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**Small Businesses Assess Their  
Options for Raising Capital to Fund  
Growth**

## Small Businesses Assess Their Options for Raising Capital to Fund Growth

by

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*BizTechReports.Com for "Solutions for Small Business"*

### Executive Summary

As we approach the end of an eventful 2009, small business leaders are looking at an improving economic environment, and asking themselves how they will optimize -- what by all accounts will be -- a modest recovery cycle.

According to survey results published in September from the National Federation of Independent Business (NFIB), small business owners are cautiously optimistic about the future (see chart).

"The small business sector has taken a real beating over the last year, but owners are seeing some upward movement in both sales and earnings," says NFIB chief economist, William Dunkelberg.

The logical question then is: How will small businesses fund that growth?

"Credit cards account for the largest single source of financing being used by small businesses today," explains National Small Business Association (NSBA) President Todd McCracken. In a survey conducted in the second quarter of 2009, the NSBA found that 59 percent of small-business respondents used credit cards in the past 12 months to finance their business, up from 49 percent in December 2008.

Moreover, the growth occurred despite steadily worsening credit card terms. Three quarters of respondents reported that credit card terms had gotten worse over the previous six months.

"In previous recessions, economic recovery has been led by the creation of millions of new small businesses. Unfortunately, today's entrepreneurs -- unlike those of past recessions -- are severely

limited in their ability to finance a new business by leveraging the value of their home, borrowing from friends and family, or securing a traditional loan," said NSBA Chair Keith Ashmus of Frantz Ward LLP in Cleveland, Ohio.

As demand does eventually catch up, however, capital will be crucial to optimizing growth, and small businesses that want to get the most out of the recovery will want to explore the range of options through into which they can tap

into capital.

"Most business owners think of bank financing when you say debt, and venture capital when you say equity," says Tiffany Wright, author of the new book, *Help! I Need Money for My Business Now!!*

Optimism Components	Percent Change
Plan to increase employment	3
Plan to increase capital outlays	-2
Plan to increase inventories	-2
Expect economy to improve	13
Expect higher real sales	6
Current inventory satisfaction	0
Current job openings	-1
Expected credit conditions	1
Now a good time to expand	0
Earnings trends	5
<b>Source: NFIB</b>	

“While these two sources provide a significant amount of small business funding, there is a vast pool of working capital for business and other ways to raise capital available from other entities. There are even providers of financing that looks a little like debt and a little like equity.”

For instance, small businesses can consider factoring (selling invoices at a steep discount), asset-based financing (lines of credit against durable goods or mortgages owned by the business), as well as mezzanine financing, in which lenders reserve the right to convert their stake to an equity or ownership in the event of a default on the loan.

Or, small businesses can explore the brave new world of peer-to-peer lending resources to tap non-traditional sources of financing.

### Good News and Bad News

According to a study produced in late 2009 by PayNet, Inc., a Skokie, Illinois-based firm that provides risk management tools and credit market insight to the commercial credit industry, U.S. businesses with less than \$100,000 in outstanding debts began borrowing again cautiously last spring to invest in their businesses -- a trend that continued through the end of the study period in September 2009.

The report, which was first published by the Reuters News Service, found that financing originations among very small enterprises are not back to where they were a year ago. However, the study determined that the financial health of these firms was no longer deteriorating at the pace that it was during the height of the crisis.

This is good news because according to PayNet executives, “these little businesses are a leading indicator and the signals they’re sending are improving.”<sup>1</sup>

Still, the overall context of the credit situation remains murky, and small businesses need to understand that there are plenty of good reasons for lenders to be leery of exposure.

A separate report released by PayNet this fall uncovered an alarming trend in business bankruptcies. Traditionally, loan delinquencies have provided lenders with an early warning that borrowers may be headed for trouble. But in this economic downturn, that rule of thumb no longer seems to be the best indicator.

“We’ve had many commercial lender clients discussing the rapid and unexpected deterioration of what were thought to be strong customers,” said Bill Phelan, president and founder of PayNet, Inc.

The PayNet Loss Reduction Study consisted of 750 small businesses that filed for bankruptcy in the first half of 2009, resulting in \$58 million in losses. The purpose of the study was to shed light on future bankruptcies to avoid sudden losses resulting from the approximately 100,000 small business bankruptcies in the past 12 months, which placed obligations totaling more than \$10 billion in commercial loans at risk for lenders.

PayNet ran the 750 businesses through its extensive proprietary database of small business loan performance --which encompasses more than 16 million current and historic contracts worth over \$700 billion -- and found that 50 percent of the businesses were current with one or more of their lenders when they filed for bankruptcy.

“Approximately half of the lenders never saw it coming. They were blindsided,” Phelan said.

“Take the case of a Midwest printing distributor that filed Chapter 11 in March, owing creditors over \$15 million,” said Phelan. “At the time of the bankruptcy, many of the dozen lenders

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<sup>1</sup> EXCLUSIVE: Smallest U.S. businesses borrowing again: PayNet,

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<http://www.reuters.com/article/smallBusinessNews/idUSTRE5AM1C120091123>

expressed some surprise at the business' failure," he said.

This is a finding that will undoubtedly serve to inhibit credit-based liquidity for small business from many of the most traditional sources of finance. So what is a small business owner or manager to do?

### **Innovation Key to Small Business Financing**

"Creative" and "accounting" are two words that you never want to see together. However, when it comes to raising funds -- to build the business or simply maintain existing operations -- thinking outside of the box and being innovative are key ingredients to finding adequate access to financial resources.

While large organizations may have the resources to tap internal CPAs and MBAs, as well as the well-heeled experts from the major consulting and accounting firms, most small businesses will have to navigate the new financial waters on their own.

There is no single solution -- or set of options -- that will be right for everybody. It will be important for small business owners and managers to develop a multi-faceted strategy that provides options during the process of getting financing, and reduces risk as organizations meet their obligations.

Here are some ideas and options for small businesses to consider in developing a business financing strategy:

- **Credit Cards.** As pointed out at the beginning of this report, credit cards are the dominant form of financing for the overwhelming majority of small businesses. An online survey by payroll service provider SurePayroll questioned 279 small business owners on their credit card usage.

In addition to financing, among the other primary uses and benefits for using credit cards, business record

keeping was cited by 22 percent of those surveyed, convenience was highlighted by 20 percent, rewards earned on purchases applauded by 18 percent, and help with short-term cash flow issues was indicated by 10 percent.<sup>2</sup>

On the downside, interests rates can be raised (a lot) at will by credit card providers, and/or credit limits can be instantly removed. According to one industry analyst, a skittish credit card sector could pull back as much as \$2 trillion in credit lines out from under the small business community, even as the sector continues to muddle through the economic recovery.<sup>3</sup>

- **Peer-to-Peer Small Business Borrowing.** This is an emerging field of finance in which private investors/lenders use the power of the web to find borrowers (or vice versa). Business borrowers describe the purpose and specifications for the loan they need, including the terms and the interest they would like to pay, and then let the digital marketplace respond. The total value of the loan may be provided by several different lender/investors who are pitching in as little as \$50 (or even less) until the total value of the loan is built.

According to American Banking News, borrowers will generally pay interest rates between 8 percent and 20 percent on the loans that they get. Often, however, these are better deals than business owners would be able to get from a bank loan or via a credit card.<sup>4</sup>

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<sup>2</sup> [http://www.creditcards.com/credit-card-news/small-business-study-shows-expense-separation-1269.php?a\\_aid=1017&a\\_cid=1204](http://www.creditcards.com/credit-card-news/small-business-study-shows-expense-separation-1269.php?a_aid=1017&a_cid=1204)

<sup>3</sup> <http://smallbusiness.blogs.cnnmoney.cnn.com/2008/12/17/credit-cards-gone-wild/>

<sup>4</sup> <http://www.americanbankingnews.com/2009/11/29/lending-clubs-what-is-online-peer-to-peer-lending/>

LendingClub.com and Prosper.com are places to start exploring this option.

- **Mezzanine Financing.** This is a hybrid of debt and equity financing that is typically used to finance the expansion of existing companies. According to Answers.com, mezzanine financing is basically debt capital that gives the lender the right to convert to an ownership or equity interest in the company if the loan is not paid back in time and in full. It is generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

Since mezzanine financing is usually provided to the borrower very quickly with little due diligence on the part of the lender and little or no collateral on the part of the borrower, this type of financing is aggressively priced with the lender seeking a return in the 20 to 30 percent range.

This type of instrument is not necessarily for the new kids on the block. According to Investopedia, it is typically reserved for organizations that already have a track record, and are seen by investors as good prospects to back as the business expands.<sup>5</sup>

- **Accounts Receivable Financing or Factoring.** This is a form of asset financing in which small business owners use invoices in good standing within their accounts receivable as collateral for securing a loan. Businesses can borrow up to 80 percent of the face value of the invoice. The main benefit of this strategy is that loans can usually be secured pretty quickly. This is because the credit quality of the customer that has been invoiced is more

important than that of the small business seeking the loan.

Usually the accounts receivable are assigned to the factoring organization – meaning that the check from the customer will go directly to the factoring organization. At that point, the loan advance, plus fees (which can be as high as 3 percent of the face value of the invoice), are subtracted. The rest is then forwarded to the small business borrower.

- **Advance Pay Programs.** For small businesses that do a high volume of credit/debit card transactions, advance pay programs offer a way to cash in on “future sales.” In this case, lenders “purchase” a fixed dollar amount of a small business’ future credit card receivables at a discount by giving a lump sum to the borrower. As credit/debit card transactions are processed, the lender directly collects the money owed until the full fixed amount of the small business loan has been paid off.

## Conclusion

This is by no means a comprehensive list and description of the options that small businesses have before them. Beyond the brief treatment of financing sources above, there are vehicles such as:

- Commercial finance lines
- Lease financing
- Purchase order and supplier guarantee financing
- Strategic alliances
- Grants; and, of course,
- Angel funding and venture capital.

Each option has its own risks and opportunities that should be well understood before making strategic finance decisions. The key point of this report, however, is that in difficult credit markets it is important to develop a broader

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<sup>5</sup> <http://www.answers.com/topic/mezzanine-financing>

understanding of finance options, and to take a hard look at some of these alternative opportunities.

For more information on the critical trends and issues faced by small businesses as they seek to raise capital in a cash-constrained environment, log in to an excellent discussion led by NFIB's William Dunkelberg via a free archived webcast provided by SolutionsforSmallBusiness.com.

**Links to Watch:**  
[www.nfib.com](http://www.nfib.com)  
[www.nsba.biz](http://www.nsba.biz)  
[www.moneytogrowbusiness.com](http://www.moneytogrowbusiness.com)  
[www.SolutionsforSmallBusiness.com](http://www.SolutionsforSmallBusiness.com)

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