The role of non-bank lenders in small-business financing

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September 2000
Abstract

Small business enterprises obtain financial leverage through internal resources, which are often inadequate in meeting the firm's financial needs. In order to address such problems, an increasing number of small-business owners are resorting to non-bank lenders for their financing needs. Small business owners have a wide variety of non-bank financing options, including commercial finance companies or venture capitalists, credit unions, life insurance companies and credit card firms. In this paper, I will examine some of the issues facing small businesses in raising capital, how they go about raising capital and the people and institutions that help finance these small businesses.
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Introduction

Your small-business has been growing to the point that you desperately need to expand. You find a piece of property, an old warehouse owned by the city. It’s perfect for your business if only the city will give it to you in return for expanding its tax base. You manage to convince the city to sell it to you at a give-away price. Now you need some capital to renovate it so that you can move your engineering and construction offices to the new site. All your capital is tied in a consulting bid and other projects. Where do you turn for help and what type of help can you get? How do you go about securing capital to grow the business?

Those were some of the questions that Namdi Iwuoha, the 37-year old owner of Avalon Consulting Services, a Baltimore-based engineering consulting & construction firm faced when he needed capital to expand his small business. Whether it’s raising capital to grow an existing business, or capital to start a new one, the scenario described above is often faced by too many small-business owners all over these United States.

Local financial institutions (i.e., banks, savings and loan associations, and credit unions) generally are not very interested in start up businesses. Often times, they are conservative and want to know ones ability to repay. So they tend to thoroughly examine a loan request and the monetary amount one is willing to put at risk. For start-up expenses, loans generally are limited to 50 percent of the money needed. Loan officers look for borrowers with good credit ratings and sound business plans. Interest rates and repayment plans are often too expensive for small businesses and may vary from institution to institution. Fortunately, there has been a proliferation of other alternatives for raising capital in recent years. These other sources of raising capital by the small-business owner are what some call non-bank lenders.
This paper examines the role non-bankers play in short-term and long-term financing of small businesses. Before developing the roles played by non-bank lenders, it would be worthwhile to define the role of banks with respect to the subject matter. In addition, the following terms, small business, short-term financing, long-term financing, and non-bank lenders need to be defined as to how they will be used throughout the paper.
Definition of Terms

Banking Roles

Traditionally, banks have two main things they do -- accept deposits and then lend some of the money to customers. In addition to deposit and loan functions, other services include trusts whereby they handle money for people who cannot do so directly. Many banks also provide safe deposit boxes for their customers, issue travelers’ checks, wire funds around the globe, exchange currency, and issue credit cards, among other things.

Deposit Functions

The only way a bank can stay in business is if depositors deposit money with the bank. And to attract depositors, banks usually do one of two things or both. First, they can offer depositors interest on their money. Second, they can offer services such as deposit insurance, free or low-cost checking accounts, extended hours into the evening and weekend services, convenient local branches, placement of automatic teller machines (ATM) in convenient locations, and so on (Rachman, 1987). In the past decade, banks have been coming up with creative incentives to attract and retain customers.

Since banks were deregulated in the early 1980s, the line between checking and savings accounts has been blurred. Banks and thrifts compete for depositors by offering a variety of options featuring various combinations of privileges, fees, and interest rates. Although regular checking accounts pay little or no interest with regular savings accounts paying modest interest rate, the chief attractions of these types of accounts is that there are no restrictions on when one can withdraw his or her money.
Loan Functions

When the bank gets the depositors’ money, they put it with everyone else’s deposits and then use the total to make loans. Since the banks know that all their depositors will not ask for their funds simultaneously, they feel free to lend a majority of those funds available to borrowers. While making loans, banks usually create new money and in the process, make some profit. But they have to be careful and make sure that they keep a percentage of the deposits on reserve to meet withdrawal demands from depositors. For the purposes of this paper, this paper will be focusing mainly on the loan functions of the banks.

Asset Management

For people that have a little more money to invest, say $15,000 to $25,000 or more in cash and/or securities, banks do offer asset management packages, which entitles the depositor to a number of benefits. For example, the bank can perform automatic transfer of funds from the depositor’s interest-bearing accounts to checking account, manage real-estate investments, provide financial planning services and trade securities for the depositor at discounted rates. When the depositor sells securities or earns dividend, the proceeds are deposited directly in the high-yielding bank account. Such customers also receive preferential terms from the bank when requesting a loan (Rachman, 1987).

Discount Brokerage

Many banks added discount brokerage to their service package in the early 1980s after deregulation. After Bank of America succeeded in acquiring the number one discount broker, Charles Schwab and Company, other banks followed suit. Although the securities industry disapproved of this invasion of its turf and challenged the practice in court, the Supreme Court
ruled in 1986 that banks are within their rights to expand into discount brokerage. (Rachman, 1987).

**Electronic Banking**

While electronic banking to most people means 24-hour access to cash through an automated teller machine (ATM) or paychecks deposited directly into checking or savings accounts, electronic banking, also known as electronic fund transfer (EFT), uses computer and electronic technology as a substitute for checks and other paper transactions. Electronic fund transfers are initiated through devices such as cards or codes that one uses to gain access to his or her account. Many financial institutions use an automated teller machine (ATM) card and a personal identification number (PIN) for this purpose. The federal Electronic Fund Transfer Act (EFT Act) covers some consumer transactions (Federal-Trade-Commission, 1997).

*Automated Teller Machines* (or 24-hour tellers) are electronic terminals that let people bank almost any time. To withdraw cash, make deposits, or transfer funds between accounts, the consumer generally inserts an ATM card and enter his or her personal identification number (PIN). Some ATMs impose a surcharge, or usage fee, on consumers who are not members of their institution or on transactions at remote locations. ATMs must disclose the *existence* of a surcharge on the terminal screen or on a sign next to the screen.

*Direct Deposit* lets the consumer authorize specific deposits, such as paychecks and social security checks, to his or her account on a regular basis. The consumer may also pre-authorize direct withdrawals so that recurring bills, such as insurance premiums, mortgages, and utility bills, are paid automatically.
Pay-by-Phone Systems let consumers telephone their financial institutions with instructions to pay certain bills or to transfer funds between accounts. One must have an agreement in advance with the institution to make such transfers.

Personal Computer Banking allows individuals to conduct many banking transactions electronically via their personal computer. For instance, consumers may use their computers to view their account balance, request transfers between accounts, and pay bills electronically.

Point-of-Sale Transfers allow consumers to pay for retail purchases with an EFT (or "debit") card. In some instances, this card also may be an ATM card. This is similar to using a credit card, but with one important exception, the money for the purchase is transferred immediately — or very shortly — from the consumer’s bank account to the store’s account. Today, an increasing number of merchants are accepting this type of payment.

As time and technology are moving faster than ever before, more and more banks are turning to computers to address people’s banking needs. Banks have developed electronic banking services with people’s lifestyle in mind. With Visa Check Card, Telephone Banking and convenient ATM locations, many banks bring banking to customers anywhere, anytime, anyway so that they can bank when and where it is convenient for them.

Small Business

The Internal Revenue Service (IRS) defines Small business as any company with assets less than $5 million. On the other hand, the Small Business Administration (SBA) defines Small business differently. The SBA ACT as amended December 9, 1999 defines it as follows, “a small-business concern, including but not limited to enterprises that are engaged in the business of production of food and fiber, ranching and raising of livestock, aquaculture, and all other farming and agricultural related industries, shall be deemed to be one which is independently
owned and operated and which is not dominant in its field of operation: provided, that notwithstanding any other provision of law, an agricultural enterprise shall be deemed to be a small business concern if it (including its affiliates) has annual receipts not in excess of $500,000” (SBAOnline, 2000)

For the purposes of this paper, in addition to the definition given by the SBA, a small business means any firm with 500 or fewer employees. These types of businesses function as key element of the country’s economic engine by creating the most jobs and developing new products. For example, in 1994, small businesses accounted for fifty percent of the U.S. private gross domestic product, employed fifty-four percent of the private work force, and created sixty-two percent of the new job (Allebach, 1999). Despite the importance of this segment of the business world on the economy of the United States, small-business organizations still face tremendous challenges in raising capital to finance their businesses. The main objective of this paper is to explore other financial options available to these small businesses.

**Short-term Financing**

Short term refers to the time for which a loan is required and the period over which its repayment is expected to take place. Short-term financing is “debt that matures in one year or less and is used to fulfill seasonal and current asset needs.” (Gitman, 1995). Short-term loans usually take the form of operating term loans (less than one year) and revolving lines of credit. These finance the day-to-day operations of the business, including wages of employees and purchases of inventory and supplies. Supplies are used up quickly and inventory is sold resulting in stock-turns.

Traditionally, short-term credits such as revolving lines of credit are the preferred borrowing formats of most commercial businesses and manufacturers. The normal sources of
these loans are commercial lenders, the chartered banks, and more recently, some credit unions. Recently the banks have fine-tuned this program to what could be called a planned overdraft scheme. The bank simply approves a business for a certain overdraft amount. The actual interest rate has been dropped to one or two points above the prime rate and a system of service charges for the overdrafts has been substituted to make up the difference.

**Long-term Financing**

*Long-term financing* is defined as “financing with an initial maturity of more than one year that enables firms to finance corporate growth and the replacement of worn-out equipment and to pay off debts and other obligations as they come due.” *(Gitman, 1995).* Long-term loans usually have a maturity term greater than one year but usually less than seven years. Real estate and equipment loans may have maturity term of up to 25 years. Long-term loans are used for major business expenses such as purchasing real estate and facilities, construction, durable equipment, furniture and fixtures, vehicles, etc. In the current lending climate, interest rates on long-term financing tend to be higher than on short-term financing. Above all, long-term financing usually requires more substantial collateral as security against the extended period of the lender’s risk.

**Non-bank Lender**

The Webster’s student dictionary defined a bank as “an institution for keeping or lending money” *(Collin, 1999).* Given such a definition of what a bank is, a *non-bank lender* then is any person, group of persons or an institution whose main function traditionally is not to keep or lend money, decides to provide loan services to individuals or businesses. There are many sources that fit this definition.
Friends and relatives qualify as non-bank lenders. Many entrepreneurs look to private sources such as friends and family when starting out in a business venture. Often, money from such sources is loaned interest free or at a low interest rate, which can be beneficial when getting started. Other sources that qualify as non-bank lenders include personal savings, which is usually the primary source of capital for most new businesses.

Others are thrift institutions such as Savings & Loan associations, credit unions, limited service banks, finance companies, large brokerage houses, insurance companies, pension funds, investment banks, and venture capital firms that help startup and expanding companies grow in exchange for equity or partial ownership.

Although financial institutions differ in the specific services they provide, most do two things. They attract deposits from customers and then turn around and lend some of the money to other customers. In addition to accepting deposits and making loans, most financial institutions offer other money-handling services, for which customers pay a fee.
Issues Small-Businesses Face in Raising Capital

Lack of Access to Capital

The most common sources of funds for new businesses fall into two basic categories – debt and equity. While debt financing must be repaid with interest out of earnings, equity does not have to be repaid, but the investor has title to a piece of the business and a share of future profits. Most businesses are financed with a mix of debt and equity. While equity financing would suit most small businesses, it’s not easy to come by. But a company might have to seek equity financing out of necessity, say the business had explored all avenues for additional debt financing and found them unfavorable. Sometimes debt financing may be feasible but the company may have reached the point where it makes sense to use equity financing because of the inherent drawbacks of debt. Some of the drawbacks with debt financing include forcing the firm to adhere to a set of repayment schedule, requiring the company to enter into restrictive loan covenants. In addition, having a high debt-to-equity ratio can be detrimental to a business. If the company is highly leveraged and a business downturn occurs or interest rates rise too much, there would be no operating cushion, and the company can easily find itself in financial trouble.

Apart from the obvious problems with debt financing, there are other reasons why a company may choose equity financing. It has already been said that the money raised through selling of shares of the company does not have to be repaid. Another reason is that the capital raised can be invested in equipment or used to develop new products without worrying about a fixed repayment schedule. Adding equity would also improve the company’s debt-to-equity ratio, which may then enhance possibility for additional debt financing perhaps at better terms than previously offered. Some of the most common small business options for equity financing
are venture capital, angels, franchising, employee stock ownership plans, initial public offerings, SBICs and MESBICs. Some of these options will be discussed later under the roles of non-bankers.

But despite the current economic climate of low interest rates and available money supply, access to capital continues to be the most difficult challenge for small business owners. Recent newspaper articles point to several reasons why even under optimal conditions, entrepreneurs are still not successful at getting financing. Banks, by the very nature of their business, are resistant to the high-risk loans, which many small businesses represent. Potential entrepreneurs sometimes lack the business savvy to articulate what they need in business terminology, and such inexperienced business persons may also fail to present a well-thought out long-range alternative plan to cover emergencies and other contingencies. Factors such as these all contribute to the decision of a would-be financing source not to commit money to a particular business.

**Systemic Problems**

Several problems exist for small businesses with respect to securing debt financing. These issues include the size of the business. By their nature, small businesses are inherently risky than bigger and well-established corporations. For that reason, banks are often reluctant to lend to small businesses. Because small and rapidly growing businesses tend to exhibit erratic bursts of growth and downturn, banks are often nervous about such growth fluctuations since they don’t know if the latest downturn is part of the pattern or the beginning of a real problem for the company.

A typical small business lacks adequate collateral to secure a loan, so even when banks are willing to lend small businesses money, they often require a personal guarantee from the
owner. Such demand on the owner is problematic for the small business, even if the owner has sufficient assets to guarantee the loan. The owner may hesitate to risk his or her personal assets for the sake of financing the growth of the business.

In 1995, many small businesses reported that while most financing needs are met, there remained gaps in access to adequate capital for those small businesses that happen to be owned by women and minorities. Despite that women have started businesses at twice the rate of men, for example, in 1992, women owned one-third of all businesses in the United States, women often face greater hurdles getting loans, establishing credit, competing for contracts or finding technical assistance (Chartrand, 1996). The statistics seems to be the same year after year. According to Women’s Growth Capital Fund, a small venture capital firm based in Washington D.C., in 1997, women started businesses at twice the rate of men, but they received just two percent of the institutional venture capital money. While women owned more than thirty-six percent of the businesses in the country in 1998, they received only twenty-two percent of small business loans (Knox, 1998).

Of course women are not the only group that face obstacles that result from lack of investment capital. Blacks, Asians, and Hispanics are also starting businesses in record numbers, but they tend to face tremendous difficulties raising funds for their small businesses. In 1992, the revenue of black-owned businesses totaled $32.2 billion and $30 billion for Hispanic-owned companies (Chartrand, 1996).

However, several minority business assistance programs have been developed to break the traditional mold. The government has sought ways to intervene in financial markets with the objective of altering capital availability patterns that disadvantage minorities and low-income people. It was for this same reason that President Clinton launched the Community Development
Financial Institution (CDFI) program in 1994 (Bates, 2000). These programs have one thing in common – commitment to take a deal that is declined in the traditional lending market and find a way to “make the deal work.” Examples of such community development financial institutions include (Rossman, 1996):

- The Michigan Strategic Fund (MSF). The MSF supports innovative programs in small and minority business assistance. This program connects eighty-seven banks to small businesses. This program made over $64 million in loans to more than 1300 businesses between 1986 and 1992.

- The Midwest Manufacturing Technology Center (MMTC). The MMTC is a joint venture between the Research and Technology Program and the state of Michigan using a $13 million award from the National Institute of Standards and Technology to assist over 1800 Michigan firms with state-of-the-art manufacturing processing techniques.

- The Arizona Multibank Community Development Corporation (AMCDC). The AMCDC is a non-profit community development lender that focuses on small business lending. Thirteen banks pledged a total of $10 million for fifteen years to capitalize the community Development Corporation. It is a partnership between AMCDC and the member banking institutions for making loans for small business companies.
The Role of Non-Bank Lenders

There is a popular belief that small businesses find it difficult to borrow money. While there may be some element of truth to this belief, many small business people do indeed borrow money successfully. Banks make money by lending money. However, the inexperience of many small business owners prompts banks to deny loan requests. In addition, lack of knowledge of all the financial options available to small businesses tends to exacerbate the problem.

Fortunately, banks are not the only source for financing a business. There are several sources to consider when looking for financing, but it is important to explore all the options available before making a decision or simply giving up. Regardless of where one goes for short-term or long-term financing of a business venture, requesting a loan when not properly prepared sends a signal to the lender. That message is “high risk!”

In order to ensure that a business is in the best possible shape to secure funding, it is important to understand what lenders look for in a business. Of course, each lender is different and would have different set of requirements but there are few common requirements that almost every lender would like to know. Those things include the company’s ability to repay the loan, integrity and experience of the company’s management, collateral that can be offered to help secure the debt, the value of the business’ financial obligations including debt and equity, conditions affecting the ability of the business to grow and generate income, and an effective, well-presented case (Meisel, 1999).

Even though banks still dominate the small-business arena, non-banks are gaining on them in some of the functions or roles traditionally played by banks, particularly, in the loan function. For example, in fiscal 1997, the top small business lenders were non-banks, with the top three non-bank lenders accounting for $1.59 billion in loans. Leading all the Small Business
Administration lenders was Money Store, which took the top of the list ranking for the 15th consecutive year. Closely behind in second place was AT&T Capital Corporation and in third place was Heller Financial Inc. Bank of Commerce was the bank with the largest amount of small business loans (Nathan, 1998). Besides loan functions, there are other roles that banks play and it would be worth mentioning what those roles are.

**Educating Businesses**

Experts in the industry agree that non-bank lenders need to step up efforts to market their services to small-sized organizations. Several small firms seldom go beyond banks when seeking funding but all this could change once potential customers become aware of the services offered by non-bank financial institutions. So, the greatest challenge facing non-bank lenders today is to let potential customers know that they exist.

One such non-bank lender is GE Small Business Solutions. GE Small Business Solutions is a leading financial services provider to the small business market. They bring the same sophistication and financial expertise available to Fortune 500 companies, to businesses with annual revenues under $20 million. To serve customers when and how they want it, GE Small Business Solutions gives its customers the option of conducting business on-line, through a toll-free number or with its dedicated sales force.

As a means of educating the small businesses about its services, the GE Small Business Solutions created an online resource for businesses with $1 to $20 million dollars in revenue. By combining all the services and power of GE, GE Small Business Solutions helps small businesses build growth strategies and access capital through a wide range of products including equipment financing, corporate credit cards, employee benefits programs, and fleet financing and management.
Financial Intermediation

The success of any business start-up or expansion is its ability to obtain adequate and appropriate financing. Raising capital is one of the basic business activities, but as many entrepreneurs have learned, raising capital can be frustrating and complex. However, if one is informed and plans effectively, raising money for small business will not be such a frustrating venture. Nonetheless, the experience of so many have led to the belief that very few small businesses can secure financing to grow their business. The fact is, there are many sources and types of financing available for the persistent small business owner(s).

With some creativity and knowledge of where to look for financing when banks say no, small-business owners can and do obtain financing through other non-traditional sources. Such sources include friends and relatives, insurance policies, credit cards, venture capitalists, and angel investors.

Family and Friends

After personal resources, the next best source for financing a small business is “insiders” like family, friends, or business associates. Borrowing from friends and family is attractive because it is private, often informal, usually unsecured, and often includes favorable terms. In addition, legal default proceedings are seldom invoked. This kind of financing can be incorporated into a family’s estate plan to assist in minimizing estate and income tax liabilities.

However, financing from family and friends can be a double-edged sword. The drawback to the convenience and low-cost of insider financing are the misunderstandings, personal conflicts, and other problems that can arise from a lack of business formality or economic success. Family borrowing has severed many friendships and family relations. If a small business
owner decides to borrow within the friend or relative circle, it should be done purely on business basis.

If a friend or relative is contributing capital as a gift, that understanding should be documented in a written “statement of gift”. It must be noted that a gift may have tax consequences. The federal Internal Revenue Code allows an individual an annual exemption from gift tax per recipient. For example, if the entrepreneur’s parents want to give him or her a tax-free gift, they could each give the maximum allowable by the IRS. Gifts in excess of the allowable amount would then count against the parents’ lifetime estate tax credit and might require the filing of a gift tax return.

If the transfer of funds from friends or relatives is not intended to be a gift, then an enforceable agreement such as a promissory note should be drafted that reflects the nature and terms of exchange. The temptation to forgo arms-length formalities must be avoided. If the insider does not want to participate in control or ownership of the business, a promissory note stating that the money is a loan, and listing the terms of the loan, should be drafted. It is advisable to have an attorney develop a binding contract. The loan should then be repaid as agreed, just as though the friend or relative were a traditional lending agency.

**Insurance Policies**

Most life insurance policies (except term insurance) have a cash value amount to borrow against. If the owner has a substantial cash surrender value in a life insurance policy, the owner can borrow up to that amount from the insurer. In some cases, the interest can be deferred indefinitely. Ordinarily, the owner would borrow against the policy and then re-lend the money to the business at the same interest rate. The business can then take an interest deduction on the loan and the owner does not earn taxable interest income on the transaction.
A borrower against his or her insurance policy is not obligated to repay the loan principal, only the interest on the loan is required. Interest is typically due on an annual anniversary date. Most policies will also allow owners to simply add the accumulated interest to the principal, as long as one has not borrowed up to the maximum cash surrender value of the policy. The interest rate varies by company and the policy and the rate depends upon when the policy was purchased. Rates on older policies might be very favorable than newer policies.

It is important to note that the policy loan will reduce the dollar value of the policy, plus the loss of interest. In case of death, the loan would be repaid first, with the remainder given to the beneficiaries. The question the owner needs to ask is, does this jeopardize his or her family's security? The owner can remedy the situation by purchasing term insurance in the interim to cover the shortfall.

Credit Cards

Although credit cards are not a financing device exclusive to commercial banks, they are often a part of a bank’s lending portfolio. A revolving credit charge card can be used by a business as an alternative to a working line of credit. Many small businesses have gotten started by purchasing needed equipment and supplies and by borrowing cash with personal bankcards (Pletz, 1997).

As a result of deregulation of the banks, the competitive banking environment has forced many financial institutions to seek new sources of income and develop new financial products that meet changing demands. One of the less publicized developments is the growth of the small business credit card. Some of the largest card issuers, VISA, MasterCard, and American Express, have adopted small business card programs. Credit cards may not be considered a traditional source of money, but they are sometimes the only source for a small home-based business. As a
source for working capital, revolving credit cards offer hassle-free, quick source for limited funds. In a 1998 survey of 504 small and mid-sized companies by Arthur Andersen’s Enterprise Group and the National Small Business United, 47 percent of the owners said they had used credit cards to finance their businesses in the previous 12 months. That was up from 34 percent in 1997 and 17.3 percent in 1993. According to the survey, credit cards have become the leading financing instrument used by small businesses, with commercial loans second at 45 percent (Gold, 1999). However, their convenience is costly.

Although many independent firms have been financed via credit cards and succeeded, but credit card financing of a new and high-risk venture may not be the smartest thing to do. No doubt some have done it and succeeded but there will be many more that would attempt it and fail. If there is anything a small business must avoid it is having ongoing large credit card bills, where it is paying a rather high interest rate. It could take the business a very long time to pay them off. The prudent thing to do is to pass on that option.

**Venture Capitalists**

Venture capital (VC) firms supply funding from private sources for investing in privately held companies that have demonstrated a proprietary technology or business model that is still too risky for bank loans or conservative investors. Venture capitalists are not lenders, but they typically take an ownership stake in the business and serve an active role in its management. The companies seeking funding from venture capitalists must have a high, rapid growth potential and a need for large amounts of capital. Venture capitalists look for big opportunities, especially those with high-risk businesses producing a very high rate of return in a very short time. Venture capital firms usually invest for periods of three to seven years and expect at least twenty percent to forty percent annual returns on their investment. Companies must also have an exit strategy
for investors, and this is usually in the form of public offering of stock and sometimes through sale of the firm (Foust, 1997).

Contrary to popular belief, most modern venture capitalists do not make money by investing and building great long-term businesses. Many venture capitalists today sell shares in their ventures as soon as they can once the company goes public. So, unless your company has IPO potential, and you wish to take your company public, most venture financing is realistically unavailable to most businesses. Furthermore, due to the ease with which new Internet companies went public in the late 1990's, most venture firms now manage several hundred million dollars or more. Because of this, many firms want to back only bigger ventures. Due to the amount of money that venture capital firms spend in examining and researching businesses before they invest, they usually want to "put larger dollars to work", often in excess of a quarter of a million dollars to justify their costs.

Venture capital financing may not be available or a good choice of financing for many small businesses. Venture capitalists tend to favor existing businesses that have a minimal operating history of several years. Financing of startups is limited to situations where the high risk is tempered by special circumstances, such as a company with extremely experienced management and a very marketable product or service. Of all the business plans that are evaluated by VC firms, only one in a thousand gets selected for funding (Foust, 1997).

**Small Business Investment Corporations**

The Small Business Investment Corporation (SBIC) program is the government’s own public venture capital. An SBIC organization is a privately owned and operated small business investment company that partners with the federal government to provide venture capital to small businesses. Using a combination of private and borrowed funds from the federal
government, the SBICs provide equity capital, long-term loans and management assistance to eligible small businesses. The terms of the loans are typically five years maturity up to twenty years, with a possible ten-year extension (Bates, 2000).

SBICs operate like venture capital firms, although they may be more flexible in the terms and their investment arrangement. Like a VC firm, an SBIC is most commonly a source of financing for fast-growing, existing small businesses, rather than startups, that need substantial amount of capital to keep up with their rapid expansion. Almost anyone or any entity can be an SBIC owner if they have the minimum initial private capital of five million dollars and a Small Business Administration (SBA) approved full-time manager. However, the SBIC must be federally licensed. Every SBIC is subject to annual financial reporting requirements and onsite compliance examinations by the SBA.

**Angel Investors**

Private investors often represent the easiest and most cost-effective capital resource. The small business owner’s network of accountants, lawyers, doctors and other professionals may provide leads to those who seek investments with higher returns -- and investments that are, perhaps, less speculative than the stock market. Private investors commonly referred to as *angels*, often appear through prior business contacts or those familiar with a company’s products or services. Most angels are interested in the company’s market potential, the experience of the management team, and the uniqueness of the business idea.

The tremendous financial returns to entrepreneurs of the 1990’s created these new affluent business owners who have become angel investors. Unlike many venture capitalists, angels are not always looking for a quick IPO company. They seek new business investments for a variety of economic and personal reasons. They can be a good source of money if the business
owner is looking for outside investors but not interested in a venture capital firm. They tend to invest in companies longer term. Angels often are looking to invest anywhere from $10,000 to maybe $2,000,000 (CCH-Inc., 2000).

Some angel investors can also contribute tremendous business insight and experience. But, the business owner should be especially careful to do "due diligence" on your angel investors. Be sure they realistically can afford to make aggressive investments in your business and that they understand the risks. Agree, ahead of time, what, if any, non-investment involvement the angel will have with the company.

Angels should be labeled as "accredited investors," which is a fancy way of saying they are rich enough and smart enough to make aggressive investments. Very few angels or venture capitalists will invest without equity upswing potential. Most often, angels will want an equity interest in the business and some guaranteed exit provisions, such as a mandatory buyout, a “put” option requiring the business to repurchase the stock at the investor’s option, or a public offering of stock. With either angel investors or venture capitalists, the business owner will need to give up partial ownership of the company.

If the business owners wish to retain full equity of the small business, then they would only have debt financing available to them. This means that, if they are lucky enough to get a loan, they will be required to pay back interest and principal, but they will own 100% of their company. On the plus side, they will have no interest to pay and will own 100% of their business. Most banks will not loan money to small, start-up businesses. Although debt financing of a new business is possible, it is not the best option because interest payments become another mouth to feed. If debt financing is not an option for the business, the only remaining option to financing a small business is the owner’s own savings, which is how most businesses get started.
Retirement Savings

Dipping into retirement savings is an option, which, if the business fails, creditors cannot attack any retirement money one has (say in an IRA). While dipping into retirement savings is a viable option, one has to be very careful. An entrepreneur that wants to take this route needs to ask himself or herself a question, can such an action lead to eating dog food in old age? It’s important to leave something in reserve for old age. But, if the small-business owner is young and entrepreneurial, then it may not be wise to start stashing all of his/her money in deferred retirement plans. It is possible for the young entrepreneur to find a better use for the money within his or her own company.

Employee Stock Ownership Plans

If the company has employees, it may be possible to find equity financing within the company, assuming that the owners are willing to share some ownership control with the employees. An Employee Stock Ownership Plan (ESOP) is a qualified retirement benefit plan in which the major investment is securities of the employee’s company. In an ESOP, employees can purchase shares of stock in the company by paying cash or by agreeing to reductions from salary or benefits. The employees become part owners of the business and the company obtains additional funds for other business purposes. In addition, the company contributes to the ESOP by either making annual cash contribution to the plan for the purchase of company securities or by directly contributing stock to the plan. Either way, the company’s contribution results in the cash price of the stock being returned to the company. The company gets a tax deduction for the ESOP contribution while effectively retaining the cash.

However, because ESOP requires that the company has employees and the implementation of an ESOP can be expensive and time consuming, this financing tool may not be sensible for many startup and existing small businesses. It’s also possible for plan participants
who terminate employment to demand distribution of stock itself, rather than simply the stock’s cash value. A closely held business may not want former employees to own stock in the company or to be able to vote as shareholders.

**Financing Through Franchising**

Franchising is the transfer of the right to sell a trademarked product or service through a system prescribed by the owner of the trademark ("franchisor"). Since the 1980s, franchising has become increasingly popular. Part of the reason is because a good franchise provides a "turnkey" package of how to run all aspects of the business. For the franchisee, franchising is a way to reduce the risks of a new business by buying into an established product or concept. The new business owner simply gets forms to use for personnel, administration, marketing and other areas of the business. For the franchisor, franchising makes it possible to expand his or her business quickly, by sharing some of the costs, risks, and rewards with franchisees. Perhaps this is why while over 93% of small businesses fail sometime during the first 5 years (about 50% in the first 12 to 18 months), the failure rate for franchisors is only 10% (Small-Business-Help-Center, 1999).

**Customer Financing**

Another excellent source of small business financing when traditional bank debt is not available is customer financing. One of the advantages is that it conceivably solidifies the client/vendor relationship while at the same time providing a source of financing that might not be readily available through the bank. Many companies have raised several millions of dollars using this technique. One such company is OLI Systems Inc. of Morris Plains, N.J., a company that develops computer simulations for the chemical industry, which has raised more than $3 million from customers to help develop new products.
While customer investment can be a regular money-for-equity (company stock) transaction, OLI Systems took a different route. In exchange for funding its research and development, customers were simply allowed to use the resulting software free of charge. Seven customers formed the first investment posse. Six kicked in $150,000 apiece with the third handing over $300,000, for a total of $1.2 million (McCune, 2000).

The big disadvantage of this form of financing is that the business gives away its future sales. But the cost doesn't even start to compare to the benefit for a small company not having to take on extra debt or experience a loss of control through a venture capital deal. In a straight equity arrangement, the chief downside of a customer investment is the high cost of capital involved. One runs the risk of giving up more equity in their business than what they might be able to do with traditional bank financing.

**Supplier Financing**

Supplier financing involves a period of delay allowed by a firm's supplier to pay its invoices. Frequently, the terms are 2% discount on invoice if paid in 10 days or net if paid in 30 days. Supplier financing is similar to customer financing but in a way better. If the small business prospers and grows, the company will buy more and more from its suppliers. So, in a sense, the suppliers have a vested interest in seeing the business succeed. People and companies like to help themselves.

One disadvantage is that with a supplier investor, the business may not have as much freedom to shop around for better deals on goods and services. Of course, the business owner will need to approach the right person in the supplier's organization.
Asset-based Financing

To generate working capital or to meet specific short-term cash needs, small businesses may use certain short-term assets as collateral for commercial loans. The most common types of asset-based financing are accounts receivables, inventory financing and factoring.

Accounts receivable uses the receivables as collateral. As the business collects the receivables, the proceeds are used to repay the loan or line of credit. This form of financing is a type of secured loan in which the account receivables are pledged as collateral in exchange for cash. The loan is repaid within a specified short-term period as the receivables are collected.

Accounts receivable financing is most often used by businesses facing short-term cash flow problems. The major source of accounts receivable financing for small businesses are commercial finance companies, although banks will also consider receivables as security for a business loan.

Accounts receivable are typically “aged” by the borrower before a value is assigned to them. The older the account, the less value it has. For example, financiers often lend approximately seventy-five percent of the face value of accounts less than thirty days old. Some lenders don't pay attention to the age of the accounts until they are outstanding for over ninety days, and then they may refuse to finance them. Other lenders apply a graduated scale to value the accounts so that, for instance, accounts that are from thirty-one to sixty days old may have a loan-to-value ratio of only sixty percent, and accounts from sixty-one to ninety days old are only thirty percent.

Delinquencies in the accounts and the overall creditworthiness of the account debtors may also affect the loan-to-value ratio. A monthly interest rate on accounts receivable is calculated by applying a daily percentage rate to the receivables outstanding each day (the less the outstanding receivables, the lower the interest charge). A default on payment can result in the
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financier seizing the pledged accounts receivable. Some states require notice to the business's debtors that their debt has been pledged as loan security. In states that do not have this requirement, some businesses do not notify their customers because the businesses fear that customers might perceive this method of financing as a sign of financial instability.

Inventory financing is similar to accounts receivable financing, except the business's current inventory is used as collateral for the secured loan. You can anticipate a very conservative valuation of your inventory and a maximum loan amount that is somewhat less than hundred percent of the lender's valuation figure. Average lender discounting would allow lending of up to sixty percent to eighty percent of the value of your ready-to-go retail inventory. A manufacturer's inventory, consisting of component parts and other unfinished materials, might be only thirty percent.

The key factor is the merchantability of the inventory — how quickly and for how much money could the inventory be sold. The loans are typically short-term and the interest rates are similar to those for accounts receivable lending. The most common use of inventory financing is for the purchase of new inventory, especially when an upcoming season requires that you keep additional inventory in stock.

Factoring is a process whereby accounts receivable are actually sold to a third party (the factor) for a discount price, after which the factor takes on the job of collections (Hupalo, 1999). By selling the invoices for future payment, you generate cash sooner than if you collected the money on your own. The factor company that purchases the receivables takes title to the invoices and collects them when they are due. That company also assumes responsibility for all of the costs, as well as the hard work and hassles that comes with customer debt collection.
Commercial financial companies, some banks, and a variety of different types of financial companies will purchase receivables. For businesses with relatively small monthly amounts of receivables (e.g., less than $10,000), it may require some effort to locate a factor company willing to purchase those receivables.

The downside to factoring is that it's not cheap. The factor company discounts the cash price of accounts receivable. The final cost will nearly always exceed the amount paid as an interest rate on a short-term commercial loan for an equal amount. Moreover, because factoring requires accounts receivable, it is usually limited to existing businesses. Most commonly, factoring is used by rapidly growing businesses ($125,000 to $10 million in annual sales) that face temporary cash flow problems. Except in certain industries, such as the garment industry, factoring is not used on a long-term basis (Hupalo, 1999).

The advantages to factoring include receiving quick cash, being debt-free, and having no collections to make.

1. **Quick cash:** The business can receive quick payment in cash after shipment of the merchandise, delivery and invoicing of a customer. This immediate payment for invoices nearly eliminates the sale-to-collection business cycle and allows businesses caught in a cash crunch to obtain fast relief. If a relationship with a factor already exists, turnaround on the sale of receivables should take only about 24 hours. When making a first-time purchase of invoices from a business, factors typically take one to two weeks to check the credit ratings of the customers and communicate a discount price.

2. **No debt:** Factoring is a sale of assets (invoices), not a loan. For businesses that either cannot qualify for traditional debt financing or that simply do not want to incur more debt, factoring is a good alternative means of financing.
3. **Elimination of collections:** Most factoring is called "nonrecourse," meaning that the factor company purchases all rights in the invoices and the seller has no responsibilities for collection. The factor's anticipated cost and time in making collections is computed into the discounted purchase price of the receivables. In some states, however, "recourse" factoring is also permitted. In recourse factoring, the business is secondarily liable for any invoices not collected. The Factor Company undertakes debt collection, but the business remains ultimately responsible to repay any portion of the cash price attributable to an account that went uncollected.

The disadvantages to factoring are the cost involved and the possibility of severing customer-relationship.

1. **Cost:** Traditional loans will typically be less expensive than the costs of factoring. The upfront cash price for accounts receivable is typically seventy percent to ninety percent of face value, depending upon the credit history of the customers and the nature of your business. The initial price is treated as a cash advance and the business typically receives an additional portion of the face value when (and if) the accounts are collected. The final price is usually between ninety percent to ninety-five percent of the original invoice amount. The longer the invoice period, the higher the rate. Most factors will not take invoices with longer than ninety-day payment periods. In addition, the credit history of the customers can affect the final costs.

2. **Possible harm to customer relations:** Collection actions taken by the factor company may endanger an ongoing business relationship with some customers. In a small business, there may be circumstances in which the company would compromise a debt, extend payment deadlines to a preferred customer, or employ a more lenient collection approach for a specific customer. A factor company has little interest in preserving the business’s future relationship with the debtor and some factor companies may be overzealous in collecting receivables.
The Future of Non-bank Lenders in Financing Small Businesses

Impact of Government Regulations

Banks are highly regulated in order to minimize the government's risks from insuring the accounts of depositors. As a consequence, bank-lending policies toward small businesses tend to be very conservative. As the small business sector is the most dynamic in terms of its capacity to generate jobs, it is of vital importance that policymakers understand the financial needs and constraints small businesses face. Having access to enough capital is generally considered a central factor in determining the success of any enterprise. On the other hand, insufficient equity capital or retained earnings may precipitate the need for bank borrowing, and such borrowing can put a firm, especially small business, in a precarious position. Although all firms must deal with these problems of finance, they are particularly significant for small businesses, whose product diversity, technological flexibility, markets, and sales revenues tend to be limited compared to those of large firms.

It has been said that commercial banks tend to be the single most important external source of credit for small businesses (Meyer, 1998). For the small business firm, especially the smallest, this has a number of implications. First, the largest of the small firms are a minority of small businesses, but account for a majority of small business credit. For example, small firms with more than $1 million in sales constitute less than one-fifth of small businesses, but account for more than two-thirds of the credit that all small firms obtain (Cole, Wolken, & Woodburn, 1996). This suggests that the majority of small firms, those with annual sales less than $1 million, are at a disadvantage in their efforts to get bank credit.

Second, a number of authors (Berger & Udell, 1995), (Peek & Rosengren, 1996) have argued that financial innovation and changes in bank regulation in the 1980s and 1990s may
have made banks less willing to lend to small firms. Of course, tightness of credit will also depend on phases of the business cycle, and so overall business conditions must be taken into account when trying to gauge the extent to which the smallest firms are discriminated against (Avery, Bostic, & Samolyk, 1998).

Third, the tumultuous waves of bank collapses and mergers in the 1980s and 1990s may have contributed to small businesses' reduced access to credit. Deregulation, mergers, and consolidation of the banking industry from 1987 to 1993 sharply lowered the proportion of small banks, which are the banks that specialize in small business (Berger & Udell, 1995), (Peek & Rosengren, 1996). Although the current economic expansion has led to an increase in the supply of credit as well as the easing of the conditions under which it is granted, a slowdown could accelerate the disappearance of small business lenders and thereby increase the liquidity squeeze faced by borrowers.

Despite what has been said above, things have gotten a little better for small businesses in the past eight years. For example, in July 1992, the Security and Exchange Commission (SEC) adopted the small business initiatives (SBI) designed to make it cheaper and easier for smaller companies to raise capital (Opler, 1995). This small business initiative caused Regulation A, Rule 504 of Regulation D and the Trust Indenture Act to be revised, and a new offering mechanism for small business (Regulation S-B) established. Those changes have made it easier for small businesses to raise money without registering with the SEC. They also cut the paperwork requirements when firms have to register.

Additionally, in 1993, the four federal banking agencies announced a number of regulatory changes to enhance the availability of credit to small businesses. One of the
components of the policy was giving banks more freedom to make “character” loans (Opler, 1995).

Role of non-bank lenders in the new economy

The Internet is the vehicle to take financial business to the next level. In no other market segment has Internet technology been more successfully implemented than in the financial industry. For those financial institutions in the midst of their due diligence about vendors and product capabilities, it is very important that they gain a greater sense of the Internet economy and convey that knowledge to their customers and prospects. Decidedly, businesses and customers have come to rely on banks and the technologies they embrace, particularly in the area of self-service, to offset time-intensive activities. Empowering small businesses and customers to conduct banking transactions when they want to, as opposed to when they have to, is a fundamental shift in the banking business. Financial institutions, particularly, non-bank lenders have to let small businesses and customers know that they have heard and do understand their banking needs and intend to act upon those needs. This will clearly enhance their commitment to remain a leader in providing user-friendly financing to small businesses. The Internet economy is already poised to level the playing field for financing small businesses.

Although credit scoring is still the exception to the rule, some call it the "wave of the future." Many small banks and non-bank lenders are now seizing the opportunities in electronic banking to provide such services. The new credit scoring technology may soon make approving some small-business lines of credit as easy as processing an application for a car loan. Some experts believe that as the use of commercial credit scoring spreads, women and minority entrepreneurs may find it easier to obtain loans for their small businesses. Credit scoring will
lead to more lending to minorities and women because it provides a much more objective measure, it eliminates subjectivity from the process.

The Small U.S. businesses which represent more than ninety-nine percent of employers, with more than seventy-five percent of them having fewer than ten employees are looking for cost-effective ways to conduct business from their homes or offices. These small business owners are looking to the Internet to manage their business more efficiently and small banks and non-bank lenders seem to be listening (Sackenheim, 1999). As business use of the Internet has seen the most significant growth, it makes sense for lenders, especially non-bank lenders to establish their presence on the Internet as well. According to a study by Forrester Research group, business-to-business commerce is expected to increase by forty-fold, from $8 billion in 1997 to $327 billion in 2002 (Yerkes, 1998). With an online product such as Cash Management, which allows the bank customer to perform ACH transactions, bill pay, payroll, and EFT tax payment, the bank will attract and retain more of the commercial accounts in their community.
Summary and Conclusion

Banks have long served as an important source of credit for businesses. However, their role as credit providers especially for small businesses, has diminished in recent years. Even medium to large businesses have been increasingly satisfying their credit needs through non-bank sources, including markets for commercial paper and the medium-term note market. As the preceding discussion has shown, although banks and credit unions are the obvious sources of small-business capital, there are other alternatives available to small-business owners. Whether it is taking out a loan against one's life insurance policy, using credit cards, taking advantage of customer and supplier financing, or using asset-based financing techniques, there are other places to look to finance a new business or grow a business.

Although commercial credit may be difficult for a small-business to obtain, persistent and creative small businesses worthy of financing can find the money they need to operate. The strategies for obtaining small business financing include: examining non-bank sources such as family and friends, SBA loans, asset-based financing, factoring, supplier financing, venture capital, insurance companies, offering warrants or other equity vehicles, and going public. Even though banks may still dominate the small-business arena, non-banks are gaining on them. Changes in financial markets have created significant growth opportunities for non-traditional lenders. Small-business lending is increasing for non-bank institutions, such as GE Capital Small Business Finance Corp, at the expense of commercial banks. The bottom line for small businesses is that when banks say no, there are other alternatives to financing their businesses that they may be overlooking, and it is called “non-bank” lenders.
References


