Startling Facts about Financing Small Businesses...

And pointers to ensure your venture gets funded

by Mike Elia

Often a small business is small because the industry dictates that a small business is more effective than a larger one. Sometimes a business is small because it's just getting started—either as a new business in an established industry or as a new businesses in a developing industry.

Either way, running a small business means you face different financing decisions than those of larger businesses. Why? It's likely that you base your goals on your personal ambitions rather than those of a large group of investors. Also, your ability or lack there of to gain access to money and capital markets naturally creates a special set of problems for you. Here are a few ways to finance a traditional small business and a small business with growth potential.

Traditional Small Business

Many industries warrant small businesses for underlying economic reasons. These industries or industry segments in which traditional small businesses dominate have three common economic characteristics. They typically serve a localized market, need little capital, and employ simple technology. These underlying economics make it difficult for small businesses, even successful ones, to gain access to the general capital markets for funds. If you are a traditional small business and you own any real estate, you may be able to get a mortgage from a bank or savings and loan. You can buy your equipment with a term loan or perhaps lease it. If your business has been around a few years and has a proven financial history, bank financing may become available but usually not as permanent growth capital.

As a traditional small business, it's not practical for you to sell bonds or stock. You, the owner-manager, or your friends and family must provide equity and rely on trade credit (credit extended to you by suppliers) to provide most of your short-term or working capital financing. Banks will provide most of your long-term external financing.

Financing Small Business with Growth Potential

Typically, a small business with growth potential has developed a new product or an innovative method of providing an existing service. The personal computer is a prime example of a new product that spawned a new industry. McDonalds is a prefect example of a new way of providing an old service. A small business with growth potential needs different types of financing as it progresses through it's life cycle—evolving from formation to maturity. Thus, it's important to understand the life cycle of a business and the financing sources used most often to fund small businesses with growth potential.

The Typical Business Life Cycle

1. Formation. This is the beginning. The business is experimenting and working to prove itself. To transcend from an idea to a company, the business needs funds. Without funds, your business will remain just an idea.

2. Rapid Growth. The business has achieved initial market acceptance and is beginning to experience rapid growth. Although the business may be reasonably profitable, grow makes managing cash flow and working capital increasingly difficult. To fund it's growth, the business needs an extraordinary amount of outside financing. However, the business is often not large enough at this stage to go public; it needs more funds than it can produce itself and more than the owners, friends, and family can provide.

   While the business potential may seem great at this point, it is far from being "out of the woods" from a risk perspective. Continued financial and internal pressures make it difficult to manage the growth, cash flow and working capital. Competition is likely to enter the picture and take a portion of the market being created—slowing your growth projections and reducing your share of the potential market.

3. Growth to Maturity. This is the point where going public becomes probable. The size and prospects for the business provide it access to the broader money and capital markets.

4. Maturity. Without the continued development of new products or markets, the business will stop growing and eventual decline. It is at this point that financial tactics such as share repurchases or stock buybacks and mergers with other companies become practical. However, the time to plan these tactics is before the business leaves the previous stage.

Two Financing Alternatives

Funding for the formation stage is called seed money. At this stage investors take the biggest gamble—investing long money at high risk in hope of a high return usually on nothing more than an idea.

1) Venture Capital
The high risk, high profit potential of early stage growth businesses is ideal for venture capitalist. Venture capitalists are wealthy individuals, partnerships, or corporations whose business is supplying money to start-up and expand businesses.

However, the natural tendency at this stage is to look to friends and family for funding. I believe this is because most entrepreneurs don't want to take the time to prepare for the rigorous examination of a venture capitalist. Thus, many entrepreneurs take the friends and family route which often ends with disappointed, estranged family members and friends. If you step back and think about this, why would your friends or family members do better at evaluating a start-up business than the professionals who do this for a living?

Venture capitalists typically play a continuing and active role in the businesses they invest in. They usually have at least one member on the board of directors, but do not always insist on voting control. Surprised? You shouldn't be. Venture capitalists want to invest in businesses with management teams that make sound decisions. If they feel

the management team isn't capable, then it's not likely they'll want to investment in the first place.
Venture capitalists reject a high percentage of applications. They usually use equity to fund approved applications. But, they may also provide debt financing. When they use debt, it is usually convertible into stock, has warrants, or they tie it in someway with the purchase of stock. Because of the costs of screening and researching new business opportunities, venture capital firms do not like deals that need investments of less than $500,000. Investments below this range are better suited for an angel investor—an individual investor with money to invest in early stage or start-up companies.

It's important to understand that venture capital funds come from wealthy individuals. For tax reasons, these individuals prefer to receive their income in the form of capital gains rather than dividend income. They are also in a position to take advantage of special rules of the tax laws. For example, certain types of organizations like partnerships and limited liability corporations (LLC) let operating losses, tax credits, and so on pass through to the investor and used to offset ordinary income. Although there are limits on ordinary income that can be offset with capital losses, losses from a small business as defined by the Tax Code can be much larger. These tax sheltering opportunities provide extra incentives for wealthy individual to invest in small businesses.

To understand how these tax-sheltering opportunities help investors, let's look at an example. Suppose an investor, who is in a 35 percent federal tax bracket on ordinary income and is taxed 20 percent on long-term capital gains, is considering a $100,000 investment in the stock of a small business. After doing due diligence, the investor decides there is a 50 percent chance the business will be worth $220,000 after one year and 50 percent it will be worth nothing—zero. Here's two ways this investor might evaluate the expected rate of return on this investment before taxes and after taxes.

To start the investor calculates the before tax expected return by calculating the value of the two expected outcomes: making $220,000 or making zero. To do this, the investor multiplies $220,000 (the expected worth of the business in one year) by 50 percent (the chance of this event happening) to arrive at $110,000. Then, add to this the value of the second outcome $0 multiplied by 50 percent or $0. The result ($110,000 + $0) is an expected return of $110,000 on his initial investment of $100,000, or a 10 percent return on investment ($110,000÷$100,000 – 1).

Not an attractive return considering the risk. But look at what happens when you calculate an after-tax return.

First, an investor only pays taxes on the portion of the investment that exceeds the investor's initial investment. This means if the business increases in value to $220,000, the investor will pay a capital gains tax of 20% on the amount that exceeds the initial $100,000 investment. So, if the value of the business increases to $220,000, the investor will receive $196,000, which is the initial $100,000 investment plus $120,000 less the 20 percent capital gains tax ($96,000). Next, multiple this amount by 50 percent (the chance of this event happening) to get an expected value of $98,000. Now, calculate what happens if the business is worth zero. Not to fast. Because if the business is worth zero, the investor gets to deduct the $100,000 investment as a loss for tax purposes against ordinary income. This means the $100,000 loss has a tax value of $35,000 ($100,000 times the 35 percent tax

rate). This value is then multiples by the 50 percent chance of occurring to get a value of $17,500 ($35,000 times 50%). So, the expected after-tax value is $98,000 plus $17,500 or $115,500, which equates to an after-tax return of 15.5 percent ($115,500/$100,000 – 1).
A 15.5% expected after-tax return is not that bad for an investor in a 35 percent tax bracket, especially if the investor takes several positions in different small businesses to diversify and reduce the risk of each individual investment.

Remember, corporations as well as individuals can benefit from small business investments. Corporations like General Electric, 3M, Citicorp, and Lucent invest both money and know-how in small businesses. Founders of small businesses, who are usually specialists or technical people who need both money and help with administrative details like accounting, finance, production, and marketing, typically welcome these resources. The small business owner contributes entrepreneurship, creativity, a thirst for risk taking, and sweat equity for the chance to make millions or bust. The corporations on the other hand have found these types of relationships to be mutually worthwhile and rewarding.

2) The Small Business Administration
The federal government set up the Small Business Administration (SBA) (http://www.sba.gov/index.html) to manage several programs to help small business with the difficulties of starting, financing and running a business. One important program is the Small Business Investment Company (SBIC) (http://www.sba.gov/INV/howtoseek.html) program.

Created in 1958, the SBIC Program helps bridge the gap between venture capital availability and the needs of small businesses in the start-up and growth stages of their business life cycle. SBICs are privately owned and managed venture capital funds, licensed and regulated by the SBA, that use their own capital, plus funds borrowed with an SBA guarantee, to make equity and debt investments in qualifying small businesses. To get an SBIC license, an experience team of venture capitalists must secure minimum commitments of either $5 million (for debenture fund) or $10 million (for an equity fund) from private investors. Licensees can receive up to another $20 million in commitments from the SBA for every $10 million in private equity.

SBICs mirror venture capital companies in two ways. First, their investments are usually in the form of a convertible security or bond with warrants. This gives the SBIC a residual equity position in the company they invest. Second, SBICs stress management counsel, for which they charge a fee. However, SBICs can only invest in businesses that have a net worth of less than $18 million and have not made more than $6 million in after-tax income over the past two years.

If your business meets these criteria and you would like to get SBIC financing, you should first identify and research existing SBICs that may be interested in financing your company. Use this link to find SBICs in your state http://www.sbaonline.sba.gov/gopher/Local-Information/Small-Business-Investment-Companies/.

Be sure to find out your company's needs and research SBICs well in advance and long before you will need the money. Your research will take time, as will the SBIC's research of your business. In choosing an SBIC, consider the types of investments it makes, how much money is available for investment and how much might be available in the future. You should also consider whether the SBIC can offer you management services suitable to your needs.

Approaching a Venture Capital Firm or an SBIC

Once you've identified venture capital firms or SBICs that you think best suit your company's financing needs, you'll need to pitch your idea or business to them. How well you pitch your idea or business plan will determine whether your prospective investors will see your business any differently from all the other investment choices they are evaluating. To learn more about how investors' choose their investments sign up for my free report "The Mind of the Investors" at http://www.business-plan-secrets-revealed.com/business-investors.html.

It is up to you to bridge what I call the "Investor Confidence Gap." This is the gap that reflects an investor's inability to resolve whether the investment they are reviewing is any better or worse than the others.

The best way to bridge this Gap is to present a detailed and comprehensive business plan or prospectus that states a case for your business quickly. This case must separate you from other businesses seeking capital and truthfully lead investors to decide that you are their most appealing investment choice.

Three Steps to Bridge the Investor Confidence Gap

1. Have something good to say. Step one is to write a business plan based on a thorough investigation of your business… its products, competitors, and customers. Then, you can apply all the winning communication formulas to get the best results.

2. Say it well. Write your plan with a style that holds it together. Your words, phrases, sentences and paragraphs are the building blocks to express your idea – explanations, arguments, appeal. Neglect none of these, if you want your plan to attract investors.

At a minimum, be sure to include in your business plan the following information:

Identification
- The name of the business as it appears on the official records of the state or community in which it operates.
- The city, county, and state of the principal location and any branch offices or facilities.
- The form of business organization, and if a corporation, the date and state of incorporation.

Product or Service
- A description of the business performed, including the principal products sold or services rendered.
- A history of the general development of the products and/or services during the past five years (or since the business started).
- Information about the relative importance of each principal product or service to the volume of the business and to its profits.

Product Facilities and Property
- Description of real and physical property and adaptability to other business ventures.
- Description of the technical features of production facilities.

Marketing
- Details about your business's customer base, including potential

customers. Show the percentage of gross revenue produced by your five largest customers.

- A marketing survey and/or economic feasibility study.
- A description of the distribution system by which you provide products or services.

Competition

- A descriptive summary of the competitive conditions in the industry in which your business operates, including your concern's position relative to its largest and smallest competitors.
- A full explanation and summary of your business's pricing policies.

Management

- Brief resumes of the business's management personnel and principal owners including their ages, education, and business experience.
- Banking, business, and personal references for each member of management and for the principal owners.

Financial Statements

- Balance sheets and profit and loss statements for the last three fiscal years or from the start of your business.
- Detailed projections of revenues, expenses, and net earnings for the coming year.
- A statement outlining the funding you are seeking and the time requirement for the funds.
- The reasons for your request for funds and a description of the proposed uses.
- A description of the benefits you expect your business to gain from the financing: improvement in financial position, expense reduction, increases in efficiency, and so on.

3. Say it often. You have to understand and accept that not all investors are ready to invest at the exact time you want or need their investment. That's why you need to communicate your business case continuously to your investor base.

In short, your business plan should be in plain English and easy to read. It must communicate all the important facts about your business, especially what is likely to affect its performance. And, finally, the business plan document itself must look like it's meant to be read.

Summary

Small businesses face different financing decisions than large businesses. They also don't have the same access to capital markets as larger businesses. Knowing why you are a small business is step number one to understanding what type of financing might be available to you. Understanding what stage your business is at in its business life cycle is the second step. Once these are understood, you can determine which funding sources best match your business needs.

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