

ALTERNATIVE FINANCING SOURCES FOR YOUR SMALL BUSINESS

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University of Wisconsin System

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Planning Your Financial Needs

Inadequate capital is the cause of many small business failures. Planning for the proper initial capitalization for your business or expansion is a critical process in which to invest time and effort. There are two basic paths to finding capital for your business. The assets of your firm can be financed by obtaining either debt or equity. Debt is often obtained in the form of a loan which must be repaid with interest. Banks are the most common source of financing through debt, though there are some alternatives. This guide looks at alternative sources for debt financing and discusses equity. Our guide "**Financing Through Commercial Banks**" focuses on arranging debt financing through traditional lenders.

The first place to look for money is yourself. How much money do you have to invest in your business as equity capital? Look at your cash savings, stocks, bonds, surrender value of life insurance, vested pension or other retirement accounts, and equity in real property. How much of your personal assets you are willing to risk in the business is a personal decision. However, you must invest at least some of your own money in the business, because most lenders see this as evidence of your level of commitment to the business. If you don't have enough personal capital to meet all the financial needs of your business, then you must turn to a lender or investor for the balance.

If you approach either a lender or investor, prepare a **BUSINESS PLAN** that includes both an industry and market analysis, projected balance sheets, income statements, and cash flow projections. Capital sources prefer these financial projections monthly for the first year, and then annually for three years. The amount of detail and research needed in the financial projections is directly related to the amount of outside capital you hope to secure.

The plan should also contain information about you and anyone directly connected to the operation of the business, including the relevant business experience of each of the principals. Your demonstrated ability to effectively plan the financial needs of your new venture will be a major consideration of any lender or investor you approach. The Small Business Development Center (SBDC) can give you more detailed information on the preparation of a business plan. Call your local **SBDC (715) 425-0620**.

Other than personal assets, here are some other possible sources with which to finance your small business.

1. Friends and Relatives

Many small businesses (and possibly most start-up firms) are financed by borrowing from friends and family. These sources may not require a formal business plan. However, presenting one can often be a very important part of your request for assistance from this group of potential lenders or investors. This source of capital offers the potential for particularly stressful circumstances. If you borrow from a friend or relative, treat it as a formal business transaction by putting the agreement in writing. You can obtain a standard business loan form from an office supply store to use as the basis for negotiations. Have a lawyer assist you with the contract to insure its enforceability.

2. Trade or Supplier Credit

Payment terms offered by your suppliers are a potential source of funds. Discounts for early payment and penalties for late payment constitute virtual extensions of credit. It may pay, in some cases, to borrow from another source in order to meet a supplier's early payment deadline if the discount offered is greater than the interest you would pay on the short term loan. Do not depend too much on trade credit from one supplier, though. If repayment problems arise, you may find your major source for supplies cut off when you need it most.

3. Customers

When customers pay for work in advance or provide some of the materials of service themselves, they are in effect financing the business. It is not uncommon to ask for all or a portion of payment as cash up front, especially when providing a long term service or ordering special items.

4. Leasing Assets

Reducing expenses is really a way of raising capital because it frees up funds that would have been spent otherwise. One way to reduce cash outflow is to lease assets rather than buy them. Anything from office furniture to food processing equipment can be leased. In the long run, leasing is generally more

expensive than bank financing. Also, leasing is often limited to items that have a long serviceable life, transferable use, or are easily repossessed in the event of default. As part of the lease agreement, you may be able to negotiate the purchase of the leased equipment at the end of the lease period.

5. Commercial Finance Companies

Commercial finance companies make both personal and business loans at interest rates several points above that which banks charge. Like banks, commercial finance companies focus on your ability to repay the loan. However, they are more willing than banks to rely on the quality of your collateral rather than your track record or profit projections.

6. Equity Financing

Besides financing debt with a lender, you can also obtain financing for your business by sharing its ownership with others. Through equity financing, additional individuals or firms provide capital for the business but may or may not take part in its operations.

General partners are those who normally contribute both capital and management time. They share in business responsibilities and liabilities. **Limited partners** are individuals who contribute capital to the business but who normally have neither management responsibilities nor liabilities. A **sole proprietorship** is a business where there is only one owner, and this person is responsible for all the company's debts.

To establish a corporation, numerous equity investors are usually needed. Each investor is a stockholder and owns part of the company. A privately held corporation is one which seeks to offer ownership to the general public. Shares are sold by an investment banking or stock brokerage firm.

Since the objective is to raise money, the corporation can obtain equity financing through the issuance of a number of instruments:

Common Stock is issued to friends, relatives, and investors.

Preferred Stock represents ownership in the business, but requires that its holders be repaid first if the business should go bankrupt.

A corporation has certain advantages in obtaining funds. Keep in mind that corporations are more highly regulated than other forms of business organization. It can also be very expensive to raise funds through common stock offerings because of the legal fees associated with the Securities and Exchange

Commission (SEC) filings. Although SEC filings are not required for all public offerings, there are other costs associated with raising equity financing such as printing costs and general solicitation costs.

Although some small companies select equity financing, debt financing historically has been more accessible by most small firm owners. Interest paid for a loan is deductible as a business expense and reduces the tax burden. The money obtained through borrowing is controlled by the owner of the business and control over the company is not diminished.

7. Small Business Administration

The Small Business Administration is an independent federal government agency established in 1953 to assist small business. The SBA provides loan guarantees and, if funds are available, makes a very limited number of direct loans. To receive any financial assistance from SBA, a business must be unable to secure reasonable financing from other sources. A business must also fit the SBA's generalized criteria defining a "small" business, which varies for different types of businesses. A loan proposal for the SBA is generally more complex and requires more documentation than one for banks. However, for loans less than \$150,000, the SBA can process loan guarantee requests within 3-5 days. For more information, contact the SBA in Wisconsin at:

**Small Business Administration
212 East Washington Avenue, Room 213
Madison, WI 53703
(608) 264-5261**

8. Venture Capital

Typically, venture capital firms are interested in investing in those businesses that have significant growth potential. Significant growth means firms capable of generating very large returns on investment, usually greater than 50% annually or three to five times their investment in five to seven years. An entrepreneur is more likely to receive a serious hearing from a venture capitalist if the venture firm learns of the business through referral by bankers, brokers, attorneys, accountants, or investors in a strong marketing plan. They will also closely examine the qualifications of the management team.

Private venture capital firms may be found through the Yellow Pages of major cities. Many firms invest regionally and even nationally. Look under "Venture Capital". For more information on venture capital and locating venture capitalists in Wisconsin (including Small Business Investment Companies (SBIC) see the SBDC's publication **Sources of Venture Capital**. Or for information on Wisconsin venture capital and procedures for obtaining venture capital, contact:

**Business Information Center
Department of Commerce
PO Box 7970
Madison, WI 53707
1-800-HELP-BUSINESS
or
1-800-435-7287**

9. Certified Development Companies (CDC)

The Certified Development Company program helps finance small business activities by providing long-term financing for fixed assets through the sale of SBA-guaranteed debentures to private investors. Under the program, the Small Business Administration (SBA) guarantees the timely payment of 100% of the principal and interest on debentures issued by development companies it has certified. A public-private group organizes itself as a CDC to sell debentures, raising capital for small businesses in its state or local geographic area. After meeting certain requirements, the group is certified by the SBA as a CDC and its debentures are fully guaranteed by the agency. The guarantee reduces the investor's risks, which lowers the debentures rate of interest and attracts purchasers. In the end, all of this means lower borrowing costs to small businesses.

The CDC makes loans to small, independent for-profit businesses. Loan recipients cannot have a net worth exceeding \$6 million, nor can their average annual profit for the previous two years be greater than \$2 million. Certain types of companies are ineligible, notably media, lending, investment, non-profit organizations, or gambling enterprises. The small business also must meet an owner occupancy test. Projects financed or aided through SBA-guaranteed debentures under the CDC program may include land or building acquisition; facilities construction, renovation, or modernization; leasehold improvements; or machinery and equipment purchase. Interim construction interest and professional fees for services such as appraisals, surveying, accounting, engineering, and architectural services may also be paid with debenture funds. Proceeds cannot be used for counseling, loan-application fees, working capital, or a single-purpose building. The minimum loan is \$100,000.

The CDC source for the central Wisconsin area is:

**Wisconsin Business Development Finance Corporation
PO Box 2717
Madison, WI 53701
(608) 258-8830**

For additional information about Certified Development Companies, contact the SBA district or regional office, or agency headquarters.

District Office:

**Small Business Administration
East Washington Avenue, Room 213
Madison, WI 53703
(608) 264-5261**

Headquarters:

**Office of Loan Programs
Small Business Administration
409 3rd Street, SW, Ste 8300
Washington, DC 20426
(202) 205-6570**

10. Miscellaneous Government Agencies

There are a variety of government assistance programs available to small businesses on the local, state and national levels. This assistance normally takes the form of targeted loan packages or loan guarantees. In general, there is **not** grant money available for small businesses. The following is a highly selected list of some of the government programs available. This list is not exhaustive, but it is illustrative of the programs that exist.

At the **LOCAL** level, contact your city, village, or county board to inquire as to the existence of any Community Development Block Grants (CDBG). This is money provided by the federal government (through the Department of Housing and Urban Development), to municipalities for use in providing a revolving loan fund to local businesses that will add to economic development through the creation of jobs. Interest is typically below the prevailing prime rate. Contact your local Economic Development Council for status of funds and requirements.

At the **STATE** level, the Department of Commerce (DOC) has several programs available.

- **Wisconsin Development Fund** is available for loans to businesses which will have a major economic impact on the state. **(608) 266-6675** for details.
- **Rural Development Program** — grants for technical assistance and micro-loans for expansion of businesses in rural and/or small communities.

- **Minority Business Development Fund** — loan for minority-owned businesses; only for expansion or acquisition of **existing** businesses. Use of funds: land, working capital, inventory, buildings.
- **Minority Business Development Early Planning Grants** — grants for minority-owned existing or start-up businesses. Awarded annually. Use of funds: business plans, feasibility studies, market studies.
- **Business Development Initiative** — Micro loans for business expansions or start-ups and grants for technical assistance for businesses which are owned by persons with disabilities or which hire employees with severe disabilities; rehabilitation facilities included. Applications are issued in August and due by October 1 of each year. Use of funds: equipment, and, building, working capital. Call **608-266-8381** for information and applications.

For any of the above DOC loan programs:

DOC
123 W. Washington Avenue
PO Box 7970
Madison, WI 53707
(800) 435-7287

- **Wisconsin Department of Veterans Affairs** — provides low-interest loans to Wisconsin veterans for economic assistance, business start-up or expansion or purchase. Generally bridge financing. Use of funds: working capital, buildings, inventory, research and development, and other non-business purposes. Loan programs available:

1. Economic Assistance Loan Program for Wisconsin Veterans
2. Wisconsin Veterans Business Loan Program
3. Part-time Study Grant — reimbursement for tuition, fees and textbooks for courses/workshops related to occupational, professional or educational goals.

Contact: County Veteran Service Office (yellow pages: "Government-county")

- **Business & Industry Loan Guarantee Program** for existing and start-up projects in rural communities which save or create jobs. Use of funds: land, buildings, equipment, inventory, working capital. Average loan is \$500,000.
- **WHEDA** (Wisconsin Housing and Economic Development Authority)

Contact:

WHEDA
201 West Washington Avenue
PO Box 1728
Madison, WI 53702-1728
1-800-334-6873

1. *WHEDA Small Business Loan Guarantee* - The Small Business Loan guarantee is designed to help an existing business that is unable to obtain conventional financing at reasonable terms. The venture must create or retain jobs. The only start-up business that qualifies are child care centers.
2. *WHEDA Mini-Application Small Business Loan Guarantee* —for loans of less than \$75,000; existing businesses that have been in operation for at least 12 months; exception is start-ups for child or elder care.
3. *Linked Deposit Loan* -- women or minority-owned businesses for start-up or expansion. Use of funds: land, buildings, machinery, equipment. The business must create or retain jobs.
4. *Agribusiness Fund* -- used for small businesses who are engaged in projects which will result in the development of new products or more viable methods of processing or marketing a Wisconsin-grown commodity. Use of funds: land, working capital, buildings, inventory, and marketing expenses.

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