening process are not easily measured; they are the intuitive, intangible factors the venture capitalist detects by gut feeling. This feeling might be the result of the small firm's solid sense of direction, its strategic planning process, the chemistry of its management team, or a number of other factors.

Entrepreneurs in search of financing must understand the implications of accepting venture capital.

A Company Example

When his daughter developed a seizure disorder that required taking bitter medicine four times a day, Kenny Kramm began experimenting with different flavorings that could be mixed with regular medicines to make them taste better without affecting their efficacy. He finally found success with a banana flavoring that proved to be a huge hit not only with his *daughter but also with the customers at the pharmacy his parents owned. Kramm went on to develop 42 more flavors ranging from orange Creamsicle to chocolate silk pie, which became the basis for his company. **FlavorX**, launched in 1995 with $1 million he invested and raised from family members, friends, and private investors. Building brand awareness required significant expenditures on advertising and a sales force to call on pharmacies and veterinarians. (Pets appreciate the flavors, too!) The large amounts of capital needed to stoke the company's growth required Kramm to turn to venture capitalists. In return for company stock, several venture capital firms invested $2 million in FlavorX, leaving Kramm with 34 percent of the company, whose sales now exceed $5 million a year.*[36]

Thanks to Kenny Kramm, founder of FlavorX, and the venture capital firms that invested in his business, taking medicine no longer has to be a bitter experience.

Courtesy of FlavorX, Inc.

Despite its many benefits, venture capital is not suited for every entrepreneur. "VC money comes at a price," warns one entrepreneur. "Before boarding a one-way money train, ask yourself if this is the best route for your business and personal desires, because investors are like department stores the day after Christmas—they expect a lot of returns in a short period of time."[37]

Public Stock Sale ("Going Public")

4. Describe the process of "going public" as well as its advantages and disadvantages and the various simplified registrations and exemptions from registration available to small businesses.

In some cases, entrepreneurs can "go public" by selling shares of stock in their corporations to outside investors. In an **initial public offering**, a company raises capital by selling shares of its stock to the general public for the first time. A public offering is an effective method of raising large amounts of capital, but it can be an expensive and time-consuming process filled with regulatory nightmares. Once a company makes an initial public offering (IPO), *nothing* will ever be the same again. Managers must consider the impact of their decisions not only on the company and its employees but also on its shareholders and the value of their stock.

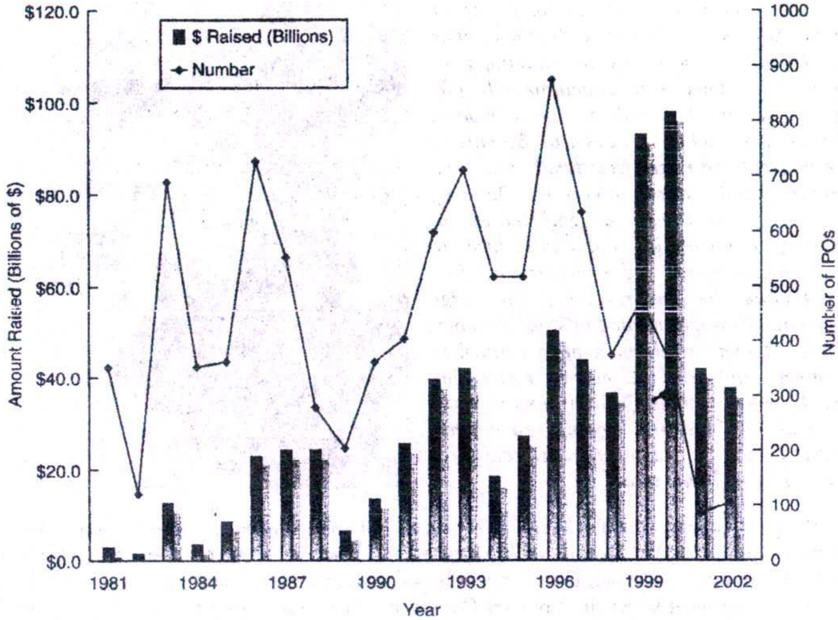
initial public offering—*a method of raising equity capital in which a company sells shares of its stock to the general public for the first time.*

Going public isn't for every business. In fact, most small companies do not meet the criteria for making a successful public stock offering. Over the past 20 years, an average of 440 companies per year have made initial public offerings of their stock, although the number of IPOs has fallen off significantly since 2000 (see Figure 12.3). Only about 20,000 companies in the United States—less than 1 percent of the total—are publicly held. Few companies with less than $20 million in annual sales manage to go public successfully. It is extremely difficult for a start-up company with no track record of success to raise money with a public offering. Instead, the investment bankers who underwrite public stock offerings typically look for established companies with the following characteristics:

- consistently high growth rates.
- a strong record of earnings.
- three to five years of audited financial statements that meet or exceed SEC standards. After the Enron and WorldCom scandals, investors are demanding impeccable financial statements.
- a solid position in a rapidly growing industry. In 2000, the median age of companies making IPOs was three years; today it is 15 years.[38]
- a sound management team with experience and a strong board of directors.

Entrepreneurs who are considering taking their companies public should first consider carefully the advantages and the disadvantages of an IPO. The *advantages* include the following:

FIGURE 12.3 Initial Public Offerings (IPOs)



ABILITY TO RAISE LARGE AMOUNTS OF CAPITAL. The biggest benefit of a public offering is the capital infusion the company receives. After going public, the corporation has the cash to fund R&D projects, expand plant and facilities, repay debt, or boost working capital balances without incurring the interest expense and the obligation to repay associated with debt financing.

A Company Example

For instance, JetBlue, the low-cost airline founded by David Neeleman, raised $158 million when the company made an initial public offering, selling 5.87 million shares of stock for $27 each, more than the $22 to $24 anticipated price range in its S-1 filing with the SEC. JetBlue used the offering proceeds for working capital and to purchase new aircraft.[39]

IMPROVED CORPORATE IMAGE. All of the media attention a company receives during the registration process makes it more visible. Plus, becoming a public company in some industries improves its prestige and enhances its competitive position, one of the most widely recognized, intangible benefits of going public.

IMPROVED ACCESS TO FUTURE FINANCING. Going public boosts a company's net worth and broadens its equity base. Its improved stature and financial strength make it easier for the firm to attract more capital—both debt and equity—and to grow.

ATTRACTING AND RETAINING KEY EMPLOYEES. Public companies often use stock-based compensation plans to attract and retain quality employees. Stock options and bonuses are excellent methods for winning employees' loyalty and for instilling a healthy ownership attitude among them *if* the company's stock performs well in the market. Employee stock ownership plans (ESOPs) and stock purchase plans are popular recruiting and motivational tools in many small corporations, enabling them to hire top-flight talent they otherwise would not be able to afford.

USING STOCK FOR ACQUISITIONS. A company whose stock is publicly traded can acquire other businesses by offering its own shares rather than cash. Acquiring other companies with shares of stock eliminates the need to incur additional debt.

LISTING ON A STOCK EXCHANGE. Being listed on an organized stock exchange, even a small regional one, improves the marketability of a company's shares and enhances its image. Most publicly held companies' stocks do not qualify for listing on the nation's largest exchanges—the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX). However, the AMEX recently created a new market for small-company stocks, The Emerging Company Marketplace. Most small companies' stocks are traded on either the National Association of Securities Dealers Automated Quotation (NASDAQ) system's National Market System (NMS) and its emerging small-capitalization exchange or one of the nation's regional stock exchanges.

Despite these advantages, many factors can spoil a company's attempted IPO. In fact, only 5 percent of the companies that attempt to go public ever complete the process.[40] The *disadvantages* of going public include the following:

DILUTION OF FOUNDER'S OWNERSHIP. Whenever entrepreneurs sell stock to the public, they automatically dilute their ownership in their businesses. Most owners retain a majority interest in the business, but they may still run the risk of unfriendly takeovers years later after selling more stock.

LOSS OF CONTROL. If enough shares are sold in a public offering, a founder risks losing control of the company. If a large block of shares falls into the hands of dissident stockholders, they could vote the existing management team (including the founder) out.

A Company Example

George Stathakis, owner of the highly successful chain of ***Stax's*** *restaurants in Greenville, South Carolina, recalls investment bankers approaching him about taking his company public to fund its growth, but he refused them all. "The one thing you don't have when you go public is control," he says, " and that's something my partners and I just couldn't handle."*[41]

LOSS OF PRIVACY. Taking their companies public can be a big ego boost for owners, but they must realize that their companies are no longer solely theirs. Information that was once private must be available for public scrutiny. The initial prospectus and the continuous reports filed with the Securities and Exchange Commission (SEC) disclose a variety of information about the company and its operations—from financial data and raw material sources to legal matters and patents to *anyone*—including competitors. Loss of privacy and loss of control are the most commonly cited reasons that CEOs choose not to attempt IPOs.[42]

REPORTING TO THE SEC. Operating as a publicly held company is expensive. Publicly held companies must file periodic reports with the SEC, which often requires a more powerful accounting system, a larger accounting staff, and greater use of attorneys and other professionals. The cost of complying with the SEC's accounting and filing requirements alone can cost $150,000 or more a year.

A Company Example

Chief operating officer John Henderson and the top managers at ***High Falls Brewing Company****, a brewery in Rochester, New York, recently transformed the once publicly held company into a privately owned business. Henderson says that the reporting requirements of running a publicly held company "took a lot more time than I expected" and that operating the brewery as a private business is "a huge relief."*[43]

FILING EXPENSES. A public stock offering usually is an expensive way to generate funds for start-up or expansion. For the typical small company, the cost of a public offering is around 12 percent of the capital raised. On small offerings, costs can eat up as much as 40 percent of the capital raised; however, on offerings above $20 million, just 5 percent typically goes to cover expenses.[44] Once an offering exceeds $10 million, its relative issuing costs drop. The largest cost is the underwriter's commission, which is typically 7 percent of the proceeds on offerings less than $10 million and 13 percent on those over that amount.

ACCOUNTABILITY TO SHAREHOLDERS. The capital that entrepreneurs manage is no longer just their own. The manager of a publicly held firm is accountable to the company's shareholders. Indeed, the law requires that managers recognize and abide by a relationship built on trust. Profit and return on investment become the primary concerns for investors. If the stock price of a newly public company falls, shareholder lawsuits are inevitable.

Source: REPRINTED WITH PERMISSION OF THE CARTOON FEATURE SYNDICATE.

"We threw an IPO and nobody came."

Investors whose shares decline in value often sue the company's managers for fraud and the failure to disclose the potential risks to which their investments expose them.

PRESSURE FOR SHORT-TERM PERFORMANCE. In privately held companies, entrepreneurs are free to follow their strategies for success, even if those strategies take years to produce results. When a company goes public, however, entrepreneurs quickly learn that shareholders are impatient and expect results immediately. Founders are under constant pressure to produce growth in profits and in market share, which requires them to maintain a delicate balance between short-term results and long-term strategy.

TIMING. As impatient as they can be, entrepreneurs often find the time demands of an initial public offering frustrating and distracting. Managing the IPO takes time away from managing the company. Working on an IPO can consume as much as 75 percent of top managers' time. "You want to make sure you're not becoming a chief 'going public' officer as opposed to a chief executive officer," advises an investment banker.[45]

A Company Example

When one company that produced sports entertainment software decided to go public, managers spent so much time focusing on the demands of the IPO that the company failed to get a new product to market in time for the Christmas season. Because it missed this crucial deadline, the company never recovered and went out of business.[46]

During this time, a company also runs the risk that the overall market for IPOs or for a particular industry may go sour. Factors beyond managers' control, such as declines in the stock market and potential investors' jitters, can quickly slam shut a company's "window of opportunity" for an IPO. For instance, when the NASDAQ began sinking in 2000, many companies planning IPOs, including InternetConnect (broadband networking services) and Plumtree Software (Web-portal software for large companies), withdrew their proposed stock offerings. Plumtree finally did pull off its IPO, but it was forced to cut its offering price to $8.50 from the $13 to $15 estimate listed in its SEC filings.[47]

THE REGISTRATION PROCESS. Taking a company public is a complicated, bureaucratic process that usually takes several months to complete. Many experts compare the IPO process to running a corporate marathon, and both the company and its management team must be in shape and up to the grueling task. The typical entrepreneur *cannot* take his company public alone. It requires a coordinated effort from a team of professionals, including

TABLE 12.2

Timetable for an Initial Public Offering

Time	Action
Week 1	Conduct organizational meeting with IPO team, including underwriter, attorneys, accountants, and others. Begin drafting registration statement.
Week 5	Distribute first draft of registration statement to IPO team and make revisions.
Week 6	Distribute second draft of registration statement and make revisions.
Week 7	Distribute third draft of registration statement and make revisions.
Week 8	File registration statement with the SEC. Begin preparing presentations for road show to attract other investment bankers to the syndicate. Comply with blue-sky laws in states where offering will be sold.
Week 12	Receive comment letter on registration statement from SEC. Amend registration statement to satisfy SEC comments.
Week 13	File amended registration statement with SEC. Prepare and distribute preliminary offering prospectus (called a "red herring") to members of underwriting syndicate. Begin road show meetings.
Week 15	Receive approval for offering from SEC (unless further amendments are required). Issuing company and lead underwriter agree on final offering price. Prepare, file, and distribute final offering prospectus.
Week 16	Company and underwriter sign the final agreement. Underwriter issues stock, collects the proceeds from the sale, and delivers proceeds (less commission) to company.

Sources: Adapted from "Initial Public Offering," *Entrepreneur*, June 14, 2002, www.entrepreneur.com/article/0,46-21,300892,00.html; PriceWaterhouseCoopers "Going Public Timetable," www.pwcglobal.com/Extweb/industry.nsf/docid/2C9CA8A7F060404A85256AC5007A86B8#.

company executives, an accountant, a securities attorney, a financial printer, and at least one underwriter. Table 12.2 shows a typical timetable for an IPO. The key steps in taking a company public include:

CHOOSE THE UNDERWRITER. The single most important ingredient in making a successful IPO is selecting a capable **underwriter (or investment banker)**. The underwriter serves two primary roles: helping to prepare the registration statement for the issue and promoting the company's stock to potential investors. The underwriter works with company managers as an advisor to prepare the registration statement that must be filed with the SEC, promoting the issue, pricing the stock, and providing after-market support. Once the registration statement is finished, the underwriter's primary job is selling the company's stock through an underwriting syndicate of other investment bankers it develops.

underwriter (or investment banker)—*a financial company that serves two important roles: helping to prepare the registration statement for an issue and promoting the company's stock to potential investors.*

NEGOTIATE A LETTER OF INTENT. To begin an offering, the entrepreneur and the underwriter must negotiate a **letter of intent**, which outlines the details of the deal. The letter of intent covers a variety of important issues, including the type of underwriting, its size and price range, the underwriter's commission, and any warrants and options included. It almost always states that the underwriter is not bound to the offering until it is executed—usually the day before or the day of the offering. However, the letter usually creates a binding obligation for the company to pay any direct expenses the underwriter incurs relating to the offer.

letter of intent—*an agreement between the underwriter and the company about to go public that outlines the details of the deal.*

PREPARE THE REGISTRATION STATEMENT. After a company signs the letter of intent, the next task is to prepare the **registration statement** to be filed with the Securities and Exchange Commission (SEC). This document describes both the company and the stock offering and discloses information about the risks of investing. It includes information on the use of the proceeds, the company's history, its financial position, its capital structure, the risks it faces, its managers' experience, and *many* other details. The statement is extremely comprehensive and may take months to develop. To prepare the statement, entrepreneurs must rely on their team of professionals.

registration statement—*the document a company must file with the SEC that describes both the company and its stock offering and discloses information about the risk of investing.*

FILE WITH THE SEC. When the statement is finished (with the exception of pricing the shares, proceeds, and commissions, which cannot be determined until just before the issue goes to market), the company officially files the statement with the SEC and awaits the review of the Division of Corporate Finance, a process that takes 30 to 45 days (or more). The division sends notice of any deficiencies in the registration statement to the company's attorney in a comment letter. The company and its team of professionals must cure all of the deficiencies in the statement noted by the comment letter. Finally, the company files the revised registration statement, along with a pricing amendment (giving the price of the shares, the proceeds, and the commissions).

WAIT TO GO EFFECTIVE. While waiting for the SEC's approval, the managers and the underwriters are busy. The underwriters are building a syndicate of other underwriters who will market the company's stock. (No stock sales can be made prior to the effective date of the offering, however.) The SEC also limits the publicity and information a company may release during this quiet period (which officially starts when the company reaches a preliminary agreement with the managing underwriter and ends 90 days after the effective date).

road show—*a gathering of potential syndicate members sponsored by the managing underwriter for the purpose of promoting a company's initial public offering.*

Securities laws do permit a **road show**, a gathering of potential syndicate members sponsored by the managing underwriter. Its purpose is to promote interest among potential underwriters in the IPO by featuring the company, its management, and the proposed deal. The managing underwriter and key company officials barnstorm major financial centers at a grueling pace.

A Company Example

During the road show for ***Plumtree Software****, a provider of expensive Web-portal software that raised $40 million in its IPO, CEO John Kunzie logged 45,000 miles to court potential investors in 80 different meetings in just 21 days.*[48]

On the last day before the registration statement becomes effective, the company signs the formal underwriting agreement. The final settlement, or closing, takes place a few days after the effective date for the issue. At this meeting the underwriters receive their shares to sell and the company receives the proceeds of the offering.

Typically, the entire process of going public takes from 60 to 180 days, but it can take much longer if the issuing company is not properly prepared for the process.

MEET STATE REQUIREMENTS. In addition to satisfying the SEC's requirements, a company also must meet the securities laws in all states in which the issue is sold. These state laws (or "blue-sky" laws) vary drastically from one state to another, and the company must comply with them.

Simplified Registrations and Exemptions

The IPO process just described (called an S-1 filing) requires maximum disclosure in the initial filing and discourages most small businesses from using it. Fortunately, the SEC allows several exemptions from this full-disclosure process for small businesses. Many small businesses that go public choose one of the simplified options the SEC has designed for small companies. The SEC has established the following simplified registration statements and exemptions from the registration process:

REGULATION S-B. Regulation S-B is a simplified registration process for small companies seeking to make initial or subsequent public offerings. Not only does this regulation simplify the initial filing requirements with the SEC, but it also reduces the ongoing disclosure and filings required of companies. Its primary goals are to open the doors to capital markets to smaller companies by cutting the paperwork and the costs of raising capital. Companies using the simplified registration process have two options: Form SB-1, a "transitional" registration statement for companies issuing less than $10 million worth of securities over a 12-month period, and Form SB-2, reserved for small companies seeking more than $10 million in a 12-month period.

To be eligible for the simplified registration process under process under Regulation S-B, a company:

- must be based in the United States or Canada
- must have revenues of less than $25 million

- must have outstanding publicly held stock worth no more than $25 million
- must not be an investment company
- must provide audited financial statements for two fiscal years

The goal of Regulation S-B's simplified registration requirements is to enable smaller companies to go public without incurring the expense of a full-blown registration. Total costs for a Regulation S-B registration are approximately $35,000.

REGULATION D (RULE 504): SMALL COMPANY OFFERING REGISTRATION (SCOR). Created in the late 1980s, the Small Company Offering Registration (also known as the Uniform Limited Offering Registration, ULOR) now is available in 47 states. A little-known tool, SCOR is designed to make it easier and less expensive for small companies to sell their stock to the public by eliminating the requirement for registering the offering with the SEC. The whole process typically costs less than half of what a traditional public offering costs. Entrepreneurs using SCOR will need an attorney and an accountant to help them with the issue, but many can get by without a securities lawyer, which can save tens of thousands of dollars. Some entrepreneurs even choose to market their companies' securities themselves (for example, to customers), saving the expense of hiring a broker. However, selling an issue is both time and energy consuming, and most SCOR experts recommend hiring a professional securities or brokerage firm to sell the company's shares. The SEC's objective in creating SCOR was to give small companies the same access to equity financing that large companies have via the stock market while bypassing many of the same costs and filing requirements. The capital ceiling on a SCOR issue is $1 million (except in Texas, where there is no limit), and the price of each share must be at least $5. That means that a company can sell no more than 200,000 shares (making the stock less attractive to stock manipulators). A SCOR offering requires only minimal notification to the SEC. The company must file a standardized disclosure statement, the U-7, which consists of 50 fill-in-the-blank questions. The form, which asks for information such as how much money the company needs, what the money will be used for, what investors receive, how investors can sell their investments, and other pertinent questions, closely resembles a business plan but also serves as a state securities offering registration, a disclosure document, and a prospectus. Entrepreneurs using SCOR may advertise their companies' offerings and can sell them directly to any investor with no restrictions and no minimums. An entrepreneur can sell practically any kind of security through a SCOR offering, including common stock, preferred stock, convertible preferred stock, stock options, stock warrants, and others.

A Company Example

*Steve Crane and Ari Aviles, Jr., cofounders of **CorpHQ**, a Web portal that links small and home-based business owners in an online community, decided to bypass venture capital and relied on a SCOR offering to attract their first round of outside capital. The entrepreneurs believed that taking their company public not only would save them money but also would create greater opportunities for future financing efforts, both of which have proved to be true. Early on, Crane and Aviles recognized the need to promote their newly public company, whose shares trade on the OTC Bulletin Board, in the investment community. "Our success as a public company depends not only on how well we do financially but also how well we market our company and our story to the financial markets," says Crane.*[49]

A SCOR offering offers entrepreneurs needing equity financing several *advantages*:

- Access to a sizable pool of equity funds without the expense of full registration with the SEC. Companies often can complete a SCOR offering for less than $25,000.
- Few restrictions on the securities to be sold and on the investors to whom they can be sold.
- The ability to market the offering through advertisements to the public.
- New or start-up companies can qualify.
- No requirement of audited financial statements for offerings less than $500,000.
- Faster approval of the issue from regulatory agencies.
- The ability to make the offering in several states at once.

There are, of course, some *disadvantages* to using SCOR to raise needed funds:

- Not every state yet recognizes SCOR offerings.
- Partnerships cannot make SCOR offerings.
- A company can raise no more than $1 million in a 12-month period.
- An entrepreneur must register the offering in every state in which shares of stock will be sold to comply with their blue-sky laws, although current regulations allow simultaneous registration in multiple states.
- The process can be time consuming, distracting an entrepreneur from the daily routine of running the company. A limited secondary market for the securities may limit investors' interest. Currently, SCOR shares must be traded through brokerage firms that make small markets in specific stocks. However, the Pacific Stock Exchange and the NASDAQ's electronic bulletin board recently began listing SCOR stocks, so the secondary market for them has broadened.

REGULATION D (RULES 505 AND 506): PRIVATE PLACEMENTS. Rules 505 and 506 of Regulation D, also known as the Private Placement Memorandum, are exemptions from federal registration requirements that give emerging companies the opportunity to sell stock through private placements without actually going public. In a private placement, the company sells its shares directly to private investors without having to register them with the SEC or incur the expenses of an IPO. Instead, a knowledgeable attorney simply draws up an investment agreement that meets state and federal requirements between the company and its private investors.

A Company Example

*For example, **PatchLink.com**, a company that provides software solutions for businesses over the Internet, raised $5.6 million in a private equity placement made through online broker-dealer OffRoad Capital. PatchLink used the money to expand its engineering, sales, and marketing staff and to launch new products. "We ended up raising more money than we expected to without giving up any more of the company," says CEO Sean Moshir.*[50]

A *Rule 505* offering has a higher capital ceiling than a SCOR offering ($5 million) in a 12-month period but imposes more restrictions (no more than 35 nonaccredited investors, no advertising of the offer, and more stringent disclosure requirements).

Rule 506 imposes no ceiling on the amount that can be raised, but, like a Rule 505 offering, it limits the issue to 35 nonaccredited investors and prohibits advertising the offer to the public. There is no limit on the number of accredited investors, however. Rule 506 also requires detailed disclosure of relative information, but the extent depends on the dollar size of the offering.

These Regulation D rules minimize the expense and the time required to raise equity capital for small businesses. Fees for private placements typically range from 1 to 5 percent rather than the 7 to 13 percent underwriters normally charge for managing a public offering. Offerings made under Regulation D do impose limitations and demand certain disclosures, but they only require a company to file a simple form (Form D) with the SEC within 15 days of the first sale of stock.

SECTION 4(6). Section 4(6) covers private placements and is similar to Regulation D, Rules 505 and 506. It does not require registration on offers up to $5 million if they are made only to accredited investors.

INTRASTATE OFFERINGS (RULE 147). Rule 147 governs intrastate offerings, those sold only to investors in a single state by a company doing business in that state. To qualify, a company must be incorporated in the state, maintain its executive offices there, have 80 percent of its assets there, derive 80 percent of its revenues from the state, and use 80 percent of the offering proceeds for business in the state. There is no ceiling on the amount of the offering, but only residents of the state in which the issuing company operates can invest.

A Company Example

*Years ago, Ben Cohen and Jerry Greenfield founded a small ice cream manufacturing business named after themselves that struck a chord with customers. **Ben & Jerry's Homemade** grew rapidly, and the founders needed $600,000 to build a new manufacturing plant in*

Vermont where the company was based. They decided to "give the opportunity to our neighbors to grow with our company" by making an intrastate offering under Rule 147. Cohen and Greenfield registered their offering of 73,500 shares of stock with Vermont's Division of Banking and Insurance. Ben & Jerry's Homemade sold the entire offering (mostly to loyal customers) by placing ads in newspapers and stickers on ice cream containers that touted "Get a Scoop of the Action!"[51]

REGULATION A. Regulation A, although currently not used often, allows an exemption for offerings up to $5 million over a 12-month period. Regulation A imposes few restrictions, but it is more costly than the other types of exempted offerings, usually running between $80,000 and $120,000. The primary difference between a SCOR offering and a Regulation A offering is that a company must register its SCOR offering only in the states where it will sell its stock; in a Regulation A offering, the company also must file an offering statement with the SEC. Like a SCOR offering, a Regulation A offering requires only a simplified question-and-answer SEC filing and allows a company to sell its shares directly to investors.

A Company Example

For instance, when ***Blue Fish Clothing Inc.****, an all-natural women's clothing company, needed money to fuel its rapid growth, founder Jennifer Barclay decided to make a direct public offering under Regulation A, selling 800,000 shares at $5 each. "Banks wouldn't provide the funds, and venture capital firms wanted a huge percentage of the company," says Barclay. Blue Fish publicized its $4 million offering through mailings, advertisements, fish-shaped hanging tags on its garments, and word of mouth among its base of 30,000 loyal customers and supporters. Blue Fish, whose shares are traded on the Chicago Stock Exchange, used the offering's proceeds to build new retail stores, to install a computerized information system, and to expand its management team.*[52]

DIRECT STOCK OFFERINGS. Many of the simplified registrations and exemptions discussed here give entrepreneurs the power to sidestep investment bankers and sell their companies' stock offerings directly to investors and, in the process, save themselves thousands of dollars in underwriting fees. By cutting out the underwriter's commission and many legal and most registration fees, entrepreneurs willing to handle the paperwork requirements and to market their own shares typically can make direct public offerings (DPOs) for 6 to 10 percent of the total amount of the issue, compared with 13 percent for a traditional stock offering.

A Company Example

Real Goods Trading Company*, a retailer of environmentally friendly products, was a pioneer of direct public offerings over the Web. In 1991, the company engineered a successful DPO that raised $1 million and followed with two more DPOs in later years that generated $3.6 million each! More than 5,000 of the company's loyal customers became investors. In fact, managers discovered that once customers became shareholders, they purchased nearly twice as much merchandise as customers who were not shareholders! Managers at Real Goods found that using the Web to reach potential investors was not only one of the best bargains but also one of the most effective methods for selling its stock to the public.*[53]

The World Wide Web (WWW) opens an easy-to-use avenue for direct public offerings and is one the fastest-growing sources of capital for small businesses. Much of the Web's appeal as a fund-raising tool stems from its ability to reach large numbers of prospective investors very quickly and at a low cost. "This is the only form of instantaneous international contact with an enormous population," says one Web expert. "You can put your prospectus out to the world."[54] Companies making direct stock offerings on the Web most often make them under either Regulation A or Regulation D. Direct public offerings work best for companies that have a single product or related product lines and a base of customers who are loyal to the company. In fact, the first company to make a successful DPO over the Internet was Spring Street Brewing, a microbrewery founded by Andy Klein. Klein raised $1.6 million in a Regulation A offering in 1996. Companies that make successful direct public offerings of their stock over the Web must meet the same standards as companies making stock offerings using more traditional methods. Experts caution Web-based fund seekers to make sure their electronic prospectuses meet SEC and state requirements.

Table 12.3 provides a summary of the major types of exemptions and simplified offerings. Of these, the limited offerings and private placements are most commonly used.

TABLE 12.3

Simplified Registration and Exemptions: Comparative Table

Source: Deciding to Go Public, New York: Ernst & Young, 1993, pp. 70–71.

Private and Limited Offerings Regulation D

	Rule 504	**Rule 505**	**Rule 506**
Dollar Limit	$1 million in any 12-month period	$5 million in any 12-month period	None
Limit on Number of Purchasers	No	35 nonaccredited, unlimited accredited	35 nonaccredited, unlimited accredited
Qualification for Purchasers	No	No	Nonaccredited must be sophisticated
Qualifications of Issuers	Not available for investment companies, blank check companies, or reporting companies	Not available for investment companies or those disqualified by "bad boy" provisions	No
Disclosure Requirements	Not specified	Only if one or more nonaccredited purchasers	Only if one or more nonaccredited purchasers
Financial Statement Requirements	Not specified	Period varies for audited statements	Period varies for audited statements
General Solicitation and Advertising Prohibited	No	Yes	Yes
Resale Restrictions	No	Yes	Yes

Private Placements Section 4(6)	**Intrastate Offerings Rule 147**	**Unregistered Public Offerings Regulation A**	**Small Business Issuers Registration Form SB-1**	**Small Business Issuers Registration Form SB-2**
$5 million	None	$5 million in any 12-month period	$10 million in any 12-month period	None
No	No	No	No	No
All must be accredited	All must be registrants of a single state	No	No	No
No	Must be resident and do business in same state as purchasers	Available for U.S. and Canadian companies only; not available for reporting companies, blank check companies, investment companies, sale of oil and gas or mineral rights, or those disqualified by "bad boy" provisions	Available for U.S. and Canadian companies with revenue and public float of less than $25 million; not available for investment companies or susidiaries whose parent is not qualified to use the form	Available for U.S. and Canadian companies with revenue and public float of less than $25 million; not available for investment companies or subsidiaries whose parent is not qualified to use the form
Not specified	Not specified	Yes	Yes	Yes
Not specified	Not specified	2 years of unaudited statements	2 years of unaudited statements	2 years of unaudited statements
Yes	No	No	No	No
Yes	Yes	Yes	No	No

YOU Be the Consultant . . .

Filled with Promise, but Low on Capital

After graduation, Astro Teller and three college buddies from Carnegie Mellon University worked as consultants to technology companies such as Motorola and Compaq Computers on projects involving wearable computers. Before long, they had launched a company of their own, BodyMedia, built around a product they had developed called the SenseWear armband. The 3-ounce device, which straps onto a person's arm, includes metallic sensors that monitor the wearer's perspiration levels, skin temperature, and internal temperature and then combines them into a constant measure of his or her calorie burn rate. The clever product has a wireless device that sends all captured information to a PC, where it can be displayed for easy analysis. It can run for four consecutive days before its batteries need to be recharged. Users can program the SenseWear armband to signal when they have reached a calorie goal or when it is time to take medicine. The device may be just the tool a dieter is looking for, a lifesaving device for those with medical conditions such as diabetes, and the solution to medical researchers' problems of collecting reliable data on their patients.

BodyMedia CEO Teller, who has a Ph.D. in artificial intelligence and is the grandson of Edward Teller, the inventor of the atomic bomb, saw the SenseWear armband as the centerpiece of a Web-based health portal that would track a person's daily statistics on exercise, sleep, and calorie expenditures. Unfortunately, potential lenders and investors didn't see things quite as clearly as Teller and his cofounders. "We had no credibility," says CFO Jeff Swoveland. "We kissed every frog. Nobody wanted to hear the pitch."

Teller and his friends managed to launch their company, but they knew they would need the endorsement of physicians to be able to raise the capital they needed to realize the company's potential. For five months, they worked the halls at the University of Pittsburgh Medical Center before David Kupfer, an expert in behavioral health, helped them convince the hospital to invest $2.5 million to turn the prototype into a real product. Teller soon abandoned the Web portal idea and decided to focus on selling SenseWear, which would be priced around $900, to large corporations for their employees with the idea that it would help lower their rapidly escalating health insurance costs. By 2001, however, a sluggish economy had reduced corporate America's spending on employee wellness, and Teller was in need of a device to monitor BodyMedia's cash burn rate as accurately as the SenseWear device monitored users' calorie burn rates. A falling stock market had diminished the number of IPOs to a trickle, and venture capital firms were watching the

Astro Teller, CEO of BodyMedia Inc., needs second-round financing to bring to market SenseWear armband, a device that monitors the wearer's vital signs and calorie burn rate. What recommendations can you offer Teller?

Courtesy of BodyMedia, Inc.

value of their investments and their pools of capital evaporate. BodyMedia, projected to generate sales of $700,000 in the upcoming year, was in danger of running out of money, having gone through most of the original $2.5 million from the hospital. Teller shifted the company's strategy to focus on selling the product to makers and distributors of medical testing equipment such as Roche Diagnostics, a $5 billion global giant. Teller is convinced that his company and its product will succeed, and he is setting out to attract its much-needed second round of financing.

1. What role do factors that are beyond entrepreneurs' control—such as a faltering economy or a falling stock market—have on their ability to attract the capital they need?

2. Explain why the following funding sources would or would not be appropriate for BodyMedia: family and friends, angel investors, an initial public offering, a traditional bank loan, asset-based borrowing, or one of the many federal or SBA loans.

3. Work with a team of your classmates to devise a workable strategy for raising the capital BodyMedia needs to market the SenseWear device.

Sources: Adapted from Bob Parks, "Armed for Success," *Business 2.0*, April 2003, pp. 46–48; Brad Lemley, "TEDMED," *Discover*, April 2003, www.discover.com/apr_03/gthere.html?article=featted.html; BodyMedia, www.bodymedia.com.

Learning Objective

5. Describe the various sources of debt capital and the advantages and disadvantages of each.

THE NATURE OF DEBT FINANCING

Debt financing involves the funds that the small business owner borrows and must repay with interest. Lenders of capital are more numerous than investors, although small business loans can be just as difficult (if not more difficult) to obtain. Although borrowed capital allows entrepreneurs to maintain complete ownership of their businesses, it must be carried as a liability on the balance sheet as well as be repaid with interest at some point in the future. In addition, because small businesses are considered to be greater risks than bigger corporate customers, they must pay higher interest rates because of the risk-return trade-off—the higher the risk, the greater the return demanded. Most small firms pay the **prime rate**, the interest rate banks charge their most creditworthy customers, *plus* two to three percentage points. Still, the cost of debt financing often is lower than that of equity financing. Because of the higher risks associated with providing equity capital to small companies, investors demand greater returns than lenders. Also, unlike equity financing, debt financing does not require an entrepreneur to dilute her ownership interest in the company.

prime rate—*the interest rate banks charge their most creditworthy customers.*

Entrepreneurs seeking debt capital are quickly confronted with an astounding range of credit options varying greatly in complexity, availability, and flexibility. Not all of these sources of debt capital are equally favorable, however. By understanding the various sources of capital—both commercial and government lenders—and their characteristics, entrepreneurs can greatly increase the chances of obtaining a loan.

We now turn to the various sources of debt capital.

Sources of Debt Capital

COMMERCIAL BANKS Commercial banks are the very heart of the financial market for small businesses, providing the greatest number and variety of loans to small companies. One study by the Small Business Administration found that commercial banks provide 64 percent of the credit available to small businesses, compared to 12.3 percent supplied by commercial finance companies, the next most prominent source of small business lending. The study also revealed that 67 percent of all small businesses that borrow from traditional sources get financing from banks![55] For small business owners, banks are lenders of *first* resort.

Banks tend to be conservative in their lending practices and prefer to make loans to established small businesses rather than to high-risk start-ups. One expert estimates that only 5 to 8 percent of business start-ups get bank financing.[56] Bankers want to see evidence of a company's successful track record before committing to a loan. They are concerned with a firm's operating past and will scrutinize its financial reports to project its position in the future. They also want proof of the stability of the company's sales and the ability of the product or service to generate adequate cash flows to ensure repayment of the loan. If they do make loans to a start-up venture, banks like to see sufficient cash flows to repay the loan, ample collateral to secure it, or a Small Business Administration (SBA) guarantee to insure it. Studies suggest that small banks (those with less than $300 million in assets) are most likely to lend money to small businesses.[57]

A Company Example

Some banks are willing to extend loans to start-up companies, however. Rasheed Refaey turned to bank financing to cover unexpected cost overruns in the construction and start-up of his restaurant, ***Tasca-Kitchen & Wine Bar****. Refaey already had raised $500,000 from private investors and did not want to give up any more equity in his business, so he turned to a small community bank for a $250,000 loan. His solid business plan coupled with an introduction by consultants at a nearby Small Business Development Center convinced bank officers to make the loan. Business at the restaurant is booming, giving Refaey plenty of cash to repay the loan.*[58]

When evaluating a loan application, banks focus on a company's capacity to create positive cash flow because they know that's where the money to repay their loans will come from. The first question in most bankers' minds when reviewing an entrepreneur's business plan is "Can this business generate sufficient cash to repay the loan?" Even though they rely on collateral to secure their loans, the last thing banks want is for a borrower to default, forcing them to sell the collateral (often at "fire sale" prices) and use the proceeds to pay off the loan. *That's* why bankers stress cash flow when analyzing a loan request, especially for a business start-up. "Cash is more important than your mother," jokes one experienced borrower.[59]

Short-Term Loans

Short-term loans, extended for less than one year, are the most common type of commercial loan banks make to small companies. These funds typically are used to replenish the working capital account to finance the purchase of more inventory, boost output, finance credit sales to customers, or take advantage of cash discounts. As a result, an owner repays the loan after converting inventory and receivables into cash. There are several types of short-term loans.

COMMERCIAL LOANS (OR TRADITIONAL BANK LOANS). A basic short-term loan is the commercial bank's specialty. Business owners use commercial loans for a specific expenditure—to buy a particular piece of equipment or to make a specific purchase, and terms usually require repayment as a lump sum within three to six months. Two types of commercial loans exist: secured and unsecured. A secured loan is one in which the borrower's promise to repay is secured by giving the bank an interest in some asset (collateral). Although secured loans give banks a safety cushion in case the borrower defaults on the loan, they are much more expensive to administer and maintain. With an unsecured loan, the bank grants a loan to a business owner without requiring him to pledge any specific collateral to support the loan in case of default. Until a small business is able to prove its financial strength to the bank's satisfaction, it will probably not qualify for an unsecured commercial loan. For both secured and unsecured commercial loans, an owner is expected to repay the total amount of the loan at maturity. Sometimes the interest due on the loan is prepaid—deducted from the total amount borrowed.

LINES OF CREDIT. One of the most common requests entrepreneurs make of banks is to establish a **line of credit**, a short-term loan with a preset limit that provides much-needed cash flow for day-to-day operations. With an approved line of credit, a business owner can borrow up to the predetermined ceiling at any time during the year quickly and conveniently by writing himself a loan. Banks set up lines of credit that are renewable for anywhere from 90 days to several years, and they usually limit the open line of credit to 40 to 50 percent of a firm's present working capital, although they will lend more for highly seasonal businesses. Bankers may require a company to rest its line of credit during the year, maintaining a zero balance, as proof that the line of credit is not a perpetual crutch. Like commercial loans, lines of credit can be secured or unsecured. A business typically pays a small handling fee (1 to 2 percent of the maximum amount of credit) plus interest on the amount borrowed—usually prime plus three points or more.

line of credit—*a short-term bank loan with a preset limit that provides working capital for day-to-day operations.*

Table 12.4 describes the five most common reasons bankers reject small business loan applications and how to avoid them.

FLOOR PLANNING. Floor planning is a form of financing frequently employed by retailers of big-ticket items that are easily distinguishable from one another (usually by serial number), such as automobiles, boats, and major appliances. For example, a commercial bank finances Auto City's purchase of its inventory of automobiles and maintains a security interest in each car in the order by holding its title as collateral. Auto City pays interest on the loan monthly and repays the principal as it sells the cars. The longer a floor-planned item sits in inventory, the more it costs the business owner in interest expense. Banks and other floor planners often discourage retailers from using their money without authorization by performing spot checks to verify prompt repayment of the principal as items are sold.

Intermediate and Long-Term Loans

Banks primarily are lenders of short-term capital to small businesses, although they will make certain intermediate and long-term loans. Intermediate and long-term loans, which are normally secured by collateral, are extended for one year or longer and are normally used to increase fixed- and growth-capital balances. Small companies often face a greater challenge qualifying for intermediate and long-term loans because of the increased risk to which they expose the bank. Commercial banks grant these loans for constructing a plant, purchasing real estate and equipment, expanding a business, and other long-term investments. Loan repayments are normally made monthly or quarterly. One of the most common types of intermediate loans is an installment loan, which banks make to small firms for purchasing equipment, facilities, real estate, and other fixed assets. When financing equipment, a bank usually lends the small business from 60 to 80 percent of the equipment's value in return for a security interest in

TABLE 12.4

The Six Most Common Reasons Bankers Reject Small Business Loan Applications (and How You Can Avoid Them)

Sources: Adapted from Anne Field, "Getting the Bank to Yes," *Success*, May 1999, pp. 67–71; J. Tol Broome, Jr., "How to Get a 'Yes' from Your Banker," *Nation's Business*, April 1996, p. 37.

Reason 1. "Our bank doesn't make small business loans." Cure: Before applying for a bank loan, research banks to find out which ones actively seek the type of loan you need. Some banks don't emphasize loans under $500,000, whereas others focus almost exclusively on small company loans. The Small Business Administration's reports, *Micro-Business-Friendly Banks in the United States* and *Small Business Lending in the United States*, are valuable resources for locating the banks in your area that are most likely to make small business loans.

Reason 2. "I don't know enough about you or your business." Cure: Develop a detailed business plan that explains what your company does (or will do) and describes how you will gain a competitive edge over your rivals. Also be prepared to supply business credit references and a personal credit history.

Reason 3. "You haven't told me why you need the money." Cure: A solid business plan will explain how much money you need and how you plan to use it. Make sure your request is specific; avoid requests for loans "for working capital." Don't make the mistake of answering the question, "How much money do you need?" with "How much will you lend me?"

Reason 4. "Your numbers don't support your loan request." Cure: Include a cash flow forecast in your business plan. Bankers analyze a company's balance sheet and income statement to judge the quality of its assets and its profitability, but bankers lend primarily on the basis of cash flow. They know that's how you'll repay the loan. If adequate cash flow isn't available, don't expect a loan. Prove to the banker that you know what your company's cash flow is and how to manage it.

Reason 5. "You don't have enough collateral." Cure: Be prepared to pledge your company's assets—and perhaps your personal assets—as collateral for the loan. Bankers like to have the security of collateral before they make a loan. They also expect more than $1 in collateral for every $1 of money they lend. Banks typically lend 80 to 90 percent of the value of real estate, 70 to 80 percent of the value of accounts receivable, and just 10 to 50 percent of the value of inventory pledged as collateral.

Reason 6. "Your business does not support the loan on its own." Cure: Be prepared to provide a personal guarantee on the loan. By doing so, you're telling the banker that if your business cannot repay the loan, you will. Many bankers see their small business clients and their companies as one and the same. Even if you choose a form of ownership that provides you with limited personal liability, most bankers will ask you to override that protection by personally guaranteeing the loan.

There's no magic to getting a bank to approve your loan request. The secret is proper preparation and building a solid business plan that enhances your credibility as a business owner with your banker. Use your plan to prove that you have what it takes to survive and thrive.

the equipment. The loan's amortization schedule, which is based on a set number of monthly payments, typically coincides with the length of the equipment's usable life. In financing real estate (commercial mortgages), banks typically will lend up to 75 to 80 percent of the property's value and will allow a lengthier repayment schedule of 10 to 30 years.

term loan—*a bank loan that imposes restrictions (covenants) on the business decisions an entrepreneur makes concerning the company's operations.*

Another common type of loan banks make to small businesses is a **term loan**. Typically unsecured, banks grant these loans to businesses whose past operating history suggests a high probability of repayment. Some banks make only secured term loans, however. Term loans impose restrictions (called covenants) on the business decisions an entrepreneur makes concerning the company's operations. For instance, a term loan may set limits on owners' salaries, prohibit further borrowing without the bank's approval, or maintain certain financial ratios (recall the discussion of ratio analysis in Chapter 10). Entrepreneurs must understand all of the terms attached to term loans before accepting them.

Nonbank Sources of Debt Capital

Although they are usually the first stop for entrepreneurs in search of debt capital, banks are not the only lending game in town. We now turn our attention to other sources of debt capital that entrepreneurs can tap to feed their cash-hungry companies.

ASSET-BASED LENDERS Asset-based lenders, which are usually smaller commercial banks, commercial finance companies, or specialty lenders, allow small businesses to borrow money by pledging otherwise idle assets such as accounts receivable, inventory, or purchase orders as collateral. This form of financing works especially well for manufacturers, wholesalers, distributors, and other companies with significant stocks of inventory or accounts receivable. Even unprofitable companies whose financial statements could not convince loan officers to make traditional loans can get asset-based loans. These cash-poor but asset-rich companies can use normally unproductive assets—accounts receivable, inventory, fixtures, and purchase orders—to finance rapid growth and the cash crises that often accompany it.

Like banks, asset-based lenders consider a company's cash flow, but they are more interested in the quality of the assets pledged as collateral. The amount a small business can borrow through asset-based lending depends on the **advance rate**, the percentage of an asset's value that a lender will lend. For example, a company pledging $100,000 of accounts receivable might negotiate a 70 percent advance rate and qualify for a $70,000 asset-based loan. Advance rates can vary dramatically depending on the quality of the assets pledged and the lender. Because inventory is an illiquid asset (i.e., hard to sell), the advance rate on inventory-based loans is quite low, usually 10 percent to 50 percent. A business pledging high-quality accounts receivable as collateral, however, may be able to negotiate up to an 85 percent advance rate. The most common types of asset-based financing are discounting accounts receivable and inventory financing.

advance rate—*the percentage of an asset's value that a lender will lend.*

DISCOUNTING ACCOUNTS RECEIVABLE. The most common form of secured credit is accounts receivable financing. Under this arrangement, a small business pledges its accounts receivable as collateral; in return, the lender advances a loan against the value of approved accounts receivable. The amount of the loan tendered is not equal to the face value of the accounts receivable, however. Even though the bank screens the firm's accounts and accepts only qualified receivables, it makes an allowance for the risk involved because some will be written off as uncollectible. A small business usually can borrow an amount equal to 55 to 80 percent of its receivables, depending on their quality. Generally, lenders will not accept receivables that are past due. Many commercial finance companies engage in accounts receivable financing.

A Company Example

Kyle Jodice, founder of **Milnucorp**, *a small distributor of products ranging from Hula-Hoops to tank parts, uses accounts receivable financing from Action Capital, a commercial finance company in Atlanta, to get the cash he needs to purchase inventory. Action Capital advances money based on Milnucorp's accounts receivable. After Action Capital collects payment from Milnucorp's customers, typically within 40 to 60 days, the commercial finance company remits the payments to Jodice after subtracting the amount of the loan and the interest it charges.*[60]

INVENTORY FINANCING. Here, a small business loan is secured by the company's inventory of raw materials, work in process, and finished goods. If an owner defaults on the loan, the lender can claim the pledged inventory, sell it, and use the proceeds to satisfy the loan (assuming the bank's claim is superior to the claims of other creditors). Because inventory usually is not a highly liquid asset and its value can be difficult to determine, lenders are willing to lend only a portion of its worth, usually no more than 50 percent of the inventory's value. Most asset-based lenders avoid inventory-only deals; they prefer to make loans backed by inventory *and* more secure accounts receivable.

A Company Example

David LaTorre, CFO of **Design Resource Group International**, *used inventory financing to enable his company to land a contract with a large multinational corporation to install a complete office furnishing system. Design Resource Group's rapid growth was stretching its capital base, and traditional financing sources such as banks were hesitant to lend to a small company without an established record of success. LaTorre turned to Westgate Financial Corporation, a company specializing in asset-based financing, for help. Pledging the purchase order from the multinational corporation as collateral, LaTorre negotiated a loan from Westgate that enabled it to purchase the necessary inventory and complete the job. When the multinational corporation paid the invoice, LaTorre repaid the loan out of the proceeds.*[61]

Asset-based financing is a powerful tool. A small business that could obtain a $1 million line of credit with a bank would be able to borrow as much as $3 million by using accounts receivable as collateral. It is also an efficient method of borrowing because a small business owner has the money he needs when he needs it. In other words, the business pays only for the capital it actually needs and uses.

To ensure the quality of the assets supporting the loans they make, lenders must monitor borrowers' assets, perhaps as often as once a month, making paperwork requirements on these loans intimidating, especially to first-time borrowers. Also, asset-based loans are more expensive than traditional bank loans because of the cost of originating and maintaining them and the higher risk involved. Rates usually run from two to seven percentage points above the prime rate. Because of this rate differential, small business owners should not use asset-based loans over the long term; their goal should be to establish their credit through asset-based financing and then to move up to a line of credit.

Trade Credit

Because of its ready availability, trade credit is an extremely important source of financing to most entrepreneurs. When banks refuse to lend money to a start-up business because they see it as a bad credit risk, an entrepreneur may be able to turn to trade credit for capital. Getting vendors to extend credit in the form of delayed payments (for example, "net 30" credit terms) usually is much easier for small businesses to obtain than bank financing. Essentially, a company receiving trade credit from a supplier is getting a short-term, interest-free loan for the amount of the goods purchased.

It is no surprise that businesses receive three dollars of credit from suppliers for every two dollars they receive from banks as loans.[62] Vendors and suppliers often are willing to finance a small business's purchases of goods from 30 to 60 days, interest free.

A Company Example

For instance, Gus Walboldt, owner of ***AMCAL****, a fine-art publishing company, uses supplier financing as an integral part of his company's 20-year growth plan. Because calendars represent a large portion of AMCAL's sales, its business is highly seasonal, which creates significant cash flow problems. "We would spend half the year flush with cash [and the other half] cash poor," says Walboldt. Walboldt worked out a financing arrangement with the companies that print the calendars. AMCAL pays the printers' labor and material costs when the calendars are printed during the summer months and then covers their profit margins when its cash flow swells in the fall.*[63]

The key to maintaining trade credit as a source of funds is establishing a consistent and reliable payment history with every vendor.

Equipment Suppliers

Most equipment vendors encourage business owners to purchase their equipment by offering to finance the purchase. This method of financing is similar to trade credit but with slightly different terms. Usually, equipment vendors offer reasonable credit terms with only a modest down payment with the balance financed over the life of the equipment (often several years). In some cases, the vendor will repurchase equipment for salvage value at the end of its useful life and offer the business owner another credit agreement on new equipment. Some companies get equipment loans to lease rather than to purchase fixed assets. Start-up companies often use trade credit from equipment suppliers to purchase equipment and fixtures such as counters, display cases, refrigeration units, machinery, and the like. It pays to scrutinize vendors' credit terms, however; they may be less attractive than those of other lenders.

Commercial Finan ce Companies

When denied bank loans, small business owners often look to commercial finance companies for the same types of loans. Commercial finance companies are second only to banks in making loans to small businesses and, unlike their conservative counterparts, are willing to tolerate more risk in their loan portfolios. Of course, their primary consideration is collecting their loans, but finance companies tend to rely more on obtaining a security interest in some type of collateral, given the higher-risk loans that make up their portfolios. Because commercial finance companies depend on collateral to recover most of their losses, they do not require the complete financial projections of future operations that most banks do. However, this does *not* mean that they do not carefully evaluate a company's financial position before making a loan.

Approximately 150 large commercial finance companies such as AT&T Small Business Lending, GE Capital Small Business Finance, and others make a variety of loans to small companies, ranging from asset-based loans and business leases to construction and Small Business Administration loans. Dubbed "the Wal-Marts of finance," commercial finance companies usually offer many of the same credit options as commercial banks do. However, because their loans are subject to more risks, finance companies charge a higher interest rate than commercial banks (usually at least prime plus 4 percent). Their most common methods of providing credit to small businesses are asset-based—accounts receivable financing and inventory loans. Specific rates on these loans vary but can be as high as 20 to 30 percent (including fees), depending on the risk a particular business presents and the quality of the assets involved.

In addition to short-term financing for small businesses, commercial finance companies also extend intermediate and long-term loans for real estate and fixed assets.

A Company Example

When Anna Kinney wanted to build a new building to house her metal fabrication business, ***AMK Manufacturing****, 20 banks rejected her loan application, even though she owned all of the equipment in her company and had a track record of success. Kinney then turned to Allied Capital, a Washington, DC–based commercial finance company, that quickly approved a 25-year loan for $300,000 backed by a guarantee from the Small Business Administration.*[64]

Savings and Loan Associations

Savings and loan associations (S&Ls) specialize in loans for real property. In addition to their traditional role of providing mortgages for personal residences, savings and loan associations offer financing on commercial and industrial property. In the typical commercial or industrial loan, the S&L will lend up to 80 percent of the property's value with a repayment schedule of up to 30 years. Minimum loan amounts are typically $50,000, but most S&Ls hesitate to lend money for buildings specially designed for a particular customer's needs. S&Ls expect the mortgage to be repaid from the firm's future profits.

Stock Brokerage Houses

Stockbrokers are getting into the lending business, too, and many of them offer loans to their customers at lower interest rates than banks. These **margin loans** carry lower rates because the collateral supporting them—the stocks and bonds in the customer's portfolio—is of high quality and is highly liquid. Moreover, brokerage firms make it easy to borrow. Usually, brokers set up a line of credit for their customers when they open a brokerage account. To tap that line of credit, the customer simply writes a check or uses a debit card. Typically, there is no fixed repayment schedule for a margin loan; the debt can remain outstanding indefinitely, as long as the market value of the borrower's portfolio of collateral meets minimum requirements. Aspiring entrepreneurs can borrow up to 50 percent of the value of their stock portfolios, up to 70 percent of their bond portfolios, and up to 90 percent of the value of their government securities. For example, one woman borrowed $60,000 to buy equipment for her New York health club, and a St. Louis doctor borrowed $1 million against his brokerage account to help finance a medical clinic.[65]

margin loans—*loans from stockbrokers that use the stocks and bonds in the borrower's portfolio as collateral.*

There is risk involved in using stocks and bonds as collateral on a loan. Brokers typically require a 30 percent cushion on margin loans. If the value of the borrower's portfolio drops, the broker can make a **margin call**—that is, the broker can call the loan in and require the borrower to provide more cash and securities as collateral. Recent swings in the stock market have translated into margin calls for many entrepreneurs, requiring them to repay a significant portion of their loan balances within a matter of days—or hours. If an account lacks adequate collateral, the broker can sell off the customer's portfolio to pay off the loan.

margin call—*occurs when the value of a borrower's portfolio drops and the broker calls the loan in, requiring the borrower to put up more cash and securities as collateral.*

Over the past two decades, stock brokers have been adding traditional loans to their line of small business financial services, but start-up companies rarely meet their stringent standards. For established companies, however, these loans can be an important source of funds.

A Company Example

Kevin Nikkhoo, founder of ***Vertex Systems Inc.****, a $10 million-a-year technology consulting firm, negotiated a small business loan from Morgan Stanley to finance the company's rapid growth. After negotiating with banks and other potential sources of funds, Nikkhoo decided to go with Morgan Stanley because it offered better terms and the potential to provide more funding as Vertex grew.*[66]

Insurance Companies

policy loan—*a loan insurance companies make on the basis of the amount of money a customer has paid into a policy in the form of premiums.*

For many small businesses, life insurance companies can be an important source of business capital. Insurance companies offer two basic types of loans: policy loans and mortgage loans. **Policy loans** are extended on the basis of the amount of money paid through premiums into the insurance policy. It usually takes about two years for an insurance policy to accumulate enough cash surrender value to justify a loan against it. Once he accumulates cash value in a policy, an entrepreneur may borrow up to 95 percent of that value for any length of time. Interest is levied annually, but borrowers can defer repayment indefinitely. However, the amount of insurance coverage is reduced by the amount of the loan. Policy loans typically offer very favorable interest rates, often at or below prevailing loan rates at banks and other lending institutions. Only insurance policies that build cash value—that is, combine a savings plan with insurance coverage—offer the option of borrowing. These include whole life (permanent insurance), variable life, universal life, and many corporate-owned life insurance policies. Term life insurance, which offers only pure insurance coverage, has no borrowing capacity.

mortgage loan—*a loan insurance companies make on a long-term basis for real property worth at least $500,000.*

Insurance companies make **mortgage loans** on a long-term basis on real property worth a minimum of $500,000. They are based primarily on the value of the real property being purchased. The insurance company will extend a loan of up to 75 or 80 percent of the real estate's value and will allow a lengthy repayment schedule over 25 or 30 years so that payments do not strain the firm's cash flows excessively.

Credit Unions

credit union—*a nonprofit financial cooperative that promotes saving and provides loans to its members.*

Credit unions, nonprofit financial cooperatives that promote saving and provide loans to their members, are best known for making consumer and car loans. However, many are also willing to lend money to their members to launch businesses. More than 10,000 federally and state-chartered credit unions operate in the United States, and they make loans to their members totaling more than $172 billion a year, many of them for the purpose of starting a business.[67]

Credit unions don't make loans to just anyone; to qualify for a loan, an entrepreneur must be a member. Lending practices at credit unions are very much like those at banks, but they usually are willing to make smaller loans. Entrepreneurs around the globe are turning to credit unions to finance their businesses, sometimes borrowing tiny amounts of money.

A Company Example

When ***Joseph Ogwal****, a refugee of war-torn Sudan, arrived in South Africa, he had nothing—literally. Ogwal, who has a degree in electronics engineering, wanted to start his own business to earn enough money to bring his family to South Africa, so he turned to the Cape Metropole South African Credit Co-Operative (SACCO) for a small loan. With his $115 loan, Ogwal launched a consumer electronics repair business that already is earning a profit. With another loan from the credit union, he plans to expand his business, launching a training center for repair technicians.*[68]

Bonds

Bonds, which are corporate IOUs, have always been a popular source of debt financing for large companies. Few small business owners realize that they can also tap this valuable source of capital. Although the smallest businesses are not viable candidates for issuing bonds, a growing number of small companies are finding the funding they need through bonds when banks and other lenders say no. Because of the costs involved, issuing bonds usually is best suited for companies generating sales between $5 million and $30 million and have capital requirements between $1.5 million and $10 million. Although they can help small companies raise much-needed capital, bonds have certain disadvantages. The issuing company must follow the same regulations that govern businesses selling stock to public investors. Even if the bond issue is private, the company must register the offering and file periodic reports with the SEC.

Small manufacturers needing money for fixed assets have access to an attractive, relatively inexpensive source of funds in industrial development bonds (IDBs), which were created to give manufacturers access to capital at rates lower than they could get from traditional lenders. In 1999, Congress created the mini-bond program, which allows small companies to issue bonds through a streamlined application process and lower fees. Typically, the amount of money small companies issuing IDBs seek to raise is at least $1 million, but some small manufacturers have raised as little as $500,000 using IDBs. Even though the paperwork and legal costs associated with making an IDB issue can run up to 2 to 3 percent of the financing amount, that is a relative bargain for borrowing long-term money at a fixed interest rate.

A Company Example

After using bank loans for many years to finance his company's capital needs, Ned Golterman, co-owner of ***Golterman & Sabo****, a small building materials company, decided to issue mini-bonds. Not only was Golterman able to avoid much of the complicated paperwork associated with a typical bond issue, but he also managed to get long-term financing for his company at a rate two percentage points below the best bank loan rate he could find and favorable repayment terms.*[69]

Private Placements

Earlier in this chapter, we saw how companies can raise capital by making private placements of their stock (equity). Private placements are also available for debt instruments. A private placement involves selling debt to one or a small number of investors, usually insurance companies or pension funds. Private placement debt is a hybrid between a conventional loan and a bond. At its heart, it is a bond, but its terms are tailored to the borrower's individual needs, as a loan would be.

Privately placed securities offer several advantages over standard bank loans. First, they usually carry fixed interest rates rather than the variable rates banks often charge. Second, the maturity of private placements is longer than most bank loans: 15 years rather than five. Private placements do not require hiring expensive investment bankers. Finally, because private investors can afford to take greater risks than banks, they are willing to finance deals for fledgling small companies.

Small Business Investment Companies (SBICs)

Small Business Investment Companies (SBICs)—*privately owned financial institutions that are licensed and regulated by the SBA; they use a combination of private and public funds to provide long-term capital to small businesses.*

Small Business Investment Companies (SBICs), created in 1958 when Congress passed the Small Business Investment Act, are privately owned financial institutions that are licensed and regulated by the SBA. Their function is to use a combination of private capital and federally guaranteed debt to provide long-term capital to small businesses. There are two types of SBICs: regular SBICs and specialized SBICs (SSBICs). More than 100 SSBICs provide credit and capital to small businesses that are at least 51 percent owned by minorities and socially or economically disadvantaged people. Since their inception in 1969, SSBICs have helped finance nearly 25,000 minority-owned companies with investments totaling $2.34 billion.[70] Most SBICs prefer later-round financing over funding raw start-ups. Because of changes in their financial structure made a few years ago, however, SBICs now are better equipped to invest in start-up companies. In fact, about 55 percent of SBIC investments go to companies that are no more than three years old.[71] Funding from SBICs helped launch companies such as Apple Computer, Federal Express, Staples, Sun Microsystems, and Callaway Golf.

Since 1960, SBICs have provided more than $34 billion in long-term debt and equity financing to some 105,000 small businesses, adding many thousands of jobs to the American economy.[72] Both SBICs and SSBICs must be capitalized privately with a minimum of $5 million to $10 million, at which point they qualify for up to three dollars in long-term SBA loans for every dollar of private capital invested in small businesses. As a general rule, both SBICs and SSBICs may provide financial assistance only to small businesses with a net worth of less than $18 million and average after-tax earnings of $6 million during their past two years. However, employment and total annual sales standards vary from industry to industry. SBICs are limited to a maximum investment or loan amount of 20 percent of their private capital to a single client, whereas SSBICs may lend or invest up to 30 percent of their private capital in a single small business.

SBICs provide both debt and equity financing to small businesses. Because of SBA regulations affecting the financing arrangements an SBIC can offer, most SBICs extend their investments as loans with an option to convert the debt instrument into an equity interest later. Most SBIC loans are in the much-needed range of $100,000 and $5 million, and the loan term is longer than most banks allow. The average SBIC loan is $664,200.[73] When they make equity investments, SBICs are prohibited from obtaining a controlling interest in the companies in which they invest (no more than 49 percent ownership). The average SBIC equity investment is $1.13 million, far below the average equity investment by venture capital firms of $12 million.[74] The most common forms of SBIC financing (in order of their frequency) are a loan with an option to buy stock, a convertible debenture, a straight loan, and preferred stock.

A Company Example

Outback Steakhouse, a highly successful restaurant chain based on an Australian theme, received early financing from an SBIC, Kitty Hawk Capital I, that allowed it to grow. In 1990, Outback had been in business less than three years when the SBIC decided to invest $151,000 to boost the company's working capital balance. That capital infusion gave Outback the financing it needed to get to the next level. The company made an initial public offering in 1991 and today generates sales of more than $2.5 billion a year![75]

Outback Steakhouse, which now has locations around the globe, truly is a success story for the SBIC industry.

Small Business Lending Companies (SBLCs)

Small Business Lending Companies (SBLCs) make only intermediate and long-term SBA-guaranteed loans. They specialize in loans that many banks would not consider and operate on a nationwide basis. For instance, most SBLC loans have terms extending for at least 10 years. The maximum interest rate for loans of seven years or longer is 2.75 percent above the prime rate; for shorter-term loans, the ceiling is 2.25 percent above prime. Another feature of SBLC loans is the expertise the SBLC offers borrowing companies in critical areas.

SBLCs also screen potential investors carefully, and most of them specialize in particular industries. The result is a low loan default rate of roughly 4 percent. Corporations own most of the nation's SBLCs, giving them a solid capital base.

Learning Objective
6. Identify the various federal loan programs aimed at small companies.

FEDERALLY SPONSORED PROGRAMS

Federally sponsored lending programs have suffered from budget reductions in the past several years. Current trends suggest that the federal government is reducing its involvement in the lending business, but many programs are still quite active and some are actually growing.

Economic Development Administration (EDA)

The Economic Development Administration, a branch of the Commerce Department, offers loan guarantees to create new business and to expand existing businesses in areas with below-average income and high unemployment. Focusing on economically distressed communities, the EDA finances long-term investment projects needed to stimulate economic growth and to create jobs by making loan guarantees. The EDA guarantees loans up to 80 percent of business loans between $750,000 and $10 million. Entrepreneurs apply for loans through private lenders, for whom an EDA loan guarantee significantly reduces the risk of lending. Start-up companies must supply 15 percent of the guaranteed amount in the form of equity, and established businesses must make equity investments of at least 15 percent of the guaranteed amount. Small businesses can use the loan proceeds in a variety of ways, including supplementing working capital and purchasing equipment to buying land and renovating buildings.

EDA business loans are designed to help replenish economically distressed areas by creating or expanding small businesses that provide employment opportunities in local communities. To qualify for a loan the business must be located in the disadvantaged area, and its presence must directly benefit local residents. Some communities experiencing high unemployment or suffering from the effects of devastating natural disasters have received EDA Revolving Loan Fund Grants to create loan pools for local small businesses.

Department of Housing and Urban Development (HUD)

HUD sponsors several loan programs to assist qualified entrepreneurs in raising needed capital. The Community Development Block Grants (CDBGs) are extended to cities and counties that, in turn, lend or grant money to entrepreneurs to start small businesses that will strengthen the local economy. Grants are aimed at cities and towns in need of revitalization and economic stimulation. Some grants are used to construct buildings and plants to be leased to entrepreneurs, sometimes with an option to buy. Others are earmarked for revitalizing a crime-ridden area or making start-up loans to entrepreneurs or expansion loans to existing business owners. No ceilings or geographic limitations are placed on CDBG loans and grants, but projects must benefit low- and moderate-income families.

A Company Example

*The city of **Wichita, Kansas**, and **Cessna Aircraft Company** used the loan guarantee provision of the CDBG program to purchase a large tract in a troubled neighborhood and to renovate it. They built the Cessna Learning Work Complex, which included a light assembly factory and a training/day care center for Cessna trainees from the local area. The renovation stimulated investments in the community, including a new bank, a library, a senior citizens center, and a housing complex.*[76]

HUD also makes loans to small businesses through its Enterprise Community Loan Program, including microloans (up to $15,000), façade loans (up to $50,000 for exterior improvements to buildings), and commercial revitalization loans (up to $50,000 for purchasing fixed assets or for working capital).

U.S. Department of Agriculture's Rural Business-Cooperative Service

The U.S. Department of Agriculture (USDA) provides financial assistance to certain small businesses through its Rural Business-Cooperative Service (RBS). The RBS program is open to all types of businesses (not just farms) and is designed to create nonfarm employment opportunities in rural areas—those with populations below 50,000 and not adjacent to a city where densities exceed 100 people per square mile. Entrepreneurs in many small towns, especially those with populations below 25,000, are eligible to apply for loans through the RBS program, which makes almost $900 million in loan guarantees each year.

The RBS does make a limited number of direct loans to small businesses, but the majority of its activity is in loan guarantees. Through its Business and Industry Guaranteed Loan Program, the RBS will guarantee as much as 90 percent of a bank's loan up to $25 million (although actual guarantee amounts are almost always far less) for qualified applicants. Entrepreneurs apply for loans through private lenders, who view applicants with loan guarantees much more favorably than those without such guarantees. The RBS guarantee reduces a lender's risk dramatically because the guarantee means that the government agency would pay off the loan balance (up to the ceiling) if the entrepreneur defaults on the loan.

To make a loan guarantee, the RBS requires much of the same documentation as most banks and most other loan guarantee programs. Because of its emphasis on developing employment in rural areas, the RBS requires an environmental-impact statement describing the jobs created and the effect the business has on the area. The Rural Business-Cooperative Service also makes grants available to businesses and communities for the purpose of encouraging small business development and growth.

Small Business Innovation Research (SBIR) Program

Started as a pilot program by the National Science Foundation in the 1970s, the SBIR program has expanded to 11 federal agencies, ranging from NASA to the Department of Defense. These agencies award cash grants or long-term contracts to small companies wanting to initiate or to expand their research and development (R&D) efforts. SBIR grants give innovative small companies the opportunity to attract early-stage capital investments *without* having to give up significant equity stakes or taking on burdensome levels of debt. The SBIR process involves three phases. Phase I grants, which determine the feasibility and commercial potential of a technology or product, last for up to six months and have a ceiling of $100,000. Phase II grants,

YOU Be the Consultant . . .

Two Financing Puzzles

CREATIVE CAPITAL

Lissa D'Aquanni's candy-making business, The Chocolate Gecko, had humble beginnings but a great deal of promise. After working as an executive for several nonprofit organizations, D'Aquanni decided to go into business for herself and launched her company from the basement of her Albany, New York, home. When her home-based company's sales climbed to $44,000, D'Aquanni decided it was time to leave the neighborhood behind and move into a location that could support her plans for growth. Just three blocks away from her home, she found an older building for sale that was in need of renovation and repair. She approached traditional lenders for help financing the $300,000 project, but without a proven track record and no collateral to speak of, they refused. They urged D'Aquanni to consider renting the building rather than buying it. D'Aquanni's plans called for her to purchase the building, and she wasn't backing down just because of a setback in financing.

D'Aquanni had faced challenges attracting capital before, but she had gotten the funding she needed by being creative. For instance, shortly after she had launched her business, D'Aquanni needed $5,000 to purchase molds and a temperer so she could meet demand for the upcoming Christmas season. Recalling a strategy she had read about in a small business magazine, she sold discounted gift certificates to her customers. For every $100 in gift certificates her customers bought, D'Aquanni offered $25 worth of free chocolates. Within two weeks, she had raised the $5,000 she needed to purchase the supplies. An unanticipated benefit of her capital-raising strategy was a broader customer base. "A lot of folks mailed them as gift certificates to friends, family, and co-workers, and most of those people ordered chocolates," she says. To conserve cash in her business, D'Aquanni also barters for goods and services when she can. Both her accountant and her Web site designer take chocolates rather than cash as payment for their services.

D'Aquanni knows that most likely she will have to resort to another creative financing strategy to come up with the money she needs to purchase and renovate the building to house her growing business.

STALLED OUT

John Acosta is frustrated because his business, Jolly Technologies, has stalled for a lack of capital. Acosta invented a garage door opener that installs on motorcycles in just minutes and has invested more than $30,000 of his own money in the company since founding it in 1998. To date, he has managed to sell more than $50,000 worth of the openers at $40 each through magazine ads, from the company's Web site, and at motorcycle shows. Acosta estimates that he needs $100,000 to fine-tune the product and market it effectively.

Like Lissa D'Aquanni, Acosta has run into dead ends seeking financing through traditional financing sources. Financial advisors have suggested that Acosta sell the company to someone with the financial resources to develop and market the product or to give majority control to distributors in return for using their established marketing channels. Acosta refuses to consider those options. "I don't want to relinquish power," he says. "I want to make this company work."

1. Describe the advantages and the disadvantages of both equity capital and debt capital for Lissa D'Aquanni and John Acosta.

2. Explain why the following funding sources would or would not be appropriate for these entrepreneurs: family and friends, angel investors, an initial public offering, a traditional bank loan, asset-based borrowing, or one of the many federal or SBA loans.

3. Work with a team of your classmates to brainstorm ways that Lissa D'Aquanni and John Acosta could attract the capital they need for their businesses. What steps would you recommend they take before they approach the potential sources of funding you have identified?

Sources: Adapted from Crystal Detamore-Rodman, "Out on a Limb," *Entrepreneur B.Y.O.B.*, March 2003, pp. 78–83; The Chocolate Gecko, www.chocolategecko.com; Jolly Technologies, www.jollytec.com.

designed to develop the concept into a specific technology or product, run for up to 24 months with a ceiling of $750,000. Approximately 40 percent of all Phase II applicants receive funding. Phase III is the commercialization phase, in which the company pursues commercial applications of the research and development conducted in Phases I and II and must use private or non-SBIR federal funding to bring a product to market.

Competition for SBIR funding is intense; only 12 percent of the small companies that apply receive funding. So far, more than 36,000 SBIR awards totaling in excess of $10 billion have gone to small companies that traditionally have had difficulty competing with big corporations for federal R&D dollars. The government's dollars have been well invested. Nearly 40 percent of small businesses receiving second-phase SBIR awards have achieved commercial success with their products.[77]

A Company Example

Integrated Systems Inc. of Sunnyvale, California, used SBIR funding to develop technology for writing embedded software that allowed robots to load munitions safely. The company, whose stock now trades on the NASDAQ, went on to transfer the technology to commercial applications, including software that controls robots in the auto manufacturing process and "intelligent" gas pumps that allow customers to pay at the pump with a credit card.[78]

The Small Business Technology Transfer (STTR) Program

The Small Business Technology Transfer (STTR) Program complements the Small Business Innovation Research Program. Whereas the SBIR focuses on commercially promising ideas that originate in small businesses, the STTR uses companies to exploit the vast reservoir of commercially promising ideas that originate in universities, federally funded R&D centers, and nonprofit research institutions. Researchers at these institutions can join forces with small businesses and can spin off commercially promising ideas while remaining employed at their research institutions. Five federal agencies award grants of up to $500,000 in three phases to these research partnerships.

SMALL BUSINESS ADMINISTRATION (SBA)

Learning Objective
7. Describe the various loan programs available from the Small Business Administration.

The Small Business Administration (SBA) has several programs designed to help finance both start-up and existing small companies that cannot qualify for traditional loans because of their thin asset base and their high risk of failure. In its 50-plus years of operation, the SBA has helped nearly 20 million small businesses through a multitude of programs, enabling many of them to get the financing they need for start-up or for growth. The SBA's $45 billion loan portfolio makes it the largest single financial backer of small businesses in the nation.[79] To be eligible for SBA funds, a business must meet the SBA's criteria that define a small business. Also, some types of businesses, such as those engaged in gambling, pyramid sales schemes, or real estate investment, among others, are ineligible for SBA loans.

The loan application process can take from between three days to several months, depending on how well prepared the entrepreneur is and which bank is involved. To speed up processing times, the SBA has established a Certified Lender Program (CLP) and a Preferred Lender Program (PLP). Both are designed to encourage banks to become frequent SBA lenders. When a bank makes enough good loans to qualify as a certified lender, the SBA promises a fast turnaround time for the loan decision—typically three to ten business days. About 850 lenders across the country are SBA certified lenders. When a bank becomes a preferred lender, it makes the final lending decision itself, subject to SBA review. In essence, the SBA delegates the application process, the lending decision, and other details to the preferred lender. The SBA guarantees up to 75 percent of PLP loans in case the borrower fails and defaults on the loan. The minimum PLP loan guarantee is $100,000, whereas the maximum is $500,000. About 500 lenders across the United States meet the SBA's preferred lender standards. Using certified or preferred lenders can reduce the processing time for an SBA loan considerably.

To further reduce the paperwork requirements involved in its loans, the SBA created the **Low Doc** (for "low documentation") **Loan Program**, which allows small businesses to use a simple one-page application for all loan applications. Before the Low Doc Loan Program, a typical SBA loan application required an entrepreneur to complete at least 10 forms, and the SBA often took 45 to 90 days to make a decision about an application. Under the Low Doc Loan Program, response time is just three days.

Low Doc Loan Program—*a program initiated by the SBA in an attempt to simplify and streamline the application process for small business loans.*

To qualify for a Low Doc loan, a company must have average sales below $5 million during the previous three years and employ fewer than 100 people. Businesses can use Low Doc loans for working capital, machinery, equipment, and real estate. The SBA guarantees 80 percent of loans up to $100,000 and 75 percent of loans over that amount up to the loan ceiling of $150,000. Borrowers must be willing to provide a personal guarantee for repayment of the loan principal. Interest rates are prime plus 2.75 percent on loans of seven years or longer and prime plus 2.25 percent on loans of less than seven years. The average Low Doc loan is $79,500.

A Company Example

Richard Smith, owner of a whitewater rafting business, needed money to expand his 20-year-old company and to buy new equipment. Smith, however, was hesitant to approach the SBA because he wanted to avoid "myriads of paperwork." At his banker's urging, Smith decided to try the Low Doc Loan Program, and within days of submitting his application, he received a $100,000 loan.[80]

SBA Express Program—*an SBA program that allows participating lenders to use their own loan procedures to make SBA-guaranteed loans.*

Another program designed to streamline the application process for SBA loan guarantees is the **SBA Express Program**, in which participating lenders use their own loan procedures and applications to make loans of up to $250,000 to small businesses. Because the SBA guarantees up to 50 percent of the loan, banks are often more willing to make smaller loans to entrepreneurs who might otherwise have difficulty meeting lenders' standards. Loan maturities on SBA*Express* loans typically are between five and ten years, but loan maturities for fixed assets can be up to 25 years.

SBA Loan Programs

7(A) Loan Guaranty Program—*an SBA loan program in which loans made by private lenders to small businesses are guaranteed up to a ceiling by the SBA.*

7(A) LOAN GUARANTY PROGRAM. The SBA works with local lenders (both bank and nonbank) to offer a variety of loan programs all designed to help entrepreneurs who cannot get capital from traditional sources gain access to the financing they need to launch and grow their businesses. By far, the most popular SBA loan program is the **7(A) Loan Guaranty Program** (see Figure 12.4). Private lenders extend these loans to small businesses, but the SBA guarantees them (80 percent of loans up to $100,000; 75 percent of loans above $100,000 up to the loan guarantee ceiling of $750,000). In other words, the SBA does not actually lend any money; it merely acts as an insurer, guaranteeing the lender this much repayment in case the borrower defaults on the loan. Because the SBA assumes most of the credit risk, lenders are more willing to consider riskier deals that they normally would refuse.

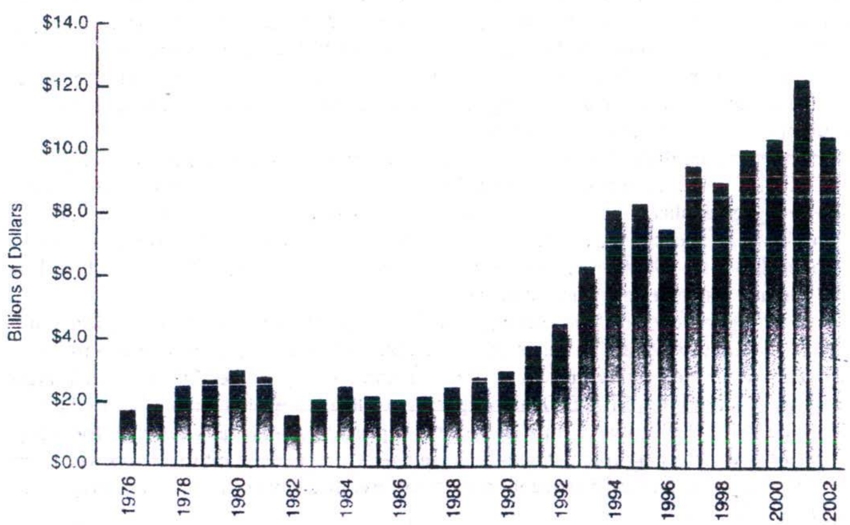
A Company Example

*For instance, when their sports-equipment-bag company, **Buck's Bags**, began to experience explosive growth that outstripped cash flow, Larry Lee and Dara Lee Howerton applied for an SBA guaranteed loan at their banker's suggestion. The Howertons have received four SBA-guaranteed loans totaling more than $600,000, using the loans to move into a larger plant, buy new equipment, and hire new workers. With the SBA loan guarantees, Buck's Bags' sales have soared. "The SBA was very helpful in getting us through our rapid-growth years," says Larry Lee. "I don't know what we would have done without them."*[81]

Qualifying for an SBA loan guarantee requires cooperation among the entrepreneur, the participating bank, and the SBA. The participating bank determines the loan's terms and sets the interest rate within SBA limits. Contrary to popular belief, SBA-guaranteed loans do *not* carry special deals on interest rates. Typically, rates are negotiated with the participating bank, with a

FIGURE 12.4 SBA 7(A) Guaranteed Loans

Source: U.S. Small Business Administration.



ceiling of prime plus 2.25 percent on loans of less than seven years and prime plus 2.75 percent on loans of seven to 25 years. Interest rates on loans of less than $25,000 can run up to prime plus 4.75 percent. The average interest rate on SBA-guaranteed loans is prime plus 2 percent (compared to prime plus 1 percent on conventional bank loans). The SBA also assesses a one-time guaranty fee of up to 3.875 percent for all loan guarantees.

The mean loan through the 7(A) guaranty program is $232,500, and the average duration of an SBA loan is 12 years—longer than the average commercial small business loan. In fact, longer loan terms are a distinct advantage of SBA loans. At least half of all bank business loans are for less than one year. By contrast, SBA real estate loans can extend for up to 25 years (compared to just 10 to 15 years for a conventional loan), and working capital loans have maturities of seven years (compared with two to five years at most banks). These longer terms translate into lower payments, which are better suited for young, fast-growing, cash-strapped companies.

THE CAPLINE PROGRAM. In addition to its basic 7(a) Loan Guaranty Program (through which the SBA makes about 84 percent of its loans), the SBA provides guarantees on small business loans for start-up, real estate, machinery and equipment, fixtures, working capital, exporting, and restructuring debt through several other methods. About two-thirds of all SBA's loan guarantees are for machinery and equipment or working capital. The **CAPLine Program** offers short-term capital to growing companies needing to finance seasonal buildups in inventory or accounts receivable under five separate programs, each with maturities up to five years: seasonal line of credit (provides advances against inventory and accounts receivable to help businesses weather seasonal sales fluctuations), contract line of credit (finances the cost of direct labor and materials costs associated with performing contracts), builder's line of credit (helps small contractors and builders finance labor and materials costs), standard asset-based line of credit (an asset-based revolving line of credit for financing short-term needs), and small asset-based line of credit (an asset-based revolving line of credit up to $200,000). CAPLine is aimed at helping cash-hungry small businesses by giving them a credit line to draw on when they need it. These loans built around lines of credit are what small companies need most because they are so flexible, efficient, and, unfortunately, so hard for small businesses to get from traditional lenders.

CAPLine Program—*an SBA program that makes short-term capital loans to growing companies needing to finance seasonal buildups in inventory or accounts receivable.*

LOANS INVOLVING INTERNATIONAL TRADE. For small businesses going global, the SBA has the **Export Working Capital (EWC) Program**, which is designed to provide working capital to small exporters. The SBA works in conjunction with the Export-Import Bank to administer this loan guarantee program. Applicants file a one-page loan application, and the response time normally is 10 days or less. The maximum loan is $1,111,111 and proceeds must be used to finance small business exports.

Export Working Capital (EWC) Program—*an SBA loan program that is designed to provide working capital to small exporters.*

A Company Example

***Crown Products Inc.**, a small company generating more than $16 million in annual sales by exporting grocery products to more than 70 countries, typifies the small companies that benefit most from the EWC program. In its early years, Crown's retained earnings and its owners financed the company's growth. But as its growth accelerated, the company's cash needs began to outstrip its internal funding sources. With the help of the Hibernia National Bank, owners Kee Lee, Sun Kim, and Jeffrey Teague were able to land a $750,000 line of credit that fueled its international growth.*[82]

The **International Trade Program** is for small businesses that are engaging in international trade or are adversely affected by competition from imports. The SBA allows global entrepreneurs to combine loans from the Export Working Capital Program with those from the International Trade Program for a maximum guarantee of $1,250,000. Loan maturities range from one to 25 years.

International Trade Program—*an SBA loan program for small businesses that are engaging in international trade or are adversely affected by competition from imports.*

SECTION 504 CERTIFIED DEVELOPMENT COMPANY PROGRAM. The SBA's Section 504 program is designed to encourage small businesses to expand their facilities and to create jobs. Section 504 loans provide long-term, fixed-asset financing to small companies to purchase land, buildings, or equipment. Three lenders play a role in every 504 loan: a bank, the SBA, and a **certified development company (CDC)**. A CDC is a nonprofit organization licensed by the SBA and designed to promote economic growth in local communities. Some 270 CDCs operate across the United States. An entrepreneur generally is required to make a down payment of just 10 percent of the total project cost. The CDC puts

certified development company (CDC)—*a nonprofit organization licensed by the SBA and designed to promote growth in local communities by working with commercial banks and the SBA to make long-term loans to small businesses.*

up 40 percent at a long-term fixed rate, supported by an SBA loan guarantee in case the entrepreneur defaults. The bank provides long-term financing for the remaining 50 percent, also supported by an SBA guarantee. The major advantages of Section 504 loans are their fixed rates and terms, their 10- and 20-year maturities, and the low down payment required. The maximum loan amount is $1.3 million.

A Company Example

When Chris Lamm decided to relocate his wholesale seafood business from Oakland's Jack London Square, his two-year search led him to an ideal site in nearby Hayward, California. His company, ***Joe Pucci & Sons Seafood****, had grown to 60 employees and needed more space. With the help of the Capital Access Group, a local development company, Lamm was able to buy a 44,000-square-foot building located on two acres that once housed a Mervyn's department store. The building was a perfect fit for the seafood company's needs with loading docks, a large parking lot, and plenty of room to handle the company's expansion. Lamm, who went to work for the company in 1993 and purchased it in 2001, put down 10 percent of the cost and borrowed the maximum $1.3 million from the CDC. A loan from a local bank rounded out the financing package.*[83]

As attractive as they are, 504 loans are not for every business owner. The SBA imposes several restrictions on 504 loans:

- For every $35,000 the CDC loans, the project must create at least one new job or achieve a public policy goal such as rural development, expansion of exports, minority business development, and others.
- Machinery and equipment financed must have a useful life of at least 10 years.
- The borrower must occupy at least two-thirds of a building constructed with the loan, or the borrower must occupy at least half of a building purchased or remodeled with the loan.
- The borrower must qualify as a small business under the SBA's definition and must not have a tangible net worth in excess of $7 million and does not have an average net income in excess of $2.5 million after taxes for the preceding two years.

Because of strict equity requirements, existing small businesses usually find it easier to qualify for 504 loans than do start-ups.

Microloan Program—*an SBA program that makes small loans, some as small as $100, to entrepreneurs.*

MICROLOAN PROGRAM. About three-fourths of all entrepreneurs need less than $100,000 to launch their businesses. Indeed, most entrepreneurs require less than $50,000 to start their companies. Unfortunately, loans of that amount can be the most difficult to get. Lending these relatively small amounts to entrepreneurs starting businesses is the purpose of the SBA's **Microloan Program**. Called microloans because they range from just a hundred dollars to as much as $35,000, these loans have helped thousands of people take their first steps toward entrepreneurship. Banks typically have shunned loans in such small amounts because they considered them to be unprofitable. In an attempt to "fill the void" in small loans to start-up companies, the SBA launched the Microloan Program in 1992; today, more than 150 authorized lenders make SBA-backed microloans. The size of the average microloan is $10,500 with a maturity of three years (the maximum term is six years), and lenders' standards are less demanding than those on conventional loans. All microloans are made through nonprofit intermediaries approved by the SBA.

A Company Example

Jonathan Reese and Jason Salfi needed capital to fund the growth of ***Comet Skateboard****, the skateboard manufacturing company they cofounded, but, given their lack of collateral, sparse credit history, and small loan need, no bank was interested. However, two $20,000 SBA-guaranteed microloans from the Oakland Business Development Corporation gave the fledgling company the solid financial footing it needed to grow. Reese and Salfi's business plan calls for steady growth that will enable them to qualify for a bank line of credit and to ultimately attract venture capital.*[84]

Prequalification Loan Program—*an SBA program designed to help disadvantaged entrepreneurs "prequalify" for SBA loan guarantees before approaching commercial lenders.*

PREQUALIFICATION LOAN PROGRAM. The **Prequalification Loan Program** is designed to help disadvantaged entrepreneurs such as those in rural areas, minorities, women, the disabled, those with low incomes, veterans, and others prepare loan applications and "prequalify" for SBA loan guarantees before approaching banks and lending institutions for business loans. Because lenders are much more likely to approve loans that the SBA has prequalified, these entrepreneurs have greater access to the capital they need. The maximum loan under this program is $250,000, and loan maturities range from seven to 25 years. A local Small Business Development Center usually helps entrepreneurs prepare their loan applications at no charge.

DISASTER LOANS. As their name implies, **disaster loans** are made to small businesses devastated by some kind of financial or physical loss. The maximum disaster loan usually is $1.5 million, but Congress often raises that ceiling when circumstances warrant. Disaster loans carry below-market interest rates. Loans for physical damage above $10,000 and financial damage of more than $5,000 require an entrepreneur to pledge some kind of collateral, usually a lien on the business property. The SBA has helped entrepreneurs whose businesses have been disrupted by a variety of disasters, ranging from hurricanes on the Southeast Coast and earthquakes on the West Coast to floods and tornadoes in the Midwest to the terrorist attacks of September 11, 2001.

disaster loans—*an SBA loan program that makes loans to small businesses devastated by some kind of financial or physical loss.*

STATE AND LOCAL LOAN DEVELOPMENT PROGRAMS

Many states have created their own loan and economic development programs to provide funds for business start-ups and expansions. They have decided that their funds are better spent encouraging small business growth rather than "chasing smokestacks"—trying to entice large businesses to locate in their boundaries. These programs come in a wide variety of forms, but they all tend to focus on developing small businesses that create the greatest number of jobs and economic benefits. Although each state's approach to economic development is somewhat unique, one common element is some kind of small business financing program: loans, loan guarantees, development grants, venture capital pools, and others. One approach many states have had success with is **Capital Access Programs (CAPs)**. First introduced in Michigan in 1986, many states now offer CAPs that are designed to encourage lending institutions to make loans to businesses that do not qualify for traditional financing because of their higher risk. Under a CAP, a bank and a borrower each pay an up-front fee (a portion of the loan amount) into a loan-loss reserve fund at the participating bank, and the state matches this amount. The reserve fund, which normally ranges from 6 to 14 percent of the loan amount, acts as an insurance policy against the potential loss a bank might experience on a loan and frees the bank to make loans that it otherwise might refuse. One study of CAPs found that 55 percent of the entrepreneurs who received loans under a CAP would not have been granted loans without the backing of the program.[85]

Capital Access Programs (CAPs)—*a state lending program that encourages lending institutions to make loans to businesses that do not qualify for traditional financing because of their higher risk.*

Even cities and small towns have joined in the effort to develop small businesses and help them grow. More than 7,500 communities across the United States operate **revolving loan funds** (RLFs) that combine private and public funds to make loans to small businesses, often at below-market interest rates. As money is repaid into the funds, it is loaned back out to other entrepreneurs. A study by the Corporation for Enterprise Development of RLFs in seven states found that the median RLF loan was $40,000 with a maturity of five years.[86]

revolving loan fund—*a program offered by communities that combine private and public funds to make loans to small businesses, often at below-market interest rates.*

A Company Example

Brian Hale transformed his passion for snowmobiles, dirt bikes, and ATVs into a thriving business with the help of a loan from the Central Vermont Revolving Loan Fund. Hale's company, ***J.B. Motorsports and Salvage****, repairs as well as refurbishes and sells these vehicles to customers looking for bargains. He used his loan to purchase an inventory of parts and to purchase a computer system to help him run the business more efficiently.*[87]

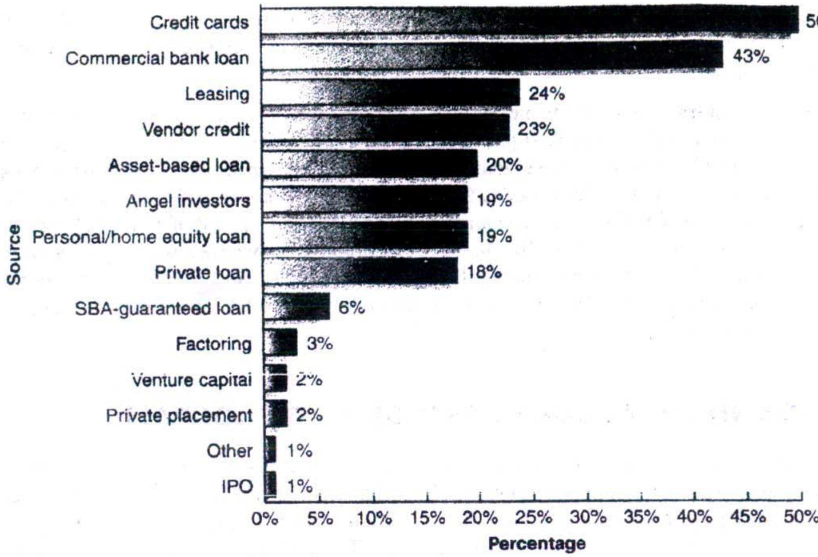
INTERNAL METHODS OF FINANCING

8. Discuss valuable methods of financing growth and expansion internally.

Small business owners do not have to rely solely on financial institutions and government agencies for capital; their businesses have the capacity to generate capital. This type of financing, called **bootstrap financing**, is available to virtually every small business and encompasses factoring, leasing rather than purchasing equipment, using credit cards, and managing the business frugally.

FIGURE 12.5 Where Do Small Businesses Get Their Financing?

Source: *Trends for 2000*, a survey by Arthur Andersen and National Small Business United.



bootstrap financing—*internal methods of financing a company's need for capital.*

factor—*a financial institution that buys a business's accounts receivable at a discount.*

FACTORING ACCOUNTS RECEIVABLE. Instead of carrying credit sales on its own books (some of which may never be collected), a small business can sell outright its accounts receivable to a factor. A **factor** buys a company's accounts receivable and pays for them in two parts. The first payment, which the factor makes immediately, is for 50 to 80 percent of the accounts' agreed-upon (and usually discounted) value. The factor makes the second payment, which makes up the balance less the factor's service fees, when the original customer pays the invoice. Factoring is a more expensive type of financing than loans from either banks or commercial finance companies, but for businesses that cannot qualify for those loans, factoring may be the only choice!

Factoring deals are either with recourse or without recourse. Under deals arranged with recourse, a small business owner retains the responsibility for customers who fail to pay their accounts. The business owner must take back these uncollectible invoices. Under deals arranged without recourse, however, the owner is relieved of the responsibility for collecting them. If customers fail to pay their accounts, the factor bears the loss. Because the factoring company assumes the risk of collecting the accounts, it normally screens the firm's credit customers, accepts those judged to be creditworthy, and advances the small business owner a portion of the value of the accounts receivable. Factors will discount anywhere from 5 to 40 percent of the face value of a company's accounts receivable, depending on a small company's:

- customers' financial strength and credit ratings.
- industry and its customers' industries because some industries have a reputation for slow payments.
- history and financial strength, especially in deals arranged with recourse.
- credit policies.[88]

LEASING. Leasing is another common bootstrap financing technique. Today, small businesses can lease virtually any kind of asset—from office space and telephones to computers and heavy equipment. By leasing expensive assets, the small business owner is able to use them without locking in valuable capital for an extended period of time. In other words, the manager can reduce the long-term capital requirements of the business by leasing equipment and facilities, and she is not investing her capital in depreciating assets. Also, because no down payment is required and because the cost of the asset is spread over a longer time (lowering monthly payments), a company's cash flow improves.

CREDIT CARDS. Unable to find financing elsewhere, many entrepreneurs launch their companies using the fastest and most convenient source of debt capital available: credit cards! A survey by Arthur Andersen and National Small Business United found that 50 percent of the owners of small and medium-sized businesses used credit cards as a source of funds, making it the most common form of business financing (see Figure 12.5).[89] Putting business start-up costs on credit cards charging 21 percent or more in annual interest is expensive and risky, but some entrepreneurs have no other choice.

A Company Example

Charlene Connell used 10 credit cards with a total credit limit of $15,000 to make payroll when she launched her computer consulting company, ***Vital Resources Inc.*** *Although it was a struggle in some months to meet the cards' minimum payments, Connell managed to do so. Today, Vital Resources is a thriving business that owes its early success to a very simple form of financing.*[90]

CHAPTER SUMMARY

1. Explain the differences between the three types of capital small businesses require: fixed, working, and growth.

- Capital is any form of wealth employed to produce more wealth. Three forms of capital are commonly identified: fixed capital, working capital, and growth capital.
- Fixed capital is used to purchase a company's permanent or fixed assets; working capital represents the business's temporary funds and is used to support the business's normal short-term operations; growth capital requirements surface when an existing business is expanding or changing its primary direction.

2. Describe the differences between equity capital and debt capital and the advantages and disadvantages of each.

- Equity financing represents the personal investment of the owner (or owners), and it offers the advantage of not having to be repaid with interest.
- Debt capital is the financing that a small business owner has borrowed and must repay with interest. It does not require entrepreneurs to give up ownership in their companies.

3. Describe the various sources of equity capital available to entrepreneurs, including personal savings, friends and relatives, angels, partners, corporations, venture capital, and public stock offerings.

- The most common source of financing a business is the owners' personal savings. After emptying their own pockets, the next place entrepreneurs turn for capital is family members and friends. Angels are private investors who not only invest their money in small companies, but they also offer valuable advice and counsel to them. Some business owners have success financing their companies by taking on limited partners as investors or by forming an alliance with a corporation, often a customer or a supplier. Venture capital companies are for-profit, professional investors looking for fast-growing companies in "hot" industries. When screening prospects, venture capital firms look for competent management, a competitive edge, a growth industry, and important intangibles that will make a business successful. Some owners choose to attract capital by taking their companies public, which requires registering the public offering with the SEC.

4. Describe the process of "going public," as well as its advantages and disadvantages and the various simplified registrations and exemptions from registration available to small businesses wanting to sell securities to investors.

- Going public involves (1) choosing the underwriter, (2) negotiating a letter of intent, (3) preparing the registration statement, (4) filing with the SEC, and (5) meeting state requirements.
- Going public offers the advantages of raising large amounts of capital, improved access to future financing, improved corporate image, and gaining listing on a stock exchange. The disadvantages include dilution of the founder's ownership, loss of privacy, reporting to the SEC, filing expenses, and accountability to shareholders.
- Rather than go through the complete registration process, some companies use one of the simplified registration options and exemptions available to small companies: Regulation S-B, Regulation D (Rule 504) Small Company Offering Registration (SCOR), Regulation D (Rule 505 and Rule 506) Private Placements, Section 4(6), Rule 147, Regulation A, direct stock offerings, and foreign stock markets.

5. Describe the various sources of debt capital and the advantages and disadvantages of each: banks, asset-based lenders, vendors (trade credit), equipment suppliers, commercial finance companies, savings and loan associations, stockbrokers, insurance companies, credit unions, bonds, private placements, Small Business Investment Companies (SBICs), and Small Business Lending Companies (SBLCs).

- Commercial banks offer the greatest variety of loans, although they are conservative lenders. Typical short-term bank loans include commercial loans, lines of credit, discounting accounts receivable, inventory financing, and floor planning.
- Trade credit is used extensively by small businesses as a source of financing. Vendors and suppliers commonly finance sales to businesses for 30, 60, or even 90 days.
- Equipment suppliers offer small businesses financing similar to trade credit but with slightly different terms.
- Commercial finance companies offer many of the same types of loans that banks do, but they are more risk oriented in their lending practices. They emphasize accounts receivable financing and inventory loans.
- Savings and loan associations specialize in loans to purchase real property—commercial and industrial mortgages—for up to 30 years.
- Brokerage houses offer loans to prospective entrepreneurs at lower interest rates than banks because they have high-quality, liquid collateral—stocks and bonds in the borrower's portfolio.
- Insurance companies provide financing through policy loans and mortgage loans. Policy loans are extended to the owner against the cash surrender value of insurance policies. Mortgage loans are made for large amounts and are based on the value of the land being purchased.
- Small Business Investment Companies are privately owned companies licensed and regulated by the SBA that qualify for SBA loans to be invested in or loaned to small businesses.
- Small Business Lending Companies make only intermediate and long-term loans that are guaranteed by the SBA.

6. Identify the various federal loan programs aimed at small businesses.

- The Economic Development Administration, a branch of the Commerce Department, makes loan guarantees to create and expand small businesses in economically depressed areas.
- The Department of Housing and Urban Development extends grants (such as Community Development Block Grants) to cities that, in turn, lend and grant money to small businesses in an attempt to strengthen the local economy.
- The Department of Agriculture's Rural Business-Cooperative Service loan program is designed to create non-farm employment opportunities in rural areas through loans and loan guarantees.
- The Small Business Innovation Research Program involves 11 federal agencies that award cash grants or long-term contracts to small companies wanting to initiate or to expand their research and development (R&D) efforts.
- The Small Business Technology Transfer Program allows researchers at universities, federally funded R&D centers, and nonprofit research institutions to join forces with small businesses and develop commercially promising ideas.

7. Describe the various loan programs available from the Small Business Administration.

- Almost all SBA loan activity is in the form of loan guarantees rather than direct loans. Popular SBA programs include Low Doc Loan Program, the SBA*Express* Program, the 7(A) Loan Guaranty Program, the CAPLine Program, the Export Working Capital Program, the Section 504 Certified Development Company Program, the Microloan Program, the Prequalification Loan Program, and the Disaster Loan Program.
- Many state and local loan and development programs such as Capital Access Programs and Revolving Loan Funds complement those sponsored by federal agencies.

8. Discuss valuable methods of financing growth and expansion internally.

- Small business owners may also look inside their firms for capital. By factoring accounts receivable, leasing equipment instead of buying it, and minimizing costs, owners can stretch their supplies of capital.

DISCUSSION QUESTIONS

1. Why is it so difficult for most small business owners to raise the capital needed to start, operate, or expand their ventures?
2. What is capital? List and describe the three types of capital a small business needs for its operations.
3. Define equity financing. What advantage does it offer over debt financing?
4. What is the most common source of equity funds in a typical small business? If an owner lacks sufficient equity capital to invest in the firm, what options are available for raising it?
5. What guidelines should an entrepreneur follow if friends and relatives choose to invest in her business?
6. What is an angel investor? Assemble a brief profile of the typical private investor. How can entrepreneurs locate potential angels to invest in their businesses?
7. What advice would you offer an entrepreneur about to strike a deal with a private investor to avoid problems?
8. What types of businesses are most likely to attract venture capital? What investment criteria do venture capitalists use when screening potential businesses? How do these compare to the typical angel's criteria?
9. How do venture capital firms operate? Describe their procedure for screening investment proposals.
10. Summarize the major exemptions and simplified registrations available to small companies wanting to make public offerings of their stock.
11. What role do commercial banks play in providing debt financing to small businesses? Outline and briefly describe the major types of short-term, intermediate, and long-term loans commercial banks offer.
12. What is trade credit? How important is it as a source of debt financing to small firms?
13. What function do SBICs serve? How does an SBIC operate? What methods of financing do SBICs rely on most heavily?
14. Briefly describe the loan programs offered by the following:
    a. Economic Development Administration
    b. Department of Housing and Urban Development
    c. Department of Agriculture
    d. local development companies
15. Explain the purpose and the methods of operation of the Small Business Innovation Research Program and the Small Business Technology Transfer Program.
16. How can a firm employ bootstrap financing to stretch its current capital supply?
17. What is a factor? How does the typical factor operate? Explain the advantages and the disadvantages of using factors as a source of funding.

THE BUSINESS DISC

What do lenders and investors look for in a business plan when deciding whether or not to put their money into a business start-up? (Hint: refer to the 5 Cs of credit in Chapter 11.)

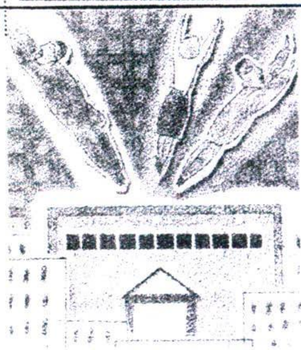
Did the loan committee at the bank approve your business plan and loan request on the first try? If so, congratulations!! If not, why not? How did you revise your plan to get it approved?

BUSINESS PLAN PRO

Business PlanPro

Now that you have created a business plan for your start-up venture, devise a strategy for using your plan to raise the capital you will need to launch the business. How much money do you need? Which sources of funding offer the greatest prospects? Which sources covered in this chapter offer the least potential of funding your business? Are there any sources you plan to avoid? Explain.

BEYOND THE CLASSROOM . . .



1. Interview several local business owners about how they financed their businesses. Where did their initial capital come from? Ask the following questions:

   a. How did you raise your starting capital? What percentage did you supply on your own?

   b. What percentage was debt capital and what percentage was equity capital?

   c. Which of the sources of funds described in this chapter do you use? Are they used to finance fixed, working, or growth capital needs?

   d. How much money did you need to launch your businesses? Where did subsequent capital come from? What advice do you offer others seeking capital?

2. Contact a local private investor and ask him or her to address your class. (You may have to search to locate one!) What kinds of businesses does this angel prefer to invest in? What screening criteria does he or she use? How are the deals typically structured?

3. Contact a local venture capitalist and ask him or her to address your class. What kinds of businesses does his or her company invest in? What screening criteria does the company use? How are deals typically structured?

4. Invite an investment banker or a financing expert from a local accounting firm to address your class about the process of taking a company public. What do experts look for in a potential IPO candidate? What is the process, and how long does it usually take?

5. After a personal visit, prepare a short report on a nearby factor's operation. How is the value of the accounts receivable purchased determined? Who bears the loss on uncollected accounts?

6. Interview the administrator of a financial institution program offering a method of financing with which you are unfamiliar, and prepare a short report on its method of operation.

7. Contact your state's business development board and prepare a report on the financial assistance programs it offers small businesses.

8. Go to the IPO section of the Web site for Hoover's (www.hoovers.com) and explore the details of a company that is involved in making an initial public offering. View some of the documents the company has filed with the SEC, especially the initial public offering filing. Prepare a brief report on the company. What is its business? Who are its major competitors? How fast is the industry growing? What risk factors has the company identified? How much money does it plan to raise in the IPO? What is the anticipated IPO stock price? How many shares of stock will the company sell in the IPO? Would you buy this company's stock? Explain.