

CHAPTER 2: OVERVIEW OF FINANCING RESOURCES

Getting Started

As a company moves through its life cycle, the sources it uses for capital change. In the early formation phase, capital is generally raised through sources independent of the operations of the organization. Capital is acquired chiefly through the personal resources of the owner or his immediate relations, and investor-related debt. Any cash generated from operations is generally used for setup costs including purchases of inventory and equipment. This initial phase calls for the use of techniques that maximize- or “stretch”- current funds, such as seeking longer credit terms from suppliers, procuring advances from customers, subcontracting, and leasing equipment, among other methods.

As the company grows, it begins to generate capital through its operations, and as it establishes a track record of profitability, it will have more opportunities to obtain outside financing. Capital needed for expansion may be available from external sources, including a greater emphasis on debt financing through commercial lenders or equity financing through private investors and firms. As the company matures, operations generally provide cash. Mature companies are in a better position to be able to afford the costs of further expansion through combinations of debt and equity financing, such as private placements or initial public offerings (IPOs).

In all of these phases of business growth, companies must keep abreast of the latest tax credits and other government incentives as well as grant opportunities. Though it is far more likely that a business will be able to avoid a tax than obtain “free” grant money, an open mind must be kept toward all sources of potential funding.

The organizational form of a business is another factor that determines the financing sources that may be available. A sole proprietorship is often the form used by a small company -- operated by a single individual (e.g. restaurant, trucking firm, gift shop) with few capital needs that cannot be met from the owner's resources or conventional lenders. A start-up formed as a limited partnership (LP) may be attractive to investors who can only be held personally liable up to the amount of their investment made. Neither partnerships nor sole proprietorships, however, can raise equity financing through a private placement or an IPO. Corporations offer greater flexibility for raising capital through a mix of debt and equity than do either sole proprietorships or partnerships. Finally, the limited liability company (LLC) is a fairly new form of organization that combines the characteristics of both corporations and partnerships.²

Start-Up (or “Seed”) Stage

External sources of financing refer to those funds not generated by business operations. During the start-up phase, among the most important sources are personal assets accessible to the owner. The emphasis is on external sources since the business is not yet generating positive cash flow. In the search for early-stage capital, loan opportunities

² For further information on forms of business organization within North Carolina (including forms, filing fees, and useful how-to guides), visit the N.C. Secretary of State's Corporations webpage: <http://www.secretary.state.nc.us/corporations>.

are usually limited by the need for collateral and personal guarantees, which serve as protection to the commercial lender. It is unlikely for most start-up companies to obtain equity investments, in part due to the high risk involved in this stage of investment. Factors such as a well-developed business plan, or prior experience in the new business's area, improve one's chances of acquiring start-up or early-stage funding.

Personal Assets

Obtaining financing for a start-up enterprise is difficult because there is no track record on which the business can be judged. Personal assets are thus the first source of capital that must be considered. A personal stake in the enterprise shows a commitment to the business and provides lenders with a potential source of collateral to secure a loan. Most banks require at least a 30 percent personal equity investment in a start-up business and 10 percent to 30 percent in a more established business. If an owner does not have access to sufficient personal resources to get through the lean times of the start-up phase, it may be wise to re-evaluate the decision of going into business at this time.

Sources of financing using personal assets (in the pre-seed stage, this is oftentimes referred to as "bootstrapping" or "bootstrap" funding) include:

- Checking and savings accounts
 - good source, if available
- Credit cards
 - disadvantage: a credit line can come with a high interest rate
- Stocks, bonds and other investments
 - disadvantage: may face capital gains tax on the sale of investments that have appreciated over the years
- Retirement funds such as a 401K
 - disadvantage: may face a penalty for early withdrawal

Family and Friends

Family and friends can provide direct investment funds, loans, or serve as guarantors on a bank loan if their credit history and resources are strong. Unlike commercial sources, this group is personally acquainted with the entrepreneur, and though they must still be objective in assessing the proposal, intangibles such as personal character are often given more weight by family and friends than by more traditional sources. If an outright loan is not possible, this group can still provide aid in procuring financing through credit enhancement. Credit enhancements are assets of recognized value that can be borrowed to support a loan or other debt obligation. This technique bolsters the asset base so that additional debt financing can be acquired. This can be accomplished through the pledge of personal assets such as a CD, stocks, or bonds as collateral.

Home Equity Loans

A home equity loan (sometimes referred to as a "second mortgage", though it may in fact constitute a third or even fourth lien on the collateral property) can be a source of funding for a small business. The feasibility of this source will vary with the amount of equity that has been built up in the home. It can usually be obtained through a bank, a mortgage company, a finance company specializing in secondary funding, or a savings-and-loan (S&L) association. The monthly payment will be a function of the length of the

loan and the interest rate. Additionally, there are usually points or fees and closing costs (and sometimes other factors, such as *balloon payments*) to be considered when assessing the costs of this mode of financing. The proceeds from the loan can either be used as a source of direct financing or as collateral to secure a credit line.

Growth Phase

Internal Financing

Cash Management Tools

Effective cash management of a business is one of the best ways to raise capital, and it also helps avoid paying interest on unnecessary external debt. Since short-term cash flow needs are vital to company operations, available cash flow management techniques must be maximized. Small business banking services are traditionally oriented around deposits and loans, with most services tied to checking accounts. However, specialized services once used primarily by larger companies are now available to smaller businesses. The following services can be used as part of an effective cash management program:

a. Lockbox

An integral part of a profitable business is a fast, efficient accounts receivable process. A lockbox is a post office box maintained by the bank to receive payments made to a business. The bank empties the lockbox frequently and immediately deposits checks into your account. The advantage is that funds become available much faster than if they are first sent to the place of business.

b. Controlled Disbursement Account

This tool enables the business to make timely payments while maintaining the maximum earning power of funds. With a controlled disbursement account, the business receives daily notification of the checks that will clear the account that day. Only the amount needed to cover those checks is transferred to the checking account, ensuring that no idle cash remains in the account.

c. Sweep Account

A sweep account is an automatic system to move excess money into an interest-bearing account every night. After all debits and credits are posted to the checking account at the end of the day, funds in that account are automatically swept into a money market or savings account.

Accounts Receivable Management

Effective short-term cash flow management is vital to a company's operations. Short-term financing needs are decreased when cash flow is maximized through matching accounts receivable with accounts payable. This is done by carefully negotiating and managing credit terms with customers and suppliers. Periods where payables exceed receivables must be handled through short-term financing such as a line of credit. If the business itself delays sending bills, the result is a longer period before payment is received. The use of that cash to cover payables or for investment is lost over that period. The same is true when the collection cycle is lengthened as a result of a failure

of customers to pay according to the credit terms. Consider using discounts to encourage timely customer payment.

Inventory Control

The less excess inventory carried, the greater the availability of funds for interest-bearing accounts or working capital purposes. Excess inventory lowers a company's profitability due to the money spent to produce or purchase the idle goods that take up warehouse space and increase insurance costs. The goal of avoiding excess inventory must be balanced with a company's ability to consolidate inventory purchases to take advantage of volume pricing. Implementing an inventory control system can help reduce excess inventory and its associated costs.

Electronic Commerce

Each of the preceding strategies for effective internal financing may be enhanced through the use of electronic commerce. Electronic commerce, mostly in the form of Electronic Data Interchange (EDI), has been around since the 1950s but until recently was primarily used by large companies doing business with the federal government over expensive private networks. Technological advancement and the increased accessibility of both personal computers and the Internet have made electronic commerce an increasingly popular and more affordable tool for small businesses. For many individuals and small businesses, some aspects of electronic commerce are a part of daily life—for example, direct deposit of payroll, credit card validations, and automatic bill paying.

Electronic commerce allows the computer-to-computer exchange of routine business information between a company and its suppliers, its customers, banks, and other trading partners. One aspect of such an exchange that offers an important financing opportunity to small businesses is the ability, through either EDI or the Internet, to establish a partner-like relationship with their suppliers. Suppliers are then able to manage their customers' material logistics, including a customer's on-hand inventory. The supplier's goods may be moved on consignment and/or the small business customer may not be expected to pay in full until the goods are used or, in the case of manufacturing components, until the final product has been sold. In this way, the supplier provides a portion of the working capital for the small business.

Procurement cards are another aspect of electronic commerce that offers significant cost-cutting potential to the small business. A procurement (or purchasing) card is a specialized corporate credit card that can be customized to limit dollar amounts and types of purchases that can be made by individual employees. Since banks replace the vendor in the task of customer billing and collection, for a small business the ability to handle procurement card transactions could mean both improved cash flow and significant cost savings.

Barter

Bartering is the trading of one item for another. Commercial trade exchanges serve as the mechanism for the transfer. Through the use of computers, exchanges can match the needs and wants of its clients. Barter is a good way to keep a business moving when cash is scarce. It is especially useful for a small business because it allows the business to trade unused or excess inventory in exchange for goods and services for which the business would otherwise have to pay. The resulting benefit to a business is that it cuts costs and eases cash flow. Trades are normally made at full retail value with a 10 percent commission paid to the exchange. The goods or services received are also considered as income for tax purposes. Among the larger exchanges operating in North Carolina are International Barter Group (IBG) (843.824.1435) and ITEX BarterWorks (<http://www.itex.com>)(919.870.9226). For more information on bartering please visit the International Reciprocal Trade Association at <http://www.irta.com>.

External Financing

As the business begins to grow, external financing sources should become more available, and debt or equity may be used to satisfy financing needs. The mix of financing sources varies depending on the growth stage of the business. During the start-up stage, entrepreneurs most often rely on “family and friends” and internal debt financing, but as the business becomes more established, it develops a credit history and outside debt financing becomes more available. High-growth companies- those growing very quickly- are attractive to equity financiers. Equity financing providers may be companies, funds, or individuals, but they all seek to invest in private companies in which they can anticipate a substantial rate of return for their investment. Debt financing is more varied, both in the types of entities that provide such financing and in the types of financing available.

Short-term Financing

Short-term financing is used to address needs of one year or less in duration and is intended to take care of a mismatch in cash flow generated from receivables and expended as payables. It is used to satisfy a business’s working capital needs and to support investments in short-lived assets such as inventory and accounts receivable. A working capital deficit indicates that a company has more short-term obligations (i.e., payables) than short-term assets (i.e., cash, accounts receivable, inventory). The gap can be bridged through accessing short-term financing (e.g., a revolving credit line).

The most common situation that challenges a company’s ability to repay its debt on a timely basis is using short-term borrowing for long-term needs. This includes financing expenditures for fixed assets or intangibles with short-term credit. Though most banks may be reluctant, refinancing short-term borrowings into long-term debt typically resolves this problem. Balance sheet management is a key factor in determining the right type of borrowing to utilize at the current stage of development.

a. Trade Credit

Accounts payable -- also called 'trade credit' - is a form of money management that is especially crucial for small firms. A business may finance itself by asking its vendors and suppliers to accept a comfortable payment schedule instead of insisting on full payment at the time of delivery. A business will seek to pay off its debts over many months (without the penalty of interest charges) while collecting payments from its customers in full. This system keeps the maximum amount of cash under the business's control.

b. Term Loan

Commercial lenders are a key source of loans. A single loan obtained from a commercial lender by a business firm is not much different from a loan obtained by an individual. Commercial term loans are direct business loans with a maturity of five or fewer years. A major advantage of the term loan is that it assures the borrower of the use of the funds for an extended period. The interest rate on term loans varies with the level of prevailing rates, the size of the loan, and the quality of the borrower, and it may be fixed for the life of the loan or it may vary. Repayment of principal and interest is made in a lump sum at maturity or in installments throughout the life of the loan. Most term loans are installment loans repayable on an amortized basis, which allows the loan to be repaid gradually over its life rather than have it due in total at maturity.

c. Line of Credit

A line of credit is a formal or informal understanding between the bank and the borrower concerning the maximum loan balance the bank will allow the borrower. This source is useful for short-term financing of working capital, seasonal needs, and unplanned expenses. The amount of the credit line is often linked to a percentage of a firm's short-term assets. In most cases, the line of credit must be paid off in full every 12 months.

d. Letter of Credit

A letter of credit is a financial instrument issued by a bank to provide a credit guarantee to an outside supplier. The purpose is to guarantee that, if all terms and conditions of the letter of credit are met, the seller will receive payment from the bank even if the buyer defaults on payment. The risk of the buyer defaulting on payments is, therefore, transferred from the supplier to the bank.

Long-term Financing

Long-term financing extends beyond five years and is generally used for investment in long-lived assets. Long-term needs can be met by debt or equity financing or a combination of the two.

a. Debt & Equity Financing**Debt Financing**

Debt obligates the business to repay its lenders the debt principal along with a specified rate of interest. The lender does not acquire an ownership interest in the organization, as would be common with equity financing. When a business becomes insolvent, creditors or debt holders are entitled to payment before equity shareholders. Interest payments on the debt by a corporation are tax deductible; dividend payments are not. The lender

looks closely at the borrower's current position, because current assets are the main source of repayment.

Debt financing entails borrowing either at a fixed or a variable rate. A fixed rate offers certainty, but variable rates are usually lower than fixed rates at the time the loan is extended and may decrease further if interest rates fall. In general, if interest rates rise, so will the variable rate and higher monthly payments will result. Some of the variable rate loans may be capped so as to guarantee not being raised above a certain rate.

Issues to consider regarding the use or pursuit of debt financing include:

- Businesses that cannot satisfy collateral requirements generally don't qualify
- Risk of high leveraging
- Increasing risk during business cycle downturns since debt payments remain fixed
- Only the interest portion of the debt is tax deductible.

Equity Financing

A business owner may choose equity financing by selling part of the business to individuals, firms, or the public. A corporation can issue shares of stock as a form of financing. Shareholders pay the corporation for their shares, and each share represents an ownership interest in the corporation. Shareholders then acquire rights to dividends and to a portion of the corporate assets on liquidation. There are two basic forms of equity financing: common and preferred stock. Common stock represents the corporation's residual ownership interest. This is what is leftover after all other claims of creditors, debt holders, and preferred shareholders are satisfied. Preferred stock has characteristics of both debt and common stock. Like debt, preferred stock earns a fixed amount of income, in this case called dividends. Preferred stock shareholders have priority over common stock shareholders as to dividends. Like common stock, it ranks behind the claims of debt holders and creditors in the event of liquidation.

Issues to consider regarding the use of equity financing include:

- Owner must relinquish percentage of ownership for equity capital
- Equity investors fall behind debt holders in the event of liquidation
- Costs of preparing and placing private offerings can be relatively high
- Dividends may be subject to double taxation.

Debt Financing vs. Equity Financing

Consider the case of an entrepreneur who needs \$150,000 to start a new corporation. For the purposes of the illustration, assume this founder contributes \$50,000 and the remaining \$100,000 is financed with debt. At the end of the first year, suppose the company has a net income of \$100,000. Assume this \$100,000 is used to pay off the original debt. The founder is still the only equity holder, with \$150,000 of equity on the balance sheet, and the liability (debt) formerly held against the business has now been paid off. Since there are no additional liabilities, all additional earnings can go towards operating expenses and/or assets for the company. Conversely, if the business lost \$100,000 after the first year, this loss would decrease the equity portion of the balance sheet to negative \$50,000 and the loan must still be paid. The company will likely have

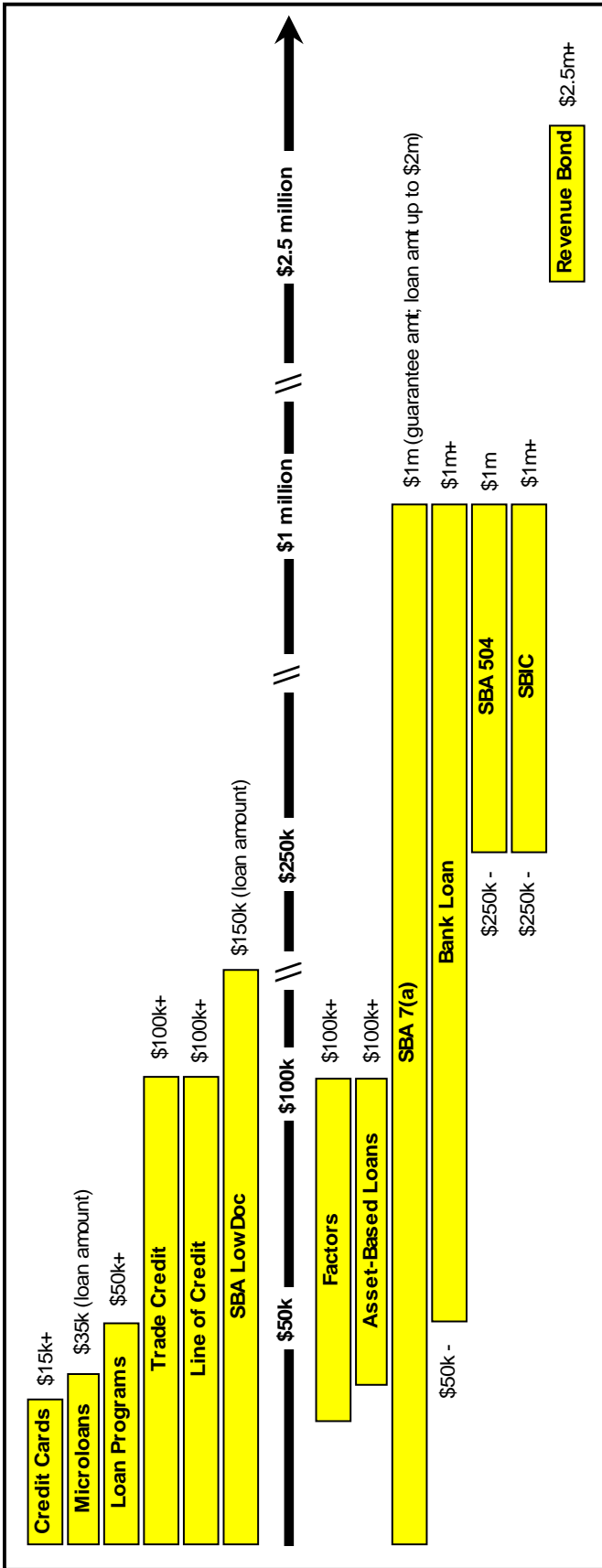
difficulty making these payments and may be in danger of defaulting. As this illustrates, debt financing provides leverage to the business owner and amplifies the impact of earnings as well as losses. In a second case, assume the company obtains \$150,000 of *equity financing*, with no debt financing, and has the same first-year net income of \$100,000. Unlike the first case, the equity position will increase to \$250,000 and there is no debt to pay. Conversely, if the company suffers a loss of \$100,000 in the first year, this loss would decrease the equity portion of the balance sheet to \$50,000.

Debt-to-Equity Ratio

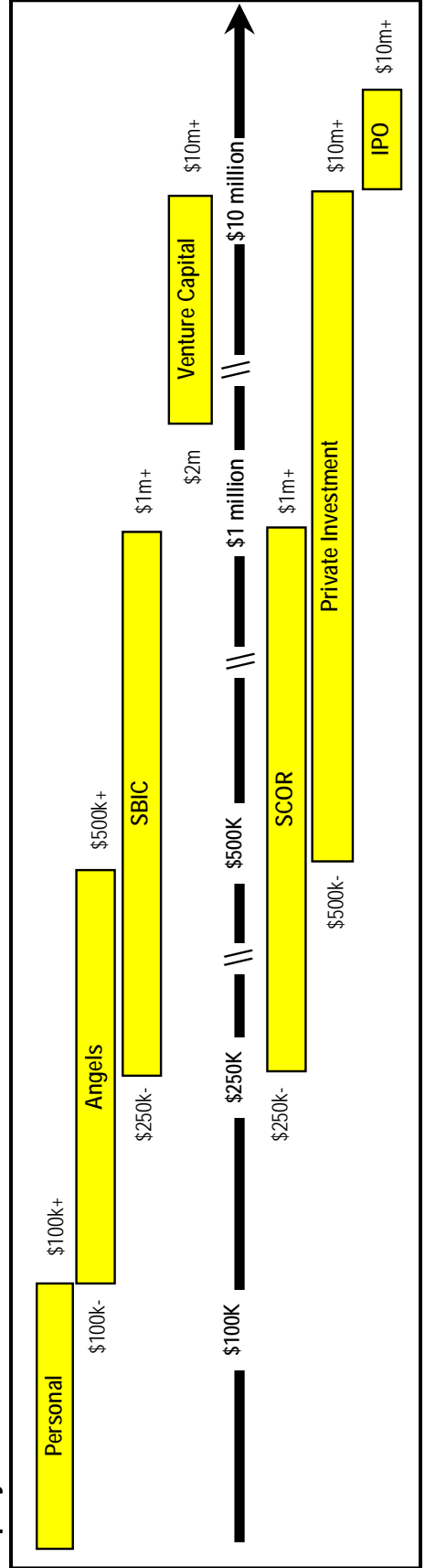
The analysis of the amount of debt financing used as compared to equity financing is referred to as the debt-to-equity ratio. The ratio of total debt to equity provides an indication of how strong a company's finances are by comparing what it owes to what it owns. Potential lenders or investors use this ratio to evaluate risk: the higher the equity in the firm's capital structure- compared to the debt- the less risk the company appears to present to a lender.

For further information on debt, equity, and other financing basics visit the SBA's *Financing Your Business* webpage at <http://www.sba.gov/financing/>.

Debt Sources



Equity Sources



b. Obtaining a Loan

The most important aspect to realize in seeking a loan as a source of capital is that the lending institution derives its return solely based on the borrower's ability to repay the principal and interest. Since a lender's expected return on investment is limited to interest payments and service fees, it will be reluctant to accept as high a degree of risk as may be acceptable to an investor who provides financing in exchange for a claim on future earnings of the company.

The lender does not gain any additional return if the business does exceedingly well. One must also realize, however, that these institutions principally derive revenue from making loans. A loan applicant, therefore, must take the time to gain an understanding of what the lending institution looks for in a loan candidate and why the business opportunity is a solid proposition for the bank.

Before approaching a financial institution, the applicant needs to have the following documents:

- A business plan
- Federal tax returns for the previous three years
- Personal and business financial statements
- Cash flow statements.

A business plan is the first indication of how the business is going to be managed. A business plan should be seen as a sales tool directed at those people who are considering backing the entrepreneur. If it is thorough and well prepared, this is a predictor that the business will be managed the same way. The business plan should be sufficiently complete to prove the ability of management to understand the critical factors of the business such as product, market demand, competition, cost structure, pricing, and management.

Information needed to support a loan request includes:

- Size of the loan requested or needed
- Capital already on hand
- Experience of management
- What the loan proceeds will be used for
- How the loan will improve the business
- Evidence of ability to repay the loan.

Factors an applicant must consider in seeking a loan include types of loans offered, rates and fees, collateral requirements, personal guarantee requirements, lending limits, and loan processing time. While the institution will have a policy regarding these elements, its flexibility will depend on the strength of the applicant. From the institution's point of view, personal credit and payment history are some of the factors indicating the degree of risk involved in making the loan. The more accounts and services an individual has with the institution -- personal and business checking account, savings account, credit card, IRA -- the more valuable they are to the bank. This gives the individual more leverage in negotiating terms and conditions of the loan.

It is important for a small firm seeking loan capital to develop a relationship with the lender early in the process. Even before the loan is needed, it is important to take steps



to solidify the foundation for a good working relationship. Once the loan is made, it is important to remain in close contact with the bank. If problems arise, the bank will want to help the company in order to avoid having a bad loan in its portfolio.

Grants

Generally speaking, grants given to business start-ups are very rare. An exception may be for a high technology business or for businesses producing products that can be used by certain agencies or departments involved in our nation's defense. Also, non-profit businesses are sometimes eligible for grants. For the most part, these grants are very specialized. In addition, many Government grants are not available year-round. That is, you can't apply for most of them at any time you please -- in general, you can apply for them only when they are announced by a Government agency.

Grant information can be found at your local library in the business section or by visiting the following websites:

1. *Grants.gov*: the electronic storefront for Federal grants- <http://www.grants.gov>
2. Federal Assistance & Financing for your Business- <http://www.sbaer.uca.edu/finance>