Financing: Small and growing business

Deloitte, Haskins & Sells
Financing

Small and Growing Businesses
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Financing

Small and Growing Businesses
Foreword

Small and growing businesses need infusions of capital financing as much as, if not more than, do large businesses. Small businesses are usually growing at dynamic rates, which often results in temporary cash shortfalls. These shortfalls are typically caused by sales expenses and capital acquisitions necessary for continued development growing faster than working capital.

Additionally, growth offers opportunities for acquisitions and increased research and development activities if financing can be obtained. This growth for which the entrepreneur has worked so hard may cause considerable strain on the company’s cash.

Yet the entrepreneur’s ability to obtain necessary capital to overcome this situation has been one of the stumbling blocks for many small businesses. Since the entrepreneur’s idea, product or business does not usually have a track record, and might be risky to a lender or investor, capital is denied and growth never occurs. The entrepreneur must therefore recognize that options are limited and that energies must be devoted to a creative approach to the opportunities available.

This booklet discusses sources of financing for the small and growing business, and the applicability of different sources and types to particular situations. Other considerations that can increase the chances of obtaining financing are also discussed. This booklet has deliberately been kept brief, and it is important that an entrepreneur get professional advice when seeking or arranging financing.
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Introduction

This booklet is designed to provide an entrepreneur with an approach to evaluate the need for external financing. In many situations, the temporary cash shortfall is upon the entrepreneur before any corrective actions can be taken, resulting in a very costly financing package or no financing whatsoever. This situation does not have to occur if an entrepreneur recognizes that financing requires planning.

The planning begins with the determination of the goals and objectives that the company seeks. Once these are stated, the company can identify where it is and where it is going. With this determination, the company can carefully consider whether it ought to seek financing to help achieve the stated goals and, if so, what type is best suited to its need.

But before going outside for financing, the internal financing sources must be examined to determine what are the company’s real needs. These needs can then be correlated to the company’s plans to ensure that external sources can be systematically reviewed as to their appropriateness.

If external financing becomes necessary, then an intelligent selection of a financing source can be made, an appropriate financing proposal prepared, and the best financing for the company obtained.

Considerations for Companies Securing Capital

Small and growing businesses have unique operating characteristics that create both dynamic opportunities and distinctive problems. In many instances the operations are managed by the owners. Their product lines are generally simple, their markets well-defined and their organizational structure very informal. These characteristics allow a small company to adapt quickly to environmental changes, develop new products and generate jobs.

These same characteristics, however, also limit the company’s ability to succeed, because the resulting management style concentrates on adapting to day-to-day changes as opposed to planning to accomplish overall objectives. With only limited or informal planning, the smaller company faces a greater degree of uncertainty in today’s highly competitive environment. This high level of uncertainty inhibits accurate evaluation of alternatives, allocation of resources and anticipation of needs. And this problem is at no time more evident than when the small and growing company seeks to obtain capital. Investors and lenders are hard to attract because the company has not formulated a business plan.
Therefore, owners and managers are not in a position to answer the basic questions that underlie a successful financing package, such as:

- Where are the proceeds to be invested?
- How much money is needed?
- What terms and repayment schedules are affordable?
- What collateral does the borrower have?

Unfortunately, many owner/managers consider these questions only when the need is upon them, thus losing access to sources or incurring significant costs in connection with the sources found. Capital availability is one of the critical factors to success, and planning enhances the ability to obtain financing.

Thus, the process of securing financing should begin with developing a statement of where the company is and where it is heading. This statement should be clearly delineated in terms of goals and objectives. For example, assessments of where a company fits into a market's price range, quality standards and competitive position can determine the advertising and production strategies necessary. Assessment of the stage of the product in the marketplace can determine whether to invest in engineering refinements or plant expansion. Analysis of the opportunities for growth or decline of the markets in which a company competes can determine the markets to be emphasized. This evaluation of a company enables the owner/managers to decide, on the basis of the prospects, the direction in which to go in the years ahead. Once a direction is determined, an identification of the resources necessary and, concurrently, any needed financing can be made.

This assessment need not be a burdensome task. Rather, it encompasses what the owner/managers intrinsically know and regularly accomplish to operate a small and growing business successfully.

A sequential list of topics and some examples of considerations that might be addressed for this assessment are:

- Identification of current position—Is the company growing in its current markets or does decline seem probable?
- Product life stage—Is the product unique and in continual demand? Is new technology on the horizon threatening obsolescence?
• Market opportunities—Are there markets in other geographical areas or niches in markets that can be exploited?

• Market threats—Has the competition introduced new products? Have consumer preferences changed? Has the product saturated the marketplace?

• Company's strengths and weaknesses—Does the company have a patent on its product? Is its distribution network strong?

• Resource availability—Is the company assured of necessary supplies at a reasonable price?

• Establishment of goals and objectives—What does the company hope to obtain in the future, and is it realistic in light of the other factors evaluated? What are the personal aspirations of the owner?

• Development of strategy—What changes are necessary to insure that the strategies developed will be successful?

• Implementation of strategy—What are the most appropriate resources for achieving the stated goals and objectives?

An identification of the stage of the company's life cycle is made during this process. This identification is important because it can help the owner/managers make a basic decision as to what type of financing, debt or equity, is most appropriate for this stage. This differentiation as to type may enhance the company's ability to obtain external financing since efforts can be focused on sources specializing in the type needed.

This process also gives a direction to the company. The small company will then have the information necessary to develop a plan that will answer the where, how and why questions that a potential lender or investor will pose.

**Cycle of Life and Types of Financing**

Although all businesses differ, there are certain stages in their economic cycle of life when different kinds of financing are most appropriate. Recognizing this, owner/managers can make a preliminary survey of the types of financing that are appropriate, using the data gathered during the goal-setting process.
Most companies have the following stages in their life cycle:

- **Conceptual Phase**
  - Success? No → New Plan and/or Job
  - Success? Yes → Initial Operations

- **Initial Operations**
  - Success? No → Salvage/Rebuilding
  - Success? Yes → Rapid Growth Phases

- **Rapid Growth Phases**
  - Success? No → Salvage/Rebuilding
  - Success? Yes → Mature Company

The *conceptual stage* is the beginning of the process, where the entrepreneur recognizes a potential niche in the market and seeks to take advantage of it. At this stage, the financing will come primarily from the entrepreneur’s own money and some additional funds from other investors, most likely, friends and relatives. In some cases, financing can be attracted through the formation of investor groups in limited partnerships that participate to shelter income with the potential of conversion to capital gains. Additionally, if the company is in a glamorous industry such as oil and gas or high technology, the possibility for a public offering exists.
The initial operations stage is marked by the creation of the organizational structure to increase volume and sales dollars either by improving market share or by adding other markets. The privately invested funds and seed capital have demonstrated that the venture is viable and profitable. But to realize this potential, additional financing will be necessary. Equity capital is a feasible source; however, another avenue of funds is now available in that debt capital can be obtained. Lenders are now more willing to participate in the venture, as the company has demonstrated viability. Therefore, the entrepreneur can expand without diluting ownership interest.

The rapid-growth stage is marked by dramatic increases in both sales volume and dollars; however, income normally lags and cash is required to support the growth. Both debt and equity capital are sources, but at this stage the entrepreneur has a greater bargaining position because of the attractiveness of the venture. The number of financing opportunities has increased, and the potential for alternative arrangements has improved.

The maturity stage occurs when the company has penetrated the market to the extent possible and may be aggressive but expansion is no longer possible. The company may decide to hold and defend its market share or harvest the rewards of past investments. Debt capital becomes the prime source of funds at this stage as the opportunity for realization of economic gains from the investors' perspective diminishes.

The salvage/rebuilding stage may occur at any time if other stages are not successful. Debt capital becomes the prime source of financing, but its availability becomes limited due to the increased risk associated with the venture.

With this information, a tentative decision can be made as to whether borrowing or the equity approach is preferable, given the preliminary goals and objectives established. There are advantages and disadvantages to each for every company, but the key is to determine what type appears to give the company the maximum opportunity to proceed in its defined direction.

Additionally, a preliminary judgment can be made as to the length of time for which the financing is needed. If the funds are needed for a business startup or seasonal peaks, then the financing would be of short-term duration, whereas financing to sustain increased working capital requirements due to growth would be of medium to long-term duration. Expansion or capital-equipment acquisitions would require long-term financing.

Now the "brainstorming" to develop goals for the company and the appropriate funding objectives must be formalized into the company's business plan.
The process of setting goals and objectives enables the entrepreneur to develop a business plan. It is important to formalize this process. No matter whether the company is in its first or tenth year of operation, written goals should be developed. Owner/managers must remember that any investor or lender will require information regarding the company and its financial requirements. A clear statement of corporate goals, areas of opportunity, agreed-upon action plans and explicit statements of resource availability can be of immense value in securing external financing.

The business plan should be for at least a one-year period and should ultimately represent the company’s roadmap to the defined goals. The detail of a business plan will vary, but matters generally included are:

- Management group and key personnel
- Organization structure
- Description of product
  - Highlights of unique features
  - Third parties and credibility
- Evaluation of market and competition
- Marketing strategy
- Production plans
- Risk factors
- Financial information
  - Historical data
  - Projections

The judgments contained in the plan will represent the most probable actions and results that the company anticipates at the time. The plan should contain alternative strategies and goals, since a major element, the necessary financing, is yet to be determined. Business planning, however, is needed before a financing plan and the preparation of the financing proposal package. A lender or investor will want to know as much as possible about the company in order to assess whether the requested funds will be used effectively. A critical element of this plan is the finan-
cial information, which should be as detailed as possible—especially the projected financial information which a lender or investor will rely upon to a great extent to make judgment about the attainability of the goals. Of prime interest is the projected cash-flow statement which justifies to the lender or investor the amount of funds needed, the period required, and the repayment schedule. To develop a meaningful cash-flow statement, an extensive review of the company’s internal financing sources is in order.

**Internal (Bootstrap) Financing**

Most small and growing businesses are unaware of the best means at their disposal to generate funds; that is, controlling cash inflows and outflows. Internally generated financing, more commonly referred to as "bootstrap financing," should be explored by any business before seeking outside financing. Whether the company is in the conceptual stage or the maturity stage, emphasis on internally generated funds can only improve profitability.

Bootstrap financing involves maximizing the amount of capital that an operation can provide. Most small companies regularly develop cash projections to insure that funds will be available when needed. However, very few small companies analyze the elements of their cash projections to determine whether changes would improve the cash position. Such an analysis could definitely improve the company’s liquidity.

Initially, a review should be made of the current cash forecasting system to insure that it:

- Includes all significant cash activities of the company
- Identifies in advance when there will be a temporary cash surplus or shortfall
- Indicates the amount of funds that would be needed from external sources
- Facilitates planning

If the system needs modification, the starting point should be with the company budget. The cash forecasting system should be interwoven with the operating budget to determine the effect that each forecast will have upon the other. Next, information should be obtained from knowledgeable personnel to adjust for known or expected changes. Analysis of prior periods should also be done to ascertain if there are any trends or patterns that should be incorporated. At this point a meaningful projection of cash receipts and disbursements can be developed.
Next, the elements that make up the receipts and disbursements must be analyzed in order to determine what changes can be made to improve the company’s liquidity. In speeding up cash receipts and slowing down cash disbursements, a significant source of financing can be obtained. The steps involved in this process are:

- Accelerating accounts-receivable collections
- Optimizing trade credit arrangements
- Improving inventory turnover
- Turning fixed assets into cash
- Reducing nonessential expenses

**Accelerating Accounts- Receivable Collections.** Since accounts receivable are a major element for practically all companies, there is a significant opportunity cost associated with lax credit policies that allow customers to pay beyond the due dates. For example, a company that permits customers to remit payments in sixty days, even though the stated repayment period is thirty days, has forgone the use of those funds for thirty days. On the other hand, credit policies that are too stringently enforced can reduce the level of sales activities. To improve cash inflows, credit policies should be examined periodically to determine that they are not causing the company undue costs, given the competitive environment.

The degree to which any company has the freedom to modify its credit policies is governed by its competitive position. For example, if the practices within the industry allow a customer to take a discount even when the discount period has expired, a company cannot stringently enforce its discount terms without suffering loss of customers. However, minor changes might reduce the cost of granting credit without damaging competitive status. For example, in an economic downturn credit terms might be liberalized or seasonal dating of invoices might be used to increase sales activity and, ultimately, cash collections. Credit policies as to the quality of the account accepted might also be modified. Collection policies could be strengthened through the setting of strict credit limits or aggressive followup. However, collection procedures can be expensive in that additional personnel might have to be added or the time of existing personnel diverted to this activity. Therefore, a change in policy is justifiable only when the expected gains exceed the cost.

Companies can accelerate cash flow through improvements in their billing functions. Procedures to insure that items are billed as shipped can be implemented. Special procedures can be established for large dollar
amount sales to speed processing. Personnel can be added to minimize the demands on the billing function, or the department can be restructured to increase efficiency. If this use of personnel is not cost-justified, cycle billing for a large number of small accounts can be set up to increase cash flow while minimizing costs.

Where competitive conditions permit, aggressive promotion of the cash discount might be beneficial. Promotions such as increased discounts over the usual amount for accelerated payments, substantial dollar-amount discounts and volume discounts might be appropriate. However, the expected results must be greater than the costs involved. For example, if a company has annual sales of $25 million, and 30 percent of its customers take the discount of 2/10 net 30, the approximate discount cost would be $150,000. Assuming the remainder of the customers pay in thirty days, the average collection period would be twenty-four days for both discounted and undiscouned sales. The average uncollections accounts-receivable balance would be

$$\frac{25,000,000 \times 360}{360 \times 24} = \$1,667,000$$

as opposed to

$$\frac{2,083,000 \times 360}{30} = \$2,083,000$$

without discount.

At this point, management must assess whether granting additional discounts on the difference of $416,000 would generate a greater return than the cost. In all likelihood, it will not; however, since competitive conditions usually require discounts, management’s only choice is not to push further discounts aggressively.

**Optimizing Trade Credit Arrangements.** In paying bills, it should be kept in mind that the longer a company can keep money, the greater the available funds on which it can earn a return. The first step is to analyze the types of bills received. For net payment bills, set up a procedure that maximizes the payment period without damaging credit relations. For discount bills, pay during the allowed period at the latest possible date. Next, review suppliers to determine that the company is doing business with those offering the best discount programs. Once a good payment history has been established, trade creditors normally extend credit interest-free for a period. A company’s objective should be to buy inventory, sell the goods and collect the receivables before the invoice due date. The profits generated through this process should reduce the need for extensive external financing. A vital key to maintaining good relations with a company’s suppliers is the elimination of surprises. A company should always keep its major suppliers informed as to any developments that may affect the payment of invoices. This may avert credit curtailment and damaged relations.
Payroll and commission procedures might also be changed so that payments are made monthly instead of weekly. Contributions to pension plans and tax payments should be scheduled at the latest possible date. Year-end accrual procedures should be strengthened to insure that all items are accrued, thereby reducing income taxes payable for the current year.

**Improving Inventory Turnover.** Inventory usually represents the most significant asset of manufacturing and trading companies. These inventories do not earn a return for the company while on site and cost money to store. Thus, the company incurs both real and opportunity costs on this investment. Most companies, therefore, will benefit from a review of their procedures for ordering and stocking. This review might highlight stockouts or excess investment situations resulting in lost profits. An optimal level for the inventory could be established that would balance the disadvantages and benefits of handling costs, carrying costs and stockout costs.

An excellent indicator for purposes of inventory control is the inventory turnover rate, which is derived by dividing cost of goods sold by the average inventory of goods. This rate, which can be determined for the entire inventory or for specific segments, indicates the number of days that it takes for the inventory to turn over. A higher rate of turnover (i.e., a decrease in the number of days that inventory is on hand) is the objective the company should strive for; however, a high turnover rate cannot be the only consideration, since a high rate might mean lost sales due to stockouts. The rate calculated should also be compared to industry statistics to assess the competitive position of the business. Therefore, the rate is only a guide to management in establishing inventory levels.

Examining sales patterns provides another guide for management. These patterns highlight periods or options that management can use to purchase materials and components strategically. This review can also indicate current procedures for volume purchases and production scheduling that are not coordinated with established sales volume or cash availability and, therefore, should be discontinued. Statistical formulas for, e.g., determining economic order quantity or fixed order cycle can also be implemented where the operating environment is relatively stable.

Finally, conversion to the LIFO method of inventory valuation might reduce income tax payments. This cash saving, however, must be evaluated in light of the expenditures that might have to be made for the conversion.
Turning Fixed Assets into Cash. Another way to increase available cash for operations is to reduce the investment in real estate and equipment. This can be done by leasing rather than purchasing. Although the actual rental will in the long run total more than the purchase price of the equipment, an owner may receive more than this difference in profits by investing the money otherwise spent on equipment back into the business. The deductibility of these payments for tax purposes also minimizes the impact on profits. These arrangements can be obtained through leasing companies or major banks that have separate subsidiaries specializing in leasing. Each company must review its own situation in detail. Short-range advantages may not always warrant long-range drawbacks, but, as an immediate means of preserving cash, leasing has great appeal.

An examination of the property ledgers might also reveal either excess or obsolete equipment that could be sold to generate cash. Additionally, the examination of the ledgers might indicate that planned purchases can be deferred or cancelled because of the availability of other equipment.

Reducing Nonessential Expenses. Tight-fisted management of expenses is critical to improving cash availability. The profit and loss statement should be examined very closely to minimize expenses which are draining corporate cash but are not generating a maximum benefit to the company. Salaries, product costs, supplies, utilities, travel and entertainment are expenses that might possibly be reduced. Costs believed to be fixed may be variable when subject to a critical review. Each company must review its own situation in order to ascertain what expenses are essential and reasonable, concentrating its efforts on reducing only those items that will not affect the achievement of short- and long-term goals.

Sources of External Financing

Armed with the knowledge of where the company is headed and the amount of resources internally available, owner/managers are now in a position to specify the financing most appropriate to the company’s stage in its life cycle. The financing for small and growing businesses is provided by either private sources, lending institutions or the government. An understanding of the lending philosophies, policies and conditions of these sources is essential to determining which offers the entrepreneur the best opportunity for obtaining financing.

Debt Capital

Seed Funds. Seed funds are the prime source of capital for an entity in the conceptual phase of its life cycle. An entrepreneur can use personal wealth to finance the business and can also seek financing from relatives
and friends. The key factor to remember is that seed funds are just that, the financing to begin with. Very rarely are the seed funds enough to carry the business past the initial stage. And even more important, people who provide seed money for new businesses are usually not in the position to provide additional funds. Therefore, an entrepreneur must realize that it is never too early to start meeting the funding requirements of the company.

**Commercial Banks.** Commercial banks have long been the cornerstone of lending for small and growing businesses. As “full service” institutions, commercial banks offer a variety of loans from which an entrepreneur can generally obtain the financing suited to his or her needs.

Commercial banks grant loans on either an unsecured or secured basis. An unsecured loan is granted on the basis of the applicant’s credit. A secured loan requires a pledge of some or all of the assets of the company and in most cases the personal guarantees of the owner. Since small businesses usually do not have the necessary financial track record to impress a banker, much of the lending by a commercial bank is done on a secured basis.

Commercial banks' lending policies are generally guided by the following criteria:

- **Character**—The borrower appears to have the reputation to insure repayment of the loan.
- **Capital**—The borrower has a sufficient amount of his or her own funds invested in the business.
- **Capacity**—The borrower has the skill to manage the business profitably.
- **Collateral**—The borrower has a very good credit rating or tangible assets to pledge.

Additionally, circumstances such as the seasonal character of the business, competitive position in the industry, innovativeness of the product and general economic conditions influence the approval of a loan request. However, the overriding consideration that determines approval is the ability of the applicant to repay the loan.

The principal types of loans available from a commercial bank include:

- Personal secured/unsecured loans
- Straight commercial loans
• Government-guaranteed loans
• Receivables/inventory financing
• Real-estate/equipment term loans
• Leasing
• Unsecured line of credit
• Unsecured term loans
• Letters of credit

Personal secured/unsecured loans, commonly referred to as character loans, are made to individuals or companies with a very good credit rating. These loans are written for a short- or medium-term duration, the funds normally being granted for general business purposes.

Straight commercial loans are written for a period of thirty to ninety days, primarily to meet seasonal needs such as a buildup of inventories. These loans are expected to be liquidated once the temporary need is past.

Government-guaranteed loans are loans guaranteed against loss to the lender by the Small Business Administration (SBA). The maximum guarantee is for 90 percent of the loan proceeds or up to a maximum loan amount, whichever is less, to eligible applicants. The lender loans the money at an interest related to "prime" but with a maximum ceiling established by Congress. Normally, personal guarantees are required. Most loans are on a secured basis. The specifics of the program are discussed more fully in the section of this booklet entitled Small Business Administration; however, the prime consideration for the entrepreneur is that the bank will be inclined to make loans of this type if the applicant can qualify.

Receivables/inventory financing are the most prevalent form of secured loans available to small and growing businesses. This method is especially common for those in small businesses that have a significant investment in such assets.

Accounts-receivable financing involves an agreement specifying the amount that will be advanced and collateralized by eligible receivables of the company. Typically, such loans are from 75 to 85 percent of the eligible receivable balances. As amounts are collected from the customer by the borrower, they are typically submitted to the lender, and an agreed-upon percentage is credited to the loan balance and the remainder is returned to the borrower. Receivables financing thus provides a revolving line of credit in which funds are continually advanced, repaid and readvanced. Receivables financing is normally contracted for a year but may be renewed for additional periods if approved by the lender. The
interest rate varies widely but is generally computed at a specific rate per
day on the amount of funds advanced.

The key factors in this type of loan from the owner/manager’s perspective
are the determination of the receivables that are eligible for the loan and
the advance percentage rate. The bank will conduct a thorough investiga-
tion of the applicant prior to the loan, reviewing such items as the credit
history, types of receivables and quality of the accounts. Thus, the better
the condition of the receivables, e.g., a minimal number of accounts over
ninety days outstanding and good credit ratings of the customers, the
more the company will be allowed to borrow.

Inventory financing, like accounts-receivable financing, provides a
revolving line of credit. Funds advanced to the company at a certain per-
centage rate are secured by the eligible raw material and finished goods
inventories. Work in process is generally excluded because of its unfin-
ished state and minimal liquidation value. Since inventories are less
“liquid” assets than accounts receivable, the amount advanced under an
inventory loan is not as great as in the case of a receivable loan. Amounts
advanced under an inventory loan are normally equal to 50 percent of
the inventory’s value, and may be less, depending upon the inventory.
The inventory loans are paid off as the products are sold. The interest
rate charged and the computation of the charge are similar to those for
receivables financing.

Inventory financing, however, presents special problems to both lender
and borrower. The lender must ascertain the liquidation value of the in-
ventory for advancing funds and be assured that the inventory is secured
in a safe location. Therefore, the borrower usually has additional admin-
istrative procedures, such as monthly reports and calculation of obsoles-
cence rates, turnover rates and gross profit margins, to justify the eligible
base. Additionally, improved procedures for controlling the inventory
may have to be implemented, even to the extent of locating inventories
in independent warehouses, to satisfy the bank’s conditions.

Real estate/equipment term loans provide a company that cannot qual-
ify for an unsecured term loan with funds for general business purposes
or purchases of equipment and real estate. Funds from 60 to 80 percent
of the equipment value are advanced on an equipment loan. The length
of these loans is generally from one to five years. Real-estate loans, com-
monly referred to as industrial mortgages, are usually from ten to twenty-
five years in length with amounts advanced up to 75 percent of the prop-
erty value.

Leasing is increasingly being used as a method of equipment financing
from commercial banks. Equipment leases are generally written for a
minimum of three years, with funds advanced up to 80 percent of the
equipment value. A unique method is the sale-leaseback arrangement
whereby a company concurrently sells its property to the bank and leases it back to use. In either case, the entrepreneur can get the use of the necessary equipment without making a substantial cash outlay.

*Unsecured line of credit* is extended by a bank to a company for a certain amount of money as long as certain conditions are met. The borrower may draw the funds as needed, with interest charged only on the outstanding funds. There is usually no defined repayment date, although generally once a year the lines are expected to be reduced to zero for a thirty-day period. Most small businesses will get this financing only when they have an established track record.

*Unsecured term loans* are granted to companies that have a strong debt to worth ratio (2 to 1) and a strong working-capital position. The loans are usually for a period of more than one year, but not in excess of ten years. The amount advanced ranges from 40 to 50 percent of the required working capital, supplementing any short-term financing. The interest cost varies with the credit worthiness of the applicant, but normally is above the "prime rate."

A *letter of credit* is also offered by a bank as a special form of financing for companies dealing in foreign markets. A letter of credit is a bank-issued document, requested by the buyer, promising that the bank will pay the seller the agreed-upon amount of money, provided that certain documents described in the letter of credit are properly prepared and received by the bank within a specified time period. "Irrevocable" letters of credit are preferable to "revocable" ones. An irrevocable letter of credit accepted by the seller cannot be altered or cancelled by the buyer without the seller's consent. In addition, it is desirable that letters of credit be "confirmed" by a U.S. bank. In confirming a letter of credit, the U.S. bank accepts the responsibility to pay should the buyer or the foreign bank default or become insolvent.

With all these types of loans, the bank seeks to earn a reasonable return on the money it lends while minimizing the risk. Therefore, the bank will have certain lending guidelines/conditions such as the following:

- The interest rate will vary with the size of the loan and the risk involved.
- The loans will generally be secured.
- The personal guarantees of the owner/managers, including those of their spouses, may be required.
- Compensating balances or exclusive banking arrangements may be required.
- Covenants such as minimum working-capital requirements, salary and dividend restrictions, pledges of stock and audited financial statements may be required.
Given the variety of loans, of lending philosophy, and of lending conditions, an entrepreneur must map a strategy to insure capital availability and avoid excessive costs. The key is to match the most appropriate type of loan to the needs of the company. The process can be improved when the type of financing is analyzed in relation to the phase of the company’s life cycle. The financing arrangement should be sought that affords the company the maximum opportunity to achieve its defined goals while minimizing the costs.

Additionally, owner/managers should recognize that not all banks will offer all varieties of loans to all customers. The operating philosophy, resource constraint and size of the bank should all be considered when deciding where to shop for financing.

The following chart capsulizes some general guidelines for the entrepreneur to consider:

<table>
<thead>
<tr>
<th>Corporate Life Phase</th>
<th>Conceptual</th>
<th>Initial Operations</th>
<th>Rapid Growth</th>
<th>Maturity</th>
<th>Salvage/Rebuilding</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of Financing</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Personal secured/unsecured loans</td>
<td>B</td>
<td>B</td>
<td>X</td>
<td>X</td>
<td>B</td>
</tr>
<tr>
<td>• Straight commercial loans</td>
<td>X</td>
<td>B</td>
<td>B</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>• Government-guaranteed loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>— Small amount</td>
<td>S</td>
<td>S</td>
<td>X</td>
<td>X</td>
<td>S</td>
</tr>
<tr>
<td>— Large amount</td>
<td>X</td>
<td>B</td>
<td>B</td>
<td>B</td>
<td>X</td>
</tr>
<tr>
<td>• Receivables/inventory financing</td>
<td>X</td>
<td>X</td>
<td>L</td>
<td>L</td>
<td>L</td>
</tr>
<tr>
<td>• Letters of credit</td>
<td>X</td>
<td>S</td>
<td>B</td>
<td>L</td>
<td>L</td>
</tr>
<tr>
<td>• Leasing</td>
<td>X</td>
<td>B</td>
<td>B</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>• Real-estate/equipment term loans</td>
<td>X</td>
<td>B</td>
<td>B</td>
<td>B</td>
<td>B</td>
</tr>
<tr>
<td>• Unsecured line of credit</td>
<td>X</td>
<td>X</td>
<td>L</td>
<td>L</td>
<td>X</td>
</tr>
<tr>
<td>• Unsecured term loan</td>
<td>X</td>
<td>X</td>
<td>B</td>
<td>B</td>
<td>X</td>
</tr>
</tbody>
</table>

**Legend**

S = Small bank; defined as a bank with $300 million or less in assets.
L = Large bank; defined as a bank with more than $300 million in assets.
B = Small or large bank.
X = Usually not applicable.
Once a decision is made as to the appropriate financing vehicle and the size of bank most likely to offer the type needed, the entrepreneur should consider the following when negotiating a loan:

- Commercial banks are generally conservative institutions and will require significant information about the company.
- Commercial banks are interested in developing a long-term relationship with a borrower.
- Most loan agreements will contain negative covenants that cannot be avoided, but should be minimized to the extent possible so that the restrictions do not hinder the company's operations.
- The commercial bank must be expected to make a reasonable profit on its relationship with a company, but the effect of required fees, deposits, and the like should be incorporated into the negotiations.
- Not all commercial banks are interested in small and growing businesses; therefore the entrepreneur should select an institution that both understands his or her business and will provide comprehensive services.

**Savings and Loan Companies.** Another institution within the financial community that offers a limited source of financing for the small and growing business is a savings and loan company. Savings and loan companies are chartered to make real estate loans on industrial and commercial property. Generally, the savings and loan company will write a mortgage for up to 75 or 80 percent of the appraised value of the property with a repayment schedule of up to twenty-five years. The limitations to this source of funds are that the real estate financing must be secured by a first mortgage, and savings and loans are not inclined to write loans for property that is to be used for a specialized purpose, such as a building uniquely designed for a manufacturing operation. This source will be feasible only when a business has a qualifying type of asset.

**Small Business Administration.** The major source of government financing available to the small and growing business has been the Small Business Administration (SBA). The objectives of the SBA are to stimulate and promote the small-business contribution to the economy. The SBA has been helping small companies obtain capital by guaranteeing intermediate- and long-term bank loans and making a limited number of direct loans.
The SBA provides the following assistance:

- **Financial** — Direct loan and loan guarantee programs
- **Investment** — Small Business Investment Companies
- **Procurement** — Government contract and subcontract programs
- **Management** — Counseling services
- **Minority** — Programs to assist minority-owned entities
- **Advocacy** — Handling of complaints about the programs

The SBA interacts the most with the small business community in the financial assistance category. The programs that have the greatest interest for small businesses may be classified as follows:

- **Business loans** — assists small businesses, as defined, with their normal operating requirements, such as working capital, equipment and property needs.
- **Economic opportunity loans** — assists low-income or socially disadvantaged persons, as defined, in their small business activities.
- **Disaster loans** — makes direct loans to small businesses, as defined, that have suffered damage in SBA-declared disaster areas to assist their return to predisaster status.
- **Economic injury loans** — assists small businesses, as defined, suffering economic injury due to conditions defined by the SBA.
- **Energy loans** — assists small businesses, as defined, engaged in or preparing to engage in defined energy measures.
- **Contract loans** — assists contractors, as defined, with short-term financing or line-of-credit guarantees.

Additionally, the SBA offers numerous other programs that an applicant might qualify for, e.g., handicapped assistance loans and regulatory injury loans.

By law, the SBA cannot make a loan if the business can obtain financing from another source, such as a bank. Therefore, it is necessary that a business attempt to seek private financing before applying. Usually this means applying to one lending institution; however, if you are located in
An SBA-defined large city, more than one application may be necessary. An applicant must be able to demonstrate to the SBA that he or she:

- Has the necessary business ability
- Will be able to repay the loan
- Has sufficient capital in the business

Furthermore, the SBA has size standards that define the eligibility requirements for small businesses. Therefore, it is prudent for an owner/manager to obtain the latest regulations from one of the SBA's district offices before actively pursuing SBA funding.

The SBA has direct loan funds and indirect funds through its guarantee program. Direct funds are at an interest rate lower than normal; however, amounts loaned are subject to a ceiling amount. These loans are difficult to obtain because of their desirability. The guarantee program is the largest source of funds for small and growing businesses. The SBA insures a lender, usually a bank, against loss. The SBA may guarantee up to 90 percent of a bank loan or up to a maximum ceiling, whichever is less. The interest rate on such a loan is based upon a statutory formula that is related to "prime." The repayment period is determined by the purpose for which the loan is granted. For example, the repayment period for a working-capital loan is generally less than that for a loan granted to acquire real estate. The amount of funds, interest rate and time limits are all subject to change from time to time.

Most SBA loans require security, which may consist of one or more of the following:

- A mortgage on land, a building or equipment
- Assignment of warehouse receipts for marketable merchandise
- A mortgage on chattels, i.e., personal property
- Guarantees or personal endorsements and, in some instances, assignment of current receivables

A pledge or mortgage on inventories is usually not satisfactory collateral, unless the inventories are stored in a bonded or otherwise acceptable warehouse. In most cases, personal guarantees to both the SBA and the lending institution will be required.
Given the myriad regulations for SBA funding, an entrepreneur should consider the following:

- Since the SBA is an arm of the government, the loan application can be complex and the time of approval may be lengthy.
- Careful completion of the SBA application is essential along with provision of detailed financial information.
- The SBA should be a prime source of funding for companies in their initial operations or rapid-growth stages, given their overall objective.
- Since there is a ceiling on interest rates, the bank may not be interested in processing an SBA request, because it must monitor the loan through its duration.
- Character of the applicant, capacity to manage and ability to repay the loan can offset a poor track record.
- Personal guarantees, including those of the owner’s spouse, are almost always required.

Other Government Programs

The Economic Development Agency (EDA) funds both business and government (state and local projects) with no upward limit as to the amount of funding. The loans are for businesses not eligible for bank loans, and are primarily intended to upgrade the economy through the development of jobs. Therefore, a small business that is in either a high-unemployment or low-income area, as designated, or in a growth industry, as defined, has a good chance to obtain financing. Additionally, a labor-intensive company should consider the EDA as a prime source.

The EDA provides financing through:

- Direct loans for working-capital requirements and equipment acquisitions
- Loan guarantees (program similar to that of the SBA)

Direct working-capital loans are generally written for the amount required, fixed asset loans generally are for 55 to 65 percent of the appraised value of the equipment and real estate, and the guarantees are for up to 90 percent of the funds lent by the private institution.

The loans are granted or guaranteed for a long-term duration except in the case of the fixed-asset loans, where the useful life of the assets determines the maturity date. The interest rate on loans is determined by a statutory formula based upon government borrowing which changes...
from time to time. This rate is generally lower than the normal rate. On
guaranteed loans, the interest rate approximates “prime.”

With EDA assistance, there is an additional requirement that at least 15
percent of the necessary project cost be privately funded by equity or
owner-subordinated debt for the same time period as the EDA loan. Of
the 15 percent funded, one-third must be supplied by a state or com-
munity (nongovernmental) organization. EDA may waive the “5-percent
community requirement” in certain hardship cases.

EDA generally makes its decision to grant a loan on the following
considerations:

• Management capabilities
• Market potential
• Company’s capitalization
• Company’s projected cash flow

*The Farmers Home Administration (FmHA)* through its Business and
Industrial Loan Program, has changed from a farm agency into a rural de-
velopment agency. The loan program is very similar to the SBA’s program
in all aspects. For example, the FmHA guarantees up to 90 percent of a
bank loan for general business purposes. Additionally, it will write a limit-
ed amount of direct loans. The one overriding condition is that the busi-
ness must be located in a defined rural area.

The program is designed to develop business, increase employment and
improve the economy of the rural areas. The loans are primarily secured
(personal guarantees required) with the length of time depending on the
collateral pledged. For working-capital loans, the length of time is approx-
imately five years.

The interest rates are renegotiable; however, there is a one-time fee im-
pose at the time the loan is granted. Considerations that an entrepre-
neur should be mindful of with a loan request are:

• The applicant does not need to be first refused financing by a private
  institution, as it does with the SBA
• Time period for a loan approval can be lengthy
• The impact of the project upon the economic community is a critical
  factor in granting a loan
• Loans under the SBA’s maximum lending of guaranteed ceiling should
  not be submitted to FmHA
The Export-Import Bank of the United States (Eximbank) is an independent, self-sustaining U.S. government agency. Eximbank’s primary purpose is to facilitate the export of American products and services through its various financing programs. Small businesses can benefit from the following Eximbank programs:

- **Exporter Credit Insurance Program**—provides insurance to exporters against loss due to nonpayment by their overseas credit customers. The insurance is available to an exporter who either holds his or her own foreign receivables or discounts them. This insurance usually enables an exporter to obtain financing from lending institutions at more favorable terms than otherwise would be possible. This enhances the liquidity of the company and its competitive position.

- **Commercial Bank Exporter Guarantee Program**—will guarantee repayment of medium-term export debt obligations. These debt obligations cover direct sales to foreign buyers of diverse items such as consumer goods, agricultural commodities and capital goods. The program is operated through commercial banks that determine the acceptability of a proposed transaction; once approved, the transaction is guaranteed by Eximbank and a nonrecourse loan is granted to the exporter. Thus, the payment is received quickly and the company’s liquidity improved. The amount of the loan advanced is based upon a percentage of the contract price; the percentage is negotiated on the basis of the risk of the transaction. The level of payments and interest rates are negotiable, but a fee is charged by Eximbank.

Although this source of financing is limited to companies participating in the export markets, the program offers nonexporters the opportunity with government aid, to compete successfully in the foreign markets.

Other significant *miscellaneous government sources* of financing include the Farm Credit Administration, which provides complete loan service for farm purposes; the Federal Reserve Board, which guarantees loans for contractors and others engaged in national defense work; the Maritime Administration, which guarantees loans for shipbuilding; the Department of the Interior, which makes and guarantees loans for businesses engaged in mineral and fishing activities; and the Department of Energy, which makes loans for manufacture or distribution of electric or hybrid vehicles. Furthermore, grants are available from numerous federal agencies for worthwhile ideas or inventions.

These agencies all have restrictive definitions and conditions which are needed to qualify for financing. The first step in investigating these potential financing sources should be to make contact with the appropriate agency for information. Although dealing with the bureaucracy can be difficult, the financing that is available may make the time invested worthwhile.
Life Insurance Companies. Most entrepreneurs think of the cash surrender value of their life insurance policies as the only source of funds available from insurance companies for small and growing businesses. However, life insurance companies themselves can be a source of financing.

Life insurance companies write two types of loans, commercial mortgages and unsecured term loans. Both loans are usually for an intermediate- or long-term duration. Commercial mortgages are the prime source of financing, with the insurance companies generally advancing up to 75 percent of the appraised value of the underlying collateral with a repayment schedule of ten to twenty-five years. In some cases, a balloon payment can be arranged to minimize initial costs and monthly payments. Interest rates are comparable to those charged by banks.

Unsecured lending is quite limited for small companies. This is because the insurance company will generally require that:

- The business be well established
- The business have a good track record
- Future earnings are sufficient to repay the loan

In short, the insurance companies prefer to offer financing to companies with moderate risks. Additionally, insurance companies usually do not grant unsecured loans below a certain minimal amount.

Commercial Finance Companies. Commercial finance companies primarily write secured loans by requiring a lien on the company's assets. The loans written can be of two types:

- Revolving loan — the commercial finance company commits itself to an overall line of credit; the borrower draws upon the line as needed and then repays. This process is repeated until the contract is terminated, usually for a maximum period of two years.
- Term loan — the commercial finance company grants a loan for a period of from one to fifteen years with a defined amortization schedule.

The collateral for these loans is usually accounts receivable, inventory, machinery and equipment, or real estate.

The loan process is very similar to that of commercial banks. It includes an analysis of the background of the borrower, an evaluation of the loan collateral, advancement of funds on the basis of a negotiated percentage and the establishment of monitoring and pay down procedures.
The services offered are much like those of a bank, but the real advantage of dealing with commercial finance companies is that they are willing to grant loans for businesses that might not qualify for bank financing. The commercial finance company looks to the quality of the collateral instead of the track record of the company. Therefore, the amount of the funds advanced will be determined solely by the commercial finance company's evaluation of the assets. The higher the quality of the assets pledged, the more financing available. The commercial finance company can also provide funds on short notice, allowing businesses to escape from quandaries without dangerous delay.

The biggest disadvantage of a commercial finance company is the high effective interest rate associated with the loans. In many cases, this rate will significantly exceed those of banks.

**Factors.** Factoring accounts receivable also may offer another means of obtaining needed funds. Factors are companies that specialize in this form of financing. Factoring involves the outright sale of an enterprise's accounts receivable. By factoring its receivables, a business is able to obtain cash on delivery while its customers are able to obtain the credit terms they need. Factoring is not a loan, since it involves the sale of the receivable to the factor without recourse. The factor assumes all the risks of bad debt losses. The factor will typically advance the company 50 to 80 percent of the receivables it buys and remit the remaining balance less fees and interest charges when the account is paid by the customer.

The key consideration for the owner/manager is that the available financing will depend primarily upon the quality of the receivables. Therefore, a realistic appraisal of the receivables is necessary. Additionally, since the factor assumes all risks, an evaluation will be made of the company's ability to operate effectively in order to insure customer satisfaction. A business in its initial operations might be advanced only 50 percent of the receivables, as opposed to a company in its mature stage, which might be advanced 80 percent of receivables. The interest rates and fees associated with factoring make it an expensive arrangement. However, in many situations, the credit and collection procedures of the company can be significantly reduced or eliminated.

**Equity Capital**

**Seed Capital.** Seed capital is the primary source of financing a business in the conceptual and initial operations stages of its life cycle. An entrepreneur can use personal wealth to finance the business and can also seek financing from relatives and friends. However, when an entrepreneur is offering ownership possibilities, a new source of seed funds be-
comes available in the person of wealthy investors. These individuals often are looking for limited partnerships that offer initial tax benefits and the potential for future profits. The entrepreneur should realize when considering this option that the proper structuring of the partnership is essential to attract investors.

When such investors enter into a limited partnership, they are interested in obtaining significant tax benefits in the initial year. Then in subsequent years, they wish to recover their investment through the company's profits. For example, if a company needs to raise $500,000 to develop a new product, a limited partnership could be formed. The limited partnership would consist of the company as the general partner and the investors, as limited partners. The agreement could be structured so that all expenses from product development would flow through to the limited partners, and once the operation became profitable, there would be an agreed-upon allocation of the profits between the general and limited partners. In year one if the company spent the entire proceeds ($500,000) on product development with no income generated, the limited partners would receive the tax benefits of the $500,000 on their individual tax returns according to their investment shares. In subsequent years, the limited partners would have taxable income on any profits of the product line. The limited partners would receive both tax benefits and an opportunity to share in the profits of a new product, while the company would receive the needed financing and a share in future profits.

This simple example is not meant to indicate that developing a limited partnership is an easy task. Limited partnerships are legally complex, may require an underwriter and will require both legal and financial assistance from professionals with expertise in the area. Therefore, the benefits of the financing must be weighed against the costs involved.

**Venture Capital.** Venture capital is the name given to private financing that provides necessary capital and management assistance to enable a promising company to grow to a position that would make the company attractive for a public stock offering or acquisition by another company, thus allowing the venture capitalists to recoup their investments. Venture capitalists invest in growth-oriented businesses. However, they are not usually a prime source of seed capital but rather invest after the business is at least two years old and profitable, or has the potential for profit. Thus, the small businessman should realize that a venture capitalist has stringent requirements. Generally, they are as follows:

- The business must have a strong management team.
- The business must have definite growth opportunities.
• The potential growth of the business must be reasonably predictable within a given time.

• The potential for gain must be greater than the associated risk.

The venture capitalist uses the following investment vehicles:

• Common stock

• Preferred stock, which may be convertible into common stock

• Long-term debt, which may be convertible into common stock

The amount invested ranges from 20 to 60 percent of the equity of the company. Usually, the venture capitalist prefers to take a minority ownership position.

Most venture capitalists will provide significant management counsel once they have invested. They will not hesitate to take an active role if it appears that the company’s objectives are not going to be achieved. In fact, some arrangements allow the venture capitalist to replace the management team.

Because of this close association, an entrepreneur should consider whether his or her company will be able to function in such an environment. Additionally, since the venture capitalist’s objectives are the ability to liquidate the investment and a reasonable return, there should be a realistic assessment of whether the company can achieve these ends. If it can, the entrepreneur should attempt to find a venture capitalist who understands the operation and will provide counsel and financing as needed. A critical element in obtaining this kind of financing is the company’s business plan.

**Small Business Investment Companies.** Small business investment companies (SBICs) are privately owned and privately operated firms licensed by the SBA to provide equity capital and long-term loans to small businesses. SBICs are eligible for loans from the Federal government at very favorable rates.

SBICs operate in the same manner as do venture capitalists, but traditionally place more emphasis on writing long-term loans. Many of these loans have equity characteristics such as warrants or conversion features, and may be packaged with equity securities.

Eligibility for funding from an SBIC is determined first by the size standards of the SBA. If a business qualifies, then the SBIC will evaluate the company in light of its growth potential, management capabilities and the inherent risks.
SBICs may also provide significant counsel to the management of their portfolio companies. An advantage of the SBICs is that a combination of financing vehicles can be obtained from the same source. Additionally, many SBICs will initially defer loan payments for a period of time to improve the liquidity position of the company. As with the venture capitalist, a business plan is essential to obtaining this kind of financing.

**Economic Development Authorities.** In many areas, economic development authorities (state, industrial and local) are extremely helpful in securing financing for small and growing businesses either through use of their own funds or providing access to federal financing programs. The development authorities' primary objectives are to help existing local businesses and broaden the employment opportunities for the community. They can be a prime source of financing for both the rapid growth and the mature business.

The development authorities are extremely flexible in structuring financing packages. They make both equity investments and long-term loans in whatever combination is appropriate for the company. Development authorities' funding is usually obtained through loans from the SBA, and therefore the size standards of the SBA can determine eligibility. Equity investments range from $50,000 to $500,000 for a period of up to ten years. Permanent equity investments may also be made. Loans are generally written for expansion or modernization of facilities. Interest rates on loans are negotiable, but are related to the prime rate.

Nearly all local offices of economic development have professional staffs whose primary function is to assist small businesses. This assistance is essential when a small business seeks certain federal government financing packages, such as EDA loans, where a percentage of local matching funds is required. The small businessman may be able to maximize the participation of private and federal financing through these local agencies. As with other government agencies, however, the time for loan approval and the detailed documentation are substantial.

**Public Offerings.** The current demand for equities has made the public market increasingly attractive to smaller companies as a source of capital. Spurred by inflation and recent changes in the tax laws, institutions are investing in new issues, looking for high growth potential that will generate significant gains. This attitude on Wall Street has made the public-offering option more attractive for the entrepreneur, even when the business is in its fledgling stage.

For a public offering to be successful in obtaining the necessary capital, companies must meet certain criteria. A public offering is appropriate for a company with:
• Growth rate higher than that of the industry
• An innovative product that has an immediate market
• Strong management team
• Satisfactory record of earnings

If a company meets any of these criteria, the public offering may be an attractive alternative to other funding sources.

The advantages of a public offering over other sources of financing, however, are not always clear. An entrepreneur will have to evaluate both quantitative and qualitative factors, including:

• Amount of financing needed
• Dilution of ownership
• Public visibility attendant on an issue
• Effect on the management activities
• Impact on personnel
• Innovativeness of the company's products
• Regulatory and reporting requirements

The decision to go public will require a trade-off between certain personal considerations and the benefits of the financing obtained. The offering may provide increased liquidity, diversification opportunities, equity incentives for management, status, and ascertainable values for estate planning, but it can also mean emphasis on short-term considerations, pressure for increased growth and demanding public exposure. Thus, an entrepreneur should base this decision on whether the public offering is the best source of capital to meet the company's goals and objectives. The deciding factors in many cases are that the company seeks public visibility and the amount of financing raised from a public offering will be significantly higher than what can be obtained from other sources, such as a venture-capital group.

When considering a public offering, the intermediary between the company needing capital and the public is the investment banker (underwriter). The underwriter is essential to the determination of the amount of financing that can be raised. The pricing and size of the new issue will be based upon the underwriter's judgment as to what price can be sustained in the market. Thus, the selection of the underwriter is an extreme-
ly important, yet difficult task. The entrepreneur should match the business with an underwriter that has an understanding of its unique qualities. This understanding will hopefully enable the underwriter to make the offering as smooth as possible. Therefore, the entrepreneur should consider, in addition to technical ability, the experience of the underwriter with companies in the same industry and of a similar size. Also, the ability of the underwriter to market the shares offered is extremely important.

Once a decision to make a public offering is made, a firm-commitment or best-efforts contract is entered into. Simply, a firm-commitment contract is an all-or-none proposition where the entire offering must be sold, while the best-efforts agreement involves selling as much of the issue as possible. Again, a number of matters must be examined to determine which contract is most appropriate for the circumstances.

At this point, the company must qualify with the Securities and Exchange Commission (SEC), since the sale of securities requires compliance with the Securities Act of 1933. The 1933 Act requires that a registration statement must be filed with the Commission disclosing prescribed categories of information before securities may be offered for sale to the public. The securities cannot be sold to the public until the registration statement becomes effective. In addition, prospective investors must be furnished a prospectus containing the most significant information in the registration statement. Congress and the SEC, however, both recognized that there are certain situations when there is no need for registration or all the prescribed categories of information. Certain registration and reporting requirements have been simplified in order to allow smaller issuers to raise limited amounts of capital, yet at the same time protect investors. The principal forms of filing or registration that are advantageous for smaller companies are:

- **Regulation A**
  - Is eligible for issues up to an aggregate amount of $1,500,000
  - Allows an issuer to sell securities in an unregistered public offering
  - Has less stringent content requirements for the offering circular (substitute for prospectus)
  - Allows filing at a regional office of the SEC
  - Has simplified financial-statement requirements

- **S-18**
  - Is eligible for registration of securities issues up to an aggregate amount of $5,000,000
- Requires audited financial statements similar in content to those required by Regulation A
- Allows for fewer narrative items in prospectus
- Allows filing at a regional office of the SEC
- Allows phased-in compliance with full periodic reporting requirements of the Securities Exchange Act of 1934

Additionally, there are certain exemptive rules within the 1933 Act (Rule 146, Rule 240, Rule 242 and Section 4(6)) that if specific conditions can be met govern offerings. These rules provide an exemption from the registration provisions and can be advantageous for small companies.

Not all companies, however, are eligible for the types of filings or registrations described above. Therefore, competent professional advisers are essential when a public offering is considered. Furthermore, the registration process requires a significant time commitment on the part of management, from the preparation stage to the effective date of registration. Significant expenses are incurred for the legal, accounting and printing costs associated with the offering. The decision to make a public offering must take these elements into consideration.

Again, the overriding consideration as to the appropriateness of the offering should be whether this source of financing is best suited for the attainment of the company's goals.

Other Sources. In addition to these major sources of equity capital, there are other sources that an entrepreneur should consider. These potential sources include pension funds, institutional investors (foundations, universities, mutual funds, investment bankers, etc.) and other companies. Given the inflation in recent times, a genuinely innovative idea or product can now attract these entities to finance ventures with the hope of recouping the investment by a multiplied amount. In many situations, the key is for the entrepreneur to develop an effective marketing program to capture the imagination of these entities.

Another source of capital, if the entrepreneur does not want outside investors, is an Employee Stock Ownership Plan (ESOP). ESOPs, unlike the traditional stock bonus plan and profit-sharing plan, have the ability to borrow large sums of money because the employer company can guarantee the loan. This ability to borrow, combined with the stipulation that the plan invest primarily in qualifying employer securities, has led
companies of all sizes to take a serious look at ESOPs and their potential to raise funds.

The benefits of an ESOP to a company are that it:

- Provides an immediate source of capital
- Stimulates employee loyalty, morale and productivity since the employees are now owners

Additionally, for the owner of a closely held company, this method can provide a market for the shares of the company, and it facilitates estate planning.

The chief advantage that an ESOP has is its ability to be used for corporate financing. It can be used in many different ways to accomplish differing objectives, depending on the circumstances confronting a company. An understanding of its basic operation is important.

Assume a corporation needs to raise $1,000,000. It might need these funds for additional capitalization, for purchase of a new building or equipment or for a variety of other reasons. The corporation can adopt an ESOP and have the ESOP borrow the $1,000,000 from a lending institution. The loan is guaranteed by the corporation and is payable in ten equal annual instalments of $150,000. The total interest for the ten-year period is $500,000.

The ESOP uses the loan proceeds to purchase $1,000,000 of newly issued stock from the corporation. The corporation then makes annual cash contributions, which are tax deductible, to the ESOP so as to enable the ESOP to retire the loan. The result is that the corporation received $1,000,000 of new funds and also receives a tax deduction for the repayment of the loan.

Assuming a 50-percent corporate tax rate, the $1,000,000 in new funds was obtained for $500,000 (interest on the loan is not considered, since it would be deductible by the corporation if it had borrowed the funds directly).

There are, however, disadvantages associated with ESOPs. The company must comply with the regulations of ERISA, the value of the company's shares must be ascertainable and the shares of the company might have to be repurchased. And, of course, a judgment must be made as to whether having the employees as owners will be good for the company.
Summary

As can be seen, there are myriad financing alternatives that may be appropriate to an entrepreneur's situation. Furthermore, the discussion of financing by source is not meant to imply that joint financing by several sources is not feasible or possibly more appropriate. There is considerable overlap of services among institutions which only complicates the selection process. But the key in many situations could be matching a source that specializes or is interested in financing ventures at certain stages of a company's life cycle. The following table provides some guidelines:

<table>
<thead>
<tr>
<th>Source</th>
<th>Conceptual</th>
<th>Initial Operations</th>
<th>Rapid Growth</th>
<th>Maturity</th>
<th>Salvage/Rebuilding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual investors</td>
<td>P</td>
<td>P</td>
<td>F</td>
<td>U</td>
<td>F</td>
</tr>
<tr>
<td>Investor groups (tax shelters)</td>
<td>P</td>
<td>F</td>
<td>F</td>
<td>F</td>
<td>U</td>
</tr>
<tr>
<td>&quot;Bootstrap&quot; (internal)</td>
<td>U</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
</tr>
<tr>
<td>Commercial banks</td>
<td>F</td>
<td>P</td>
<td>P</td>
<td>P</td>
<td>P</td>
</tr>
<tr>
<td>Savings and Loan Associations</td>
<td>U</td>
<td>F</td>
<td>U</td>
<td>U</td>
<td>U</td>
</tr>
<tr>
<td>Small Business Administration</td>
<td>F</td>
<td>P</td>
<td>U</td>
<td>F</td>
<td></td>
</tr>
<tr>
<td>Other government programs</td>
<td>F</td>
<td>P</td>
<td>P</td>
<td>U</td>
<td>P</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>U</td>
<td>U</td>
<td>F</td>
<td>P</td>
<td>U</td>
</tr>
<tr>
<td>Finance companies</td>
<td>U</td>
<td>F</td>
<td>P</td>
<td>F</td>
<td>P</td>
</tr>
<tr>
<td>Factors</td>
<td>U</td>
<td>F</td>
<td>F</td>
<td>P</td>
<td>U</td>
</tr>
<tr>
<td>Venture capitalists</td>
<td>U/F</td>
<td>P</td>
<td>P</td>
<td>U</td>
<td>P</td>
</tr>
<tr>
<td>Small Business Investment Companies</td>
<td>U/F</td>
<td>F/P</td>
<td>F/P</td>
<td>P</td>
<td>F</td>
</tr>
<tr>
<td>Development authorities</td>
<td>U</td>
<td>U</td>
<td>P</td>
<td>P</td>
<td>U</td>
</tr>
<tr>
<td>Public offerings</td>
<td>U/F</td>
<td>U/F</td>
<td>P</td>
<td>P</td>
<td>U/F</td>
</tr>
<tr>
<td>Employee Stock Ownership Plans</td>
<td>U</td>
<td>U</td>
<td>F</td>
<td>P</td>
<td>F</td>
</tr>
</tbody>
</table>

Legend

P = Prime source.
F = Feasible source.
U = Unlikely source.
Financing Proposal Package

Once a definite decision on the financing method and funding source has been made, the business plan can be put in final form and the preparation of the financing proposal package begun. The critical element in obtaining financing will be the entrepreneur’s ability to market an idea, product or company to a skeptical lender or investor. A critical aspect of this marketing effort will be the financing proposal package. This package must answer the why, where and how questions that a request for financing creates. Additionally, the package must provide sufficient detail so that a lender or investor can become knowledgeable about the company to facilitate the lending process.

The starting point for the package preparation, of course, is the business plan. The plan will contain almost all the necessary information that a proposal must have to provide an interested reader with pertinent detail about the direction in which the company is headed. A good financing proposal should contain the following:

• Fundamentals of the proposal
  ◦ How much is needed and the proposed investment form
  ◦ Time frame for financing
  ◦ Use of proceeds
  ◦ Expected return on investment and timing and method of payback
  ◦ Expected future capital needs
• Summary of the proposal
  ◦ Critical elements
• History and description of company
• Management group and key personnel
• Organization structure
• Description of product
  ◦ Highlighting of unique features
  ◦ Third parties and credibility
• Evaluation of market and competition
• Marketing strategy
• Production plans
• Risk factors
• Use of proceeds
• Financial statements
  o Historical
  o Projections

Of course, not all elements are necessary in every proposal, but a detailed and in-depth proposal will certainly enhance the prospects for success.

Conclusion

The successful strategy for obtaining financing involves the following simple steps:

• Decision on goals and objectives, for both the company and the owner
• Systematic review of sources of internal funds
• Tentative decision on the preferable financing method
• Formalization of these decisions into a business plan
• Systematic review of funding sources
• Decision on the appropriate financing method and funding source
• Preparation of a financing proposal package to obtain the desired financing

The issues discussed throughout this booklet present a brief sketch of the considerations that should be addressed when arranging financing. Any transaction the reader may be contemplating will represent a significant investment of time, and the importance of sound professional advice cannot be overemphasized. Advisers such as accountants, attorneys and other intermediaries should be consulted as early as possible in the process. Their advice should be sought frequently during the entire process to assist in making informed decisions that will achieve the desired results.
How Deloitte Haskins & Sells Can Help You

Deloitte Haskins & Sells can help in this very important process, providing the following services:

- Evaluating the current cash flow of the business
- Analyzing and recommending improvements to generate additional internal cash flow
- Reviewing and recommending improvements in the management information system
- Preparing projections for determining financing needs
- Consulting on which type of financing is most appropriate
- Preparing effective loan proposals
- Consulting with management on the development of the company's goals and objectives
- Consulting with management on the company's business plan
- Providing assistance and consulting with any public filing
- Auditing and reviewing financial statements to be presented in loan proposals or public offerings
- Providing necessary tax planning and consultation in the areas of estate planning, development of tax shelter financing vehicles and ESOPs
- Introducing company management to appropriate intermediaries and management of financing sources
- Assistance in the negotiation of the financing arrangements

For further information about our small business services, please contact:

- Your nearest Deloitte Haskins & Sells office
- Or write:

  Deloitte Haskins & Sells
  Small Business Services Department
  1114 Avenue of the Americas
  New York, New York 10036