Financing Your Small Business

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Every business, at some time during its life, needs to find money. Often that need first arises during start-up. Other regular times are during growth periods, to stock additional inventory, or to meet cash needs during times when income is temporarily low.

Money, according to the Small Business Administration, is the lifeblood of any business and inadequate capital a cause of many small business failures (Israel & Torres, 1991). Often businesses start with too few dollars available (under-capitalized) and fail to retain enough capital to meet cash needs. These problems affect the growth potential, competitiveness, and even long-term survival of the business (Van Auken & Neeley, 2000).

This fact sheet will provide the basics on financing for your small business. It discusses the financing search process and outlines small business financing alternatives. The financing programs discussed are those generally available for most businesses. However, it is important to understand that financing alternatives vary as the result of legal, legislative, economic changes, type of business and demographic characteristics of the business.

Business Financing – 2 Basic Truths

Before outlining the steps, one common myth must first be corrected – that of "free money." Except in rare circumstances for specific industries or groups of individuals, *there is no free money!* Often existing and potential business owners think that there are grant programs or gifts of money to help start the business but this is rarely the case.

Second, the expectation is that the owner provides a portion of the required capital. A typical amount will be 20% of the needed funding. For start-up companies that means a commitment of personal finances. Later that capital can come from retained earnings, or savings, generated by the company itself.

Steps to Financing Your Business

There is no one best way of raising capital for your business. Talk to a variety of business owners and each person probably approached the development of capital in a somewhat different way. There are patterns to the process listed below as a series of questions that you, the owner, can ask yourself. If the answer is positive, you move on to the next question. If the answer is negative or you can not answer the question, then you must fix that step before moving on. These questions represent what the lender will ask you when you are finally ready to approach them for funding.

Question One – What does your credit report show?

If a small business owner needs to borrow money, especially before there is any significant firm history, a primary factor in the decision to give credit is the owner's personal credit rating. This factor is even more important because the owner typically must personally guarantee the loan. Without a clean credit report, meaning no unpaid loans, a limited number of late payments, and a limit to overall debt, it will become difficult to get others interested in helping you finance your business (Urbach, 2001).

Question Two – What are the basics of your business?

This first question actually contains several sub-questions about you and your business. Few lenders, investors, or family and friends feel comfortable investing if you have not done your homework.

a. What is your business? And why do you think it will succeed?
b. What are you investing into the business?
c. How much money do you need and how will it be used?
(Murdoch, 2000; Urbach, 2001)

Raising capital for your business depends on being able to describe your business idea, what market niche you think you can capture and why you feel that way. Also, as noted above, the potential financier wants to know what you are willing to risk of your own resources. The banker will also want you to specify how much money you will need and the planned use of those funds. Finally, for most start-up business owners, you must personally guarantee the repayment of the loaned funds. This means your personal reputation and credit history are important. The banker will want to see a clear credit record that demonstrates you have control of your personal financial situation.

The inability to answer these questions demonstrates to the banker your failure to understand the basics of your potential business. Research has shown these elements as critical to business success. Not only must you be able to answer these questions but also you must be able to do so in a convincing manner. Van Auken and Neeley (2000) called this work pre-launch preparation and found such planning critical in both acquiring needed funding and in overall business success. Advanced preparation helps you, as the first investor, better understand the business and the business environment. That initial preparation should be your guide in deciding whether or not to proceed.

Question Three – What experience, both related and in general, do you have?

Bankers want to know experience you have in operating any business and, in particular, the type of business you want to start. Many owners may work for a time in the type of business that interests them in order to gain some of that real-world experience. Research has strongly linked experience, the more relevant the better, to business success.

Question Four – Does your funding request represent your real needs?

Lenders want to know that you have thoroughly considered three areas of funding. The first area of consideration is start-up costs - raw materials, equipment, inventory, supplies, marketing, etc. Second, lenders want to see future financial projections showing sales and sales growth, per unit production costs as well as on-going cash flow needs for business growth, new employees, additional equipment, etc. Typically, it will be two to three years until you are at a break-even level and often five years before the business is profitable. The lender will be interested in how you plan to cover those expenses – it might not mean a loan now but what are your plans when the need does occur. Finally, for many small, micro and home-based business owners, starting a business may represent a change in the family's income earning power. This means that the lender will be interested in how you plan to cover your own living expenses during that time when the business will not only be generating any profits and may be requiring additional infusions of money.

As part of all three sets of projections, current needs, future needs, and personal needs, the lender wants to know your assumptions and how you arrived at the figures you did (where did you get a 10% growth rate or how can you produce 50 units each requiring 40 hours in three months with no employees). Your lender compares your projections against those of similar businesses. Banks have access to such data from a variety of sources such as Robert Morris & Associates.

Question Five – Do you have a business plan?

The questions up to this point underscore the need for a business plan. Each question represents a segment of your plan. Seldom is it possible for the owner to raise outside capital without having a business plan. The depth and size of the plan can vary, but you do need a plan. The plan summarizes your business ideas and objectives. Business plans allow investors and bankers to judge the viability of the business, in particular, its ability to pay back the debt. The business plan is a document for you, to serve as a guide and to see if you are reaching your goals. Yet it is also there for the lender. For information on how to develop a business plan, go to "Developing a Business Plan for Value-Added Agricultural Products (http://osuextra.okstate.edu/pdfs/F-909web.pdf) or the Small Business Administration (www.sbaonline.sba.gov/starting/indexbusplans.html).

The business plan is part of the documentation lenders use to measure three characteristics of you and the business:

Character – you will make every possible effort to repay the loan and that you are honest, a good manager, and enjoy a good reputation. A good credit report is a key factor in establishing character.

Capacity – the business will be able to pay back the loan or will provide the investors with the return they want. For small business owners, lenders look not only to the business as possible sources of loan repayment but to other income sources you may have such as a second job, a spouse working or even other family members.

Collateral – should you not be able to pay the loan back, lenders want something of value, assets that can be sold in order to pay back the lender. These assets can include real estate, the cash value of life insurance policies, and marketable securities and can be owned by the business or be personal assets.

Financing Alternatives

#1 – Personal support

Financing your business begins with you, the owner, and your immediate family. Many individuals start a business with less than $20,000. The majority of that money comes from savings, working a second job or a spouse's income, using retirement savings, credit cards, or a home mortgage/home-equity loan. While representing risky personal financial behavior, owners with a passion to start a business will often take that risk. Since you often have the first dollar at risk, the idea of a business plan becomes even more important.

A second source of personal support comes from one's family and friends. Because of the difficulty in separating business and personal relationships, borrowing from family and friends is often not advised. Yet family financing of business ventures is a common occurrence and may be your only option. If you decide to use funding from family and friends, develop a contract that clearly outlines the terms. You can often get sample contracts from banks or other financial institutions as well as business support agencies.

Sources of capital

There are two sources of capital - debt or equity. Debt is money borrowed where you are obligated to pay the funds back plus interest. The interest and terms of the loan can vary.

Equity financing comes from selling a share of your company. The buyers are not guaranteed to get money back but do expect to share in the profits of the company and possibly its control and operation.

Each method has certain benefits to your company. Interest payments are deductible but selling equity shares puts you under no obligation to repay the money. As your company grows, it is typical that a combination, tailored to your company's needs, of debt and equity financing is used. Your fiscal and legal consultants should guide selection of the type of financing to use.

Debt Financing

Banks - The most common source of debt financing are banks. Yet business owners often report that obtaining bank funding is difficult and typically will only represent 50% of the money needed. Bank financing is typically done on a secured basis meaning that some collateral or asset, such as equipment, inventory, or accounts receivables, will be available to the lender to sell in order to pay off the loan, should the business fail to make the required payments. The money from the loan is usually designated for a specific purpose such as general operating, to buy inventory or equipment, etc. You may also get a line of credit that allows you to access the money at various times as needed by your cash flow situation. The first bank you should approach should be your personal banker. However, if that institution is not interested, talk to other bankers.

Small Business Administration – While often thought of as a funding agency, the SBA does not make loans. What the SBA does is guarantee loans made by banks and other financing institutions. You are responsible for the full amount of debt. What the SBA does is guarantee payment to the lender. This lessens the lenders risk; however, you, the owner, in the case of nonpayment, become responsible to the SBA and not the lender. Typically, though you will continue to work with the original lender to make payments and service the loan. The SBA has a variety of programs in size and length of term plus has programs that require less documentation or offer micro (smaller) loans.

U. S. Department of Agriculture – **Rural Development Program** - The primary area of assistance from this program is the Business and Industry (B&I) Guaranteed Loan Program. This program provides financial backing for rural businesses. As with the SBA program, it is a loan guarantee program of up to 90 percent of a loan used for working capital, machinery and equipment, buildings and real estate, and certain types of debt refinancing. The program is offered by recognized commercial lenders or other authorized lenders in rural areas (this includes all areas other than cities or unincorporated areas of more than 50,000 people and their immediately adjacent urban or urbanizing areas). Be aware that some portion of the loan may be kept in escrow (withheld).

Oklahoma Agriculture Enhancement & Diversification Program – This program provides funds in the forms of loans or grants for the purpose of expanding the state's value-added processing sector and to encourage farm diversification. Funds, provided on a cost-share basis, must be used for marketing, cooperative marketing, farm diversification and basic and applied research. If you have questions, call 405-522-5515.

Oklahoma Treasurer's Small Business Linked Deposit Program – Available to some Oklahoma small businesses, this program offers funding to help create new jobs or preserve existing jobs and employment opportunities. To apply, contact your local financial institution or call 405-521-3191.

Other financial institutions – In many areas, it may be possible to find other financing agencies (i.e., Rural Enterprises, Inc; Tulsa Economic Development Corp. (a small business investment corporation)). These agencies may offer a variety of programs with various terms.

Commercial Finance companies – Generally used for long-life capital equipment, the costs will be slightly higher than with traditional banks.

Other Debt Financing Options

Leasing – Instead of purchasing equipment, it may be possible to lease what you need. A lease is basically a long-term rental arrangement. While a lease may limit the length of time you are responsible to make payments, it also may bring a somewhat higher payment because of the greater risk to the lease company. Because of the higher cost, leasing should be limited to items that have a long service life.

Trade credit – An important source of financing for your company may come from the vendors and suppliers with whom you do business. Although often starting on a cash basis, suppliers will consider offering financing terms once you have gained their confidence.

Credit Cards - It is possible to start your business using your personal credit cards or credit cards issued to your business. Typically, these cards will have higher rates of interest than what you may be able to find from other alternative sources. If you do use credit cards try and use them for business only. Put personal charges on another card.

Community programs – At times, communities and/or some nonprofit agencies may offer debt-financing programs. One such Oklahoma program is the SEEDS (Self-Employment and Entrepreneurial Development System) program of the Oklahoma Association of Community Action Agencies. Also available in some areas are Certified Development Companies that offer SBA and sometimes other debt financing programs.

Micro loan opportunities – Similar to community programs, these loan programs offer small amounts of money to business owners. Often the requirements for these loans are less stringent than from commercial ventures. However some times there are additional requirements such as required participation in regular meetings of those who had borrowed money from the fund. At the current time, there are limited numbers of these funds.

Payday lenders/pawn shops, etc. – Another source of funding. Rates are often higher than those available from other resources.

Equity Financing

As noted earlier, equity financing involves trading a share or portion of your business to someone in exchange for needed capital. Some equity programs are structured to only last for a limited period of time.

Stock offerings – Although offering the potential for generating significant amounts of capital, the offering of stocks is a complicated issue with numerous tax and regulatory issues. Such programs require the help of specialists and are costly for most businesses to undertake. These are typically not used by small businesses.

Venture capital companies – Is a company that is in business to investing in companies that show high growth potential. Typically, the individuals funding such programs expect a 30+ percent return on investment and often only want to be involved for five years or less. To obtain such financing, the owner must be prepared to offer significant ownership rights to the investors. Generally, these investors are looking for companies that can go public through a stock offering within three to five years.

Private individuals (Angel investors) – Like venture capital companies only the funding comes from a single individual. Again, the expectation is a fast, high return and significant ownership rights while participating in the company. The SBA operates one network of angel investors at ACE-Net.

Small business investment companies (SBIC) or local development companies – May provide equity financing or debt-financing.

Other Programs

At times and for various areas or groups, other programs such as job creation incentives or tax incentives may be available. Your local Chamber of Commerce, local financial institutions, and various state agencies have information about such programs.

Summary

Arranging business financing is something that all owners will face at some time. Research has shown that preparation can significantly increase your chances of getting outside financing as well as the amount of financing received (Van Akin & Neely, 2000). Be prepared with answers to the basic questions and a solid business plan in hand. There are many more people searching financing than can be funded. You gain credibility by being prepared. Do not forget that there is no free money and you must be prepared to use some of your own resources.

For help, contact local support agencies:

Oklahoma Cooperative Extension Services
- Micro Business office - fcs.okstate.edu/microbiz/
- Healthy Communities - healthycommunities.okstate.edu/
- Rural & Economic Development - www.rd.okstate.edu/
- Food & Agriculture Products Center - www.okstate.edu/ag/fapc/

Oklahoma Small Business Development Centers - www.osbdc.org/

Small Business Administration - http://www.sbaonline.sba.gov/

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Issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Robert E. Whitson, Director of Cooperative Extension Service, Oklahoma State University, Stillwater, Oklahoma. This publication is printed and issued by Oklahoma State University as authorized by the Vice President, Dean, and Director of the Division of Agricultural Sciences and Natural Resources and has been prepared and distributed at a cost of 20 cents per copy. 0607