

# FINANCING YOUR SMALL BUSINESS

*An Entrepreneurs Handbook*



## **A practical guide for local small businesses**

- Basic Financing Principles
- Sources of Borrowing
- Loan application process
- Resources listing



## FINANCING YOUR SMALL BUSINESS

### ***Debt vs. Equity***

Before you evaluate your borrowing requirements, it is good to understand the relationship between debt and equity. A lot of start-up businesses assume that if their idea is good and they have a good plan that they should be able to borrow 100% of their start-up costs. This is not usually the case. In fact, very few banks loan to start-ups at all. Even with an 80% guarantee offered by the Small Business Administration, not too many banks are excited about making these loans. Those that will look real hard at the owners equity compared to their loan. In most cases, the bank wants to see you have more at stake than they do.

In your projections you had to look at what your equity would be. If you have not yet determined what your borrowing need will be, this will probably involve going back and making changes to your projections. If you do not plan to borrow to start, please read on. Many businesses find that in time they will have to borrow funds from time-to-time to support their growth.

You should realistically look at your plans for debt for any business, and ask yourself if your debt load is reasonable in the event things don't work quite as planned. Will the assets of the firm when sold at auction cover the debt? Or will you have to liquidate personal assets to pay the bank loan? On most small business loans you will have to guarantee the debt personally, which means you may have to sell personal assets to satisfy the debt.

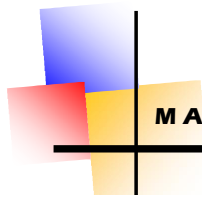
I believe there is good and bad debt. Often it relates to the purpose. Bad debt is any debt that is not supported by your assets or has a marginal payback, and should be an equity contribution. A good reason to borrow is that which has a quick turnaround, is supported by the assets and equity of the firm, and leverages your return on equity to the maximum. If the downside loss is greater than the upside potential you should consider doing it with equity rather than debt.

### ***Raising equity***

Equity is not debt, and has advantages and disadvantages. The primary advantages relate to timing of payback, less restrictive terms, and often the repayment is undetermined and dependent upon your success. It is usually subordinate to borrowed funds, which means that lenders should be paid off prior to equity holders. The disadvantages are reduced control by management and a higher cost of funds in the long run. Equity will usually require a higher return because it has a higher risk. Some of the more common sources of equity are shown herewith:

#### ***Family & Friends***

Family and friends are often a source of funds which fall into the category of equity. How you structure your arrangements can be critical for your success with these arrangements, and your future relationships with those involved. If you use this as a source of equity, make sure you have good, solid understandings in writing of their roles and responsibilities in your company. And make sure that they understand that this is not to be confused with a loan.



### *Angels*

The angel is another form of investor. This is an individual with the personal resources to bankroll your idea or business. The best angels are those who are older, more mature individuals who have been through business ownership themselves, and see in you the same potential for success, with their help. [acenet.csusb.edu](http://acenet.csusb.edu).

### *Venture capital*

Venture capital (VC) is a form of “quasi-equity” that is used for certain industries to fund start-ups. Historically, VC funds have been used to fund larger projects in high technology and biomedical fields that can lead to larger, public traded companies in the future. VC funding is usually in the \$1 to 5 million range, and such firms should have the potential to pay back VC partners within three to five years from maturing product lines and profits or from Initial Public Offerings (IPO) when the firm begins to sell its stock through a brokerage company. [sba.gov/inv](http://sba.gov/inv)

### *Initial Public Offering*

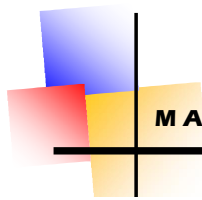
An IPO is another form of equity, which is no longer reserved for the largest corporations. Smaller, middle-sized companies have been using the stock market as a means to generate equity in amounts as small as \$5 million.

### *Sweat equity*

This is a type of equity which many smaller companies can utilize. This is where you do-it-yourself in building projects and starting-up with personal resources that you contribute as an equity to the business. An example might be a new car wash where the owner constructs the facilities and does most of the physical construction themselves. Their facility on completion may be worth \$100,000, but only cost them \$50,000 to build themselves. The difference can often be recognized as a sweat equity source.

### *Sources of Borrowing*

There are literally thousands of sources of borrowing for small businesses. I will not attempt to identify every source here, but will try to cover the major categories of borrowing, and cite some examples. The resource list at the end of the book will give you many sources you may wish to contact.



### ***Personal borrowings***

First, and foremost, don't overlook yourself. Your cash and assets are probably the most important source. If you don't have it, you can save and make the business happen over time. Don't forget to take credit for assets that you will contribute to the business. Tools, vehicles, equipment can all be contributed to the business and leased from you personally.

### ***Credit cards***

Credit cards can be a source of debt that can work for many small businesses. While credit cards have a high rate of interest, sometimes as high as 20%, this is offset by a lack of terms and conditions and flexible repayment schedule. Most have a low (2 to 4%) minimum payment, which can allow five years or more to repay the loan. If you have a good credit record personally, you may find abundant credit available from this source using your personal lines. For smaller amounts (\$50,000 or less) this is not too much more expensive than other avenues. (For example, an SBA guaranteed loan may be as high as Prime rate plus 4%, with a 2% fee, which can be as high as 18% per annum when all costs are figured.) The important point here is make sure that your use of credit represents good borrowings. If you run up large amounts of credit card debt in starting your new business that you can't repay, then you won't last long in business.

### ***Family & friends***

Loans from family and friends are usually inadvisable. As a source of equity previously described these can be a good source of funds. Loans are usually another story. The problem with family and other personal relationships is you have to see these people at family gatherings, holidays, and other events. It's just not worth risking your relationships with business dealings that run the risk of hurting these relationships.

### ***Another business you own***

Another source of loans can be from another business you own, or related entities. Often your relationship with one business with a bank can be leveraged to help you start another. One of the most critical factors to a bank or other lender is character. With your existing relationship you hopefully have a good track record in this area, which you can use to help with a new loan for another entity. Many times the bank may want to loan the funds to your other company, who they have a track record with. This is not a start-up loan to them, and repayment will probably need to be fully supported by your other company.

### ***Commercial banks***

This is the single largest source of loans for small businesses. Although most do not do start-up loans, many do SBA Guaranteed loans for start-ups in some instances. It is important that you approach a bank correctly and know what you're asking for. If you approach many asking for a business loan they will send your application to a different place than if you request an SBA Guaranteed loan. Most of the large branch banks send their applications to special loan centers in their regional offices,



some as far as California) who process large numbers of applications daily. If your application goes to the wrong place you will get a speedy decline without much explanation.

### ***SBA Guaranteed loans***

These are the most readily available loan funds for start-ups. In addition to commercial banks they are also available from lenders who specialize in them. These dedicated SBA lenders have more experience and handle much larger volumes of SBA loans. Their average loan size is also smaller. Some of the branch commercial banks consider \$500,000 to \$1,000,000 loans as small, and do loans of \$50,000 to \$250,000 very sparingly.

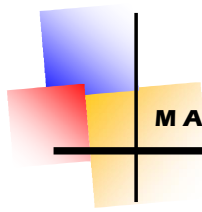
SBA offers a myriad of programs, but most of their involvement is with the 7(a), Micro Loan, and 504 Guarantee programs. I will not go into much depth here on underwriting requirements or standards, because they change often and are often interpreted differently by the banks. You will need equity (20-50% is the typical range), collateral (100-150% coverage of asset value to loan), and repayment capability (1.1 to 2.0 times cash flow coverage). Your personal credit is important and if you have had credit problems, you will need to explain 'up front' with your application what problems you show and why they appear. It is recommended that you order a copy of your credit report from the County Credit Agency, whose address and phone number are included in the resource section at the end of the book. They are normally who you have to use to dispute anything on your record to get it removed.

### ***SBA 7(a) Guarantee loans***

This is the traditional SBA loan guarantee. SBA can guarantee as high as \$5,000,000, and requires 25% equity, but the banks can fund smaller amounts with a lesser guarantee percentage. An application is quite a bit more involved than regular commercial loans, and timing for approvals can run 30 days or more. They can also be expensive, with legal limits as high as Prime +2.75% and a 3% fee. SBA's maximum exposure is \$15,000,000. SBA Express maximum is 50%.

### ***Microloan Program***

A smaller loan program (up to \$50,000, with the average amount being around \$15,000) in which SBA provides funding to a non profit community based lender (intermediaries) who make loans to small businesses. The loan can be used for working capital, purchase inventory, furniture, fixtures, machinery and/or equipment and not-for-profit child care centers. Proceeds can not be used for real estate or paying existing debt. SBA does not guarantee these loans. Technical assistance and training is provided to the borrower and may be required before the loan can be finalized.



***SBA 504 Guarantee loans***

This program is designed to fund capital projects such as building a new factory or moving into larger quarters. The 504 involves using a state-authorized Certified Development Corporation (CDC) along with a commercial bank and the SBA. The CDC will fund a portion of the total (usually 40%) using bonds which are at a fixed rate and pooled with other such projects. The commercial bank will fund a portion (usually 50%) under a first deed of trust on the property. The borrower will fund the balance (usually 10%) from their own funds. The percentages can vary, and with certain projects the equity requirement will be larger. These are typically larger dollar projects, ranging from \$500,000 to \$15 million.

***Rural Development***

A part of the U.S. Department of Agriculture, this agency will make loans and grants to small businesses and other agencies in rural Arizona. Their state office is in Phoenix, and they have a regional offices in Flagstaff. They have a variety of programs, including rural agricultural programs, reservation area programs, and a business and industry guarantee program that can guaranty larger projects that don't qualify under SBA programs.

***Micro loan funds***

We have a few private non-profits that are able to assist with small business "micro" loans which are defined as \$50,000 or less. For more information contact the Small Business Development Center directly.

***Arizona Commerce Authority***

This agency has loan and grant funds for certain applications for businesses that have been in business at least two years. Their small business training grant program is an 80% grant for the expenses of training new employees. They can fund grants and loans to assist with projects that assist with economic development for the state. They also have revolving energy loans for energy related projects.

***Arizona Multi-bank***

This agency was formed on economic development a consortium of the major banks to assist with lending on projects that have an impact for the state, yet lack the funding or access to conventional financing. They often work in assisting with gap financing on a specific project, thereby leveraging their funding requirements and impact. Typical size deal is \$50,000 to \$500,000.



### ***BIA Guarantee program***

The Bureau of Indian Affairs (BIA) offers a 90% guarantee to banks who are willing to work with this program. It requires a 20% equity for a Native American borrower with other loan criteria and pricing similar to SBA. Not many banks in Arizona have done BIA guarantees, however, which makes them difficult to get done.

### ***Other sources***

There are many specialized sources for loans, including Finance companies, Insurance companies, Credit Unions, Mortgage Brokers & Bankers, Factoring companies, Leasing companies, Export/Import financing, Asset-based financing, and others. You can consult with your local SBDC for more information on any of these programs that might be appropriate for your situation.

### ***Other traditional lending sources***

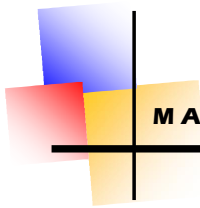
There are other sources that many small businesses have used to finance their operations which fall outside the organizational boundaries of the conventional lending sources. Customers can be a source of financing in many situations. If you have a better product your customer may be willing to prepay or even provide financing so that you can make the product and get it to them. They may also have influences on other sources that can make you a loan with their guarantee or urging. Suppliers can have the same impact. Also, they may be willing to provide you with inventory to be repaid on special terms, which is paramount to financing. With the non-traditional sources you will need to get creative. There are examples of companies raising money by using classified and advertising for their own loan.

### ***The loan application process***

Once you have put together your business plan, researched money sources, and decided to make application, there are a few guidelines which may help you get the loan. First, and foremost, a good business plan makes the job easier. By doing your plan with enough detail to impress the lender, but not too much to inundate them, you will be doing more than their average applicant. Most lenders see lots of applicants, but one who stands out is one who really acts and looks as if he knows what he's doing. Either in your plans Executive Summary, or in the form of a cover letter, you should specifically spell out what you are asking for. The loan amount, term and repayment schedule all should be spelled out. You should indicate what the lenders collateral will be, and what the sources of repayment will be. For a bank you will want to detail secondary sources if they are available.

### ***Making the pitch***

Once you have your cover letter and business plan put together you should begin presenting to your chosen lenders. Should you pursue more than one lender at the same time? This varies with the situation, but usually I recommend that a client make more than one proposal but less than five at the same time. It's unreasonable to expect that you can shop lenders one at a time. You should, however, avoid letting the prospective lenders know you are 'shopping' the deal. Usually the lenders contacted will check your credit,



and if you contact them at approximately the same time they will be unaware of your other pursuits. At this early stage you want to make sure you have the lenders interest, and they may think you less important if you are pursuing other lenders simultaneously.

It is always best to make an appointment with the prospective lending officer and present your plan in person. I recommend this be done at their office for this first meeting. If they are interested in your proposal you may want to have the second meeting at your place of business, if this is practical. For the first meeting you should dress in business attire. Not necessarily a suit and tie, but avoid your overall or dirty work clothes. You want this first meeting to leave a good impression. You will want to control the meeting in the beginning. Before you hand over your plan, take a few minutes to review your plan with the lender. If you hand over your plan too soon, they will proceed to pick through it and take control of the meeting. You want to make sure that before your meeting is over that you have a commitment from them as to when they will have an “expression of interest” for you. With most lenders this is the first step. They will have to do quite a bit more analysis and checking (they call this “due diligence”) before you will get to a solid yes or no. Ask them for a specific date, and then call them to follow up by that date. If you can’t, get a commitment on when you’ll call back to check. Remember that old expression, “the squeaky wheel get the grease”.

### ***The turn down***

If your answer is no, you need to find out why. Often the answer is a simple one liner, that you may or may not understand. For example, “you’re too leveraged” is an expression many lenders use to express too much debt. It can also mean not enough equity. Or that your collateral has been discounted and they believe the debts too high for the collateral. The point is, you should ask why, and then “was there one more thing”. Keep asking this until there isn’t one more thing in their response. Does their policy prohibit making this type of loan? Is the problem your industry? Finding out the real reason for a turndown may help you identify other sources or redo your plan with more information mitigating this area of concern.

Regarding rejection there are two important rules. The first is not to take it personally. A lender may not want loans in your industry. Or it’s too small. Or their policy doesn’t allow it. Or they have too many loans to your industry. Whatever the reason, it’s a business decision and things may change in the future. Don’t burn your bridges. Secondly, you must try, try again. Like a lot of things in life, you may not be successful on the first try. Or the second. Or the fourth or fifth. If you are persistent and reasonable in your expectations you will be successful.

### ***What if the answer is yes?***

If the lender agrees to make the loan you need to make a decision. Do you go forward with other lenders you may have contacted? In most cases, the answer should be yes. Until a loan is signed and documented you don’t really have a deal. Another offer may come in which will be a better one, and you don’t want to eliminate this possibility too soon. Assuming you get more than one offer, how do you choose? Look at the key factors, not just pricing. Ask the lenders to provide their loan covenants and conditions and evaluate differences closely. Also, which lending officer is the most interested in your business? Is their management more responsive? How do you think they’ll act if things don’t go quite as



planned? The lender who asks more questions and is more interested up front will probably be better when the chips are down.

### ***Documenting***

Depending on the size and complexity of your loan you may want to have your attorney review the agreement. If your lender is using a boiler plate, preprinted document, you may want to review it closely yourself. Read all the fine print and ask your attorney to review it if you have any major concerns.

Some typical covenants and conditions to expect are as follows. Reporting requirements are typical, with conditions for monthly or quarterly financial statements, annual financial statements prepared by a CPA, and copies of tax returns. Other items may include accounts receivable agings, inventory listings, equipment listings, etc. Financial covenants may include key ratios such as current ratio, debt to worth, profitability, etc. Here the lender is interested in keeping your performance over time in line. If your company performs more poorly, it means they will be able to renegotiate your loan. The lender is concerned that deterioration will prevent you from paying them back as agreed, and they want to see you address these problems and let them know how you will correct things. Lastly, a loan agreement may have negative covenants. These are your agreement that you will not, for instance, borrow from another lender while your loan is outstanding or pledge your assets for any other purpose.

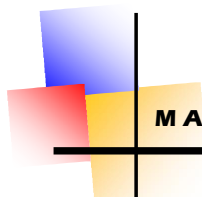
### ***General Continuing Guarantee***

Most small business loans will require you execute a guarantee. This is your personal pledge of paying back the loan with whatever personal assets or resources that are required. Most lenders want you to stand behind your loan with a guarantee or they won't make the loan. They want to see your personal commitment to the success of the project. Often this is more their reason for having a guarantee than the pledge of personal assets (after all, you may not have substantial assets or income to pledge).

### ***Care & feeding of your lender***

It is your responsibility to make sure you are in compliance with your loan agreement, not the lenders. Beyond this, it is also important to keep your lender informed of good and bad things happening to your business. Make sure that you work to keep your relationship active. Just submitting financial statements on time will not do this. Have meetings periodically, at their business or yours. Go over the pros and cons and make sure you are continuing to educate them on your business.

If you do fail to meet one of your covenants be sure to take special care to inform the bank. Don't just send the financial statements and let your lender 'discover' the violation. An initial phone call is best. Then follow up with a letter that restates the violation and detail what you will do to correct the situation. You may ask them for a waiver of the provision, or request a change or modification based on the circumstances.

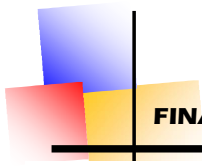


By working on your relationship with your lender, it should make renewal an easier process. Or an increase to your accommodations over time. Once you have built the relationship you will be a valuable asset to the lender. Loans are how financial institutions make money, and most value and trust their existing customers. They have to work hard to replace existing customers, and the risk of making a mistake in judgment is always looming with new clients. As an existing client you are a 'known' variable, especially if you work to keep your lender informed and involved.

### ***Misconceptions***

There are some common misconceptions in working with lenders which are shown here:

- *Being in debt is bad.* Not all loans are bad. If your return on borrowing is high it can be good. Many businesses need to borrow to support growth of their business, and would be unable to do so without some borrowings.
- *A good personal credit rating should make borrowing easy to start a new business.* With the exception of the SBA Low Doc program, most lenders will not give you much credit for your personal background in starting a new business.
- *Financial information should be kept secret.* Trying to keep secrets from your lender will often result in problems. They want to be the first to know things, not the last. If they know you have this attitude they will work hard to dump you at the first opportunity.
- *Lenders should appreciate that business is unpredictable.* They don't. They generally hate surprises. Only if you have kept your banker informed will you find them at all helpful when you report changes.
- *Lenders only lend money to those who don't need it.* This is not really true. Lenders can only make money by lending, and they need clients that borrow to do so.



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