Extracted from *Managing Technology for Profit,*
A Small Business Guide
© **Robert Muir**

8

Money - the Glue Holding the Business Together

Sources of Capital for Small Business
The Angel Network—Building Infrastructure by Investing in Small Business
Entrepreneurs Seek Gold in Venture Capital Mine
SBIR—Government a Willing Innovation Partner for Small Business
The Banker Is An Investment, Select Him Carefully

We've examined the possibilities and have decided we can maximize our opportunity by keeping the technology in-house. Like Jason, rightful Prince of Greece and seeker of the wondrous fleece of pure gold, how do we then get the money to develop, manufacture, market and sell the product?

MONEY—THE GLUE HOLDING THE BUSINESS TOGETHER

SOURCES OF CAPITAL FOR SMALL BUSINESS

An absolute must before approaching any financial source is a well prepared business plan that shows how the money will be used, and paid back!

George Bernard Shaw wrote that "lack of money is the root of all evil." Lack of funding is the number one reason given for the failure of so many small businesses. Why? Success today hinges not only on providing a quality and timely product or service, but also on knowing how to finance the business. All businesses face critical periods that can lead to temporary cash flow problems. These problems can be anticipated and overcome if the small business owner has a good working knowledge of the available sources of financing.

It's easy to despair when we've struck out for capital at our local bank. Don't. Persist. There are many alternative places to raise money: private, institutional, and government. Some sources may be better suited to a particular need: *inception, survival, growth, expansion, or maturity*. Don't be put off by their size; ask and we shall receive!

Finance for small business may be derived from four main sources: equity, debt, leasing, and grants. Before we examine the more common sources of financing, it's important to clearly understand the difference between debt and equity capital.

In its most common (mortgage) form, debt capital requires a periodic payment of interest and capital reduction, or a lump-sum balloon payment upon maturity. New enterprises, without adequate cash flow, can often ill afford debt servicing that can also adversely affect the balance sheet, and with it, hopes of raising additional finance. On the plus side, interest payments are tax-deductible and equity is not surrendered.

Contrast the trade-off with equity capital financing, which requires an ownership percentage to be given up, but without interest payments (debt service). However, raising equity capital is not without emotional strain on the founder, particularly if the operation of the company becomes subject to the whims of the new partners. Then again, a large stockholder equity can result in a good credit rating. Among the sources for equity capital, we can include the following:

- Ourselves, relatives, and friends (in cash, credit cards, goods, and equipment and services). Most small businesses in the U.S. had their beginnings from this source—*inception*.

- Employee ownership is broadening its base and can lead to increased productivity, pride, and security. Employees can participate via stock purchases, stock in lieu of salary, and even by providing personal equipment. Employees can also provide direct loans or loan guarantees—*inception, expansion, survival.*

- Successful entrepreneurs and wealthy individuals often wish to get in on the ground floor of a new or expanding enterprise. They seek growth beyond traditional returns or tax write-offs to charge against other disposable income or capital gains. In the U.S., these individuals are often called "angels"—a term borrowed from show business, where it is used to refer to the investors who put up the money for theatrical plays. Angels are investors who typically have $50,000 to $100,000 to invest and prefer a hands-off approach. Contact used to be made by referrals from CPAs, attorneys, and business incubators. More recently, groups in several states, including Texas, Massachusetts, Arizona, Missouri, and Kansas, have set up Venture Capital, or Angel Networks. The networks seek to match investor, entrepreneur, and business opportunity—*inception*, *growth, expansion, survival.*

- Customers, suppliers, and sales representatives want to expand their customer base and create new markets for their products. Financing assistance can include extending credit, guaranteeing loans, making direct loans, purchasing new stock, and lending/leasing equipment—*inception, growth, expansion.*

- Corporate parents wishing to guard against the loss of key employees through entrepreneurial spin-off are adopting an "if you can't beat 'em, join 'em" philosophy by making funds, facilities, and management services available for new ventures—*inception, growth, expansion.*

- Venture capital encompasses a fairly wide range of "risk capital" investments. At one end of the spectrum is seed capital placed into the very newest, very smallest, and highest risk companies. In the middle are first and later rounds of financing for product line additions for established companies. At the other end of the spectrum is "expansion capital" placed into older (5 to 10 years or older), more established (annual revenues $10 to $15 million or more) companies. Pension funds are found here—*inception, growth, expansion.* (For a list of Venture Capital firms, by industry, region, and financing types, consult *Pratt's Guide to U.S. Venture Capital Sources* at the local library.)

- In 1958, congress passed the Small Business Investment Act that authorized the founding of a special class of investment companies, Small Business Investment Companies (SBIC), to make equity capital and long-term credit available to small businesses. SBIC are licensed by the Federal Government's Small Business Administration (SBA), but are privately organized and managed firms. SBIC recently lost their access to the Federal Financing Bank, but are considering new alternatives in the commercial paper market; these new funds still would be guaranteed by SBA. SBIC are commonly interested in realizing capital gains from the resultant sale of stock—*growth, expansion, survival.*

- Regional development corporations have been set up by most states to encourage the growth of new industries or to help existing industries. In many instances,

© **Robert Muir**

financial assistance is available for situations where banks and other conventional lending institutions are not willing to participate—*growth, expansion, survival.*

- Retained earnings may offer a higher rate of return than more conventional investments and may often be the only alternative when a new product is introduced to the market—*inception, growth, expansion.*

- Government grants (local, state, and federal) are available through programs such as the Small Business Innovation Research Act (SBIR). Funding up to $50,000 may be made available to confirm the feasibility of a new idea. These programs are sponsored by government departments, e.g., the Departments of Defense and Energy—*inception, survival.*

- The public offering: the ultimate fantasy. If we thrive on pressure, enjoy risk, and admit the possibility of having to give up control of our company, this may be a valid option to consider—*expansion, maturity.*

Turning now to potential sources of debt capital, there are the following:

- Commercial and Industrial (nonchecking) banks, and Savings and Loan Associations offer a plethora of debt financing. Financing includes personal loans, secured credit lines, unsecured credit, and term loans. Term loans cover short- and long-term financing for established businesses with qualifiable risk—*growth, expansion, survival, maturity.*

- Institutional lenders, such as commercial-finance (General Electric, Chrysler Capital Corporation) and insurance companies have historically been a major source of long-term debt financing for industry. Investment standards are very high, and new or speculative ventures are rarely considered; public utilities, major corporations, and industrial bonds are their preferred vehicles of investment—*expansion, maturity.*

- Accounts receivable financing and factoring. Factoring companies trace their origins back some 150 years to the textile trade in Europe. Today, they are associated with the financing of trade receivables. A manufacturer assigns the receivables to a factor and receives a cash payment with a reserve payment set aside. After the customer pays for the product, the manufacturer receives the balance due less the factor's discount and interest on the funds advanced (often a hefty 20 percent). Still, unlike the more traditional bank financing, the manufacturer pays only for what he needs—*growth, expansion, maturity.*

© **Robert Muir**

- The U.S. SBA offers direct, guaranteed, and 504 Certified Development Company (CDC) loan programs. CDCs can provide long-term fixed asset (up to $500,000) financing through SBA guaranteed debentures to small business. For inception, the SBA also offers LODOC or MicroLoan programs–up to $25,000. SBA programs generally require a personal guarantee from any investor with more than a 5-percent stake in the business—*inception, growth.*

- Mortgages on buildings and homes are often used to secure loans. Be sure this is a sure thing before risking primary assets—*inception, growth, expansion, survival.*

- Manufacturers and other suppliers may ship goods on extended credit terms. They may even provide the new company with direct or guaranteed loans to establish the enterprise or to support it during lean times. These relationships typically fall under the catch-all of strategic alliances—*inception, growth, survival.*

- Government issued (local, state, and federal) loans and grants, such as Industrial Revenue Bonds, may be available to encourage new initiatives. Write to the SBA for a copy of the *Directory of State Small Business Programs.* Assistance also may be available from other government sources such as the Departments of the Interior and Housing and Urban Development—*growth, expansion.*

- Sellers may even self-finance the sale when traditional financing is unavailable or unattractive—*growth, expansion, maturity.*

Leasing can be very attractive to small business because it can provide capital assets with little or no initial investment. Products manufactured with the leased asset may provide sufficient cash flow to meet the leased payments. Typically, while the total payments over the lease period, plus the optional buy-out amount, can add up to twice the original purchase price for the equipment, the small business person may have no other choice—*inception, growth, survival.*

Another variation of leasing is the sale-lease back plan. Equipment that has already been purchased is sold to a leasing company and then leased back to the original owner. In this way, the small business acquires cash, which may be sorely needed for working capital, in exchange for the equity in the equipment—*growth, survival.*

Finally, an absolute “must” before approaching any financial source for capital, is a well-prepared business plan that documents how the funds will be used, secured, and paid back!

The Angel Network—Building Infrastructure by Investing in Small Business

The lament is heard nationwide. If we’re an entrepreneur or start-up company, the seed money needed to get our business up and running is hard to find and even tougher to get.

With banks avoiding this early stage financing, and established venture capital firms favoring larger investments in more established companies, we can fall between the cracks.

Enter the "angel" from stage left. As mentioned previously, angels are private investors who have made it to the top of the hill and are willing to invest capital in new entrepreneurial businesses.

More recently, enlightened community leaders have recognized the importance of the contribution of entrepreneurial small businesses to their communities. They have established networks to facilitate the marriage of innovation and money. Getting new companies started is a key ingredient to economic growth in the current administration's plan to jump-start the U.S. economy.

The Silicon Prairie Technology Association's Capital Resources Network (CRN—Kansas City, Missouri) is a more recent example of this type of approach. CRN is looking to build a database of 200 investors, the majority of whom will be individuals. The rest would be from the traditional group of lawyers, bankers, and accountants looking for investment opportunities for clients.

The network made its first match in January 1993 among four investors and American Echo, a firm making examination tables for cardiac patients undergoing ultrasound diagnostic tests. Although started in 1988, the injection of $500,000 (partly from the network) would accelerate American Echo's product development, sales demonstrations, and marketing activities. CRN looks for matches that return a profit in the 5-year range. Its start-up costs are underwritten by the Ewing and Marion Kaufmann Center for Entrepreneurial Leadership and several Kansas City companies.

The majority of these matchmaking services are nonprofit, regional organizations. For a small fee, they assemble information from local companies seeking investment and then pass this information along to potential investors in their database. Interested investors, in turn, contact the firms they find most promising. One of the more active networks, the Texas Capital Network in Austin, has over 100 active investors. Angel networks are getting even more attractive as they extend their reach. A group of them, led by the Texas Capital Network (TCN), is organizing a network that may eventually operate nationwide. This "consortium" could link as many as 12 different networks with as many as 2,000 investors.

The concept of these networks has been around for over a decade with groups such as the Enterprise Corp. (Pittsburgh, Pennsylvania) and The Venture Capital Network at MIT (Cambridge, Massachusetts), which is one of the most reputable and covers 21 industries. Networks are extensions of "matchmaker services" of which there are about half a dozen nationally. Xantrex (Dallas, Texas) is one of the largest with a database of 23,000 potential investors and its services sold through 65 representatives in North America.

What is new is the recognition of the need in communities to fund the smaller $200,000+ investments by bringing the underground angel investors to the surface. Capital markets are reluctant to fund this level of investment because the returns on such small loans may not bear fruit and the risk is high. Angels may also be identified by approaching the various Small Business Development Centers.

Of course, this leaves a hole in the true "seed" capital stage—up to the first $50,000. No group is actively meeting this need. What is needed is a "blind" seed fund underwritten by the public/private sector. Its advisory board would have the ability to evaluate and recommend worthwhile business ideas and innovations. Business incubators, such as the Arizona Technology Incubator in Phoenix, are good informal targets to arrange funding for this unserved part of the market.

ENTREPRENEURS SEEK GOLD IN VENTURE CAPITAL MINE

The market is up, but Dunn & Bradstreet reported 71,194 U.S. businesses failed in 1995. The soothsayers are out with doom and gloom predictions. The big players are looking for new opportunities to land their money that flew from the market. Small businesses need to find new products to survive, but first have to find the gold mine to provide the start-up capital. The people with the start-up gold are called venture capitalists.

The relationship between venture capitalists and entrepreneurs seeking funds is sometimes ghost-like. Each may be aware of the other's existence, but they fail to connect. Often, this misnetworking develops because the venture capitalist is inundated by ill-prepared entrepreneurs. Being prepared can move a small business or entrepreneur to the head of the line quickly. Okay, so how do we prepare? We analyze every conceivable aspect of the proposed venture.

Venture analyses can take many forms. Often a venture analysis (due diligence) includes answering a critical question related to the potential for success. These components might include the following:

- *Market Analysis* - is there a market, what is its size, who or what is the competition?
- *Financial Analysis* - is the venture cost competitive and profitable?
- *Market Entry Requirements* - are there preferred methods of marketing and distribution? Are there regulatory requirements, key personnel requirements, etc.?
- *Strategic Business Plan* - what are our business goals? How do we capture a given market?

The relationship between venture capitalists and entrepreneurs seeking funds is sometimes ghost-like.

Venture analyses are not reserved for high technology opportunities. They are useful whenever an entrepreneur or small business is considering a new opportunity.

Venture capitalists consider the following the most essential criteria for a successful venture:

- The entrepreneur is capable of restrained yet intense effort.
- The entrepreneur is thoroughly familiar with the market targeted by venture.
- There is at least 10 times the return on investment in 5 to 10 years.
- The entrepreneur has demonstrated leadership in the past.
- The entrepreneur is able to evaluate and react to risk well.
- The investment can easily be made liquid.
- The target market enjoys a significant growth rate.
- The entrepreneur has a track record relevant to the venture.
- The entrepreneur is articulate in discussing the venture.
- The product is proprietary or can otherwise be protected.

At least three subsets of new venture financing have evolved. The first is seed capital, which is required to reduce a technology to a commercial product and, as well, to perform a venture analysis. Seed capital carries with it a high risk factor. The second type of new venture financing is risk capital, which is required to complete the venture analysis and develop the necessary resources—plant, facility, human—to enable commercialization. Finally, to provide the added financing required by a growing new venture so it can expand and meet its full market potential, one needs venture capital.

It should be clear that the risks associated with each subset of financing decrease as time passes. Whatever the type of financing, the venture capitalist who provides the resources is an important participant in the entire chain of events.

The venture capitalist might be a firm set up for the sole purpose of financing new ventures. The venture capitalist might also be a conventional bank and/or an SBIC, an insurance company, or a large industrial firm. Any financing entity requires a well-developed business plan before it will support an application for financing.

Why should new ventures and venture capital be important to the economic development of any region? A large portion of any area's economic growth comes from expansions of existing firms and the creation of new small business. Sometimes, this

growth is in the form of spin-offs from larger parent companies. The creation and nurturing of new ventures is important because they can contribute to an area's economic growth.

As in many regions of the country, the U.S. Midwest's needs for this type of financing is not met completely by local sources. Many people must seek funding from financial centers such as New York, Boston, San Francisco, Chicago, or Denver.

In the U.S., many metropolitan areas suffer from a financially conservative posture. Financial institutions historically have preferred to loan money to traditional operations or operations with which they have a funding history, rather than to new or riskier operations. Being risk adverse is natural. In view of this, therefore, the entrepreneur or small business who seeks the capital must address the skepticism of the financial community through careful planning and preparedness.

SBIR—Government a Willing Innovation Partner for Small Business

Small business has created almost 12 million new jobs from 1990 to 1994, whereas Fortune 500 companies have laid off 3.8 million people in the same period. Most of these new jobs were created by people with a vision and a new idea or service and were driven by the fuel of their own sweat equity.

Before 1982, small business was largely left to its own means and ways to innovate new products and services. Funding was provided by personal sacrifice, a benevolent investing angel, or for the fortunate few, seed venture capital. Enter the government bearing large gifts for small business.

In 1982 the Small Business Innovation Research program (SBIR) was created. Public Law 97-219 was passed to stimulate technical innovation, to induce small business to meet federal research needs, to increase private sector commercialization of innovations derived from federal R&D, and to foster and encourage participation by minority and disadvantaged persons in technological innovation. This public law requires that all federal agencies with outside R&D budgets in excess of $100 million must award a portion of their funds to smaller companies through grants.

By law, the following federal agencies were included in the 1986 SBIR program: Department of Defense, National Aeronautics and Space Administration, Department of Energy, Health and Human Services, National Science Foundation, U.S. Department of Agriculture, Department of Transportation, Department of Commerce, Nuclear Regulatory Commission, Environmental Protection Agency, Department of Interior, and the Department of Education.

How does the SBIR program work? The SBIR program consists of three phases: Phase 1 (Idea Stage) provides for up to $50,000 for 6 months of feasibility related experimental

or theoretical research on topics of significant interest to the government; Phase 2 (Product Stage) provides for up to $500,000 for 24 months of related R&D for those projects found most promising after Phase 1 and is intended to finance prototype developments; and Phase 3 (Business Stage) funding, the actual commercialization stage, comes from the private sector.

Has the SBIR program been successful? In 1994, the last year for which data was available, 4,030 grants were awarded, amounting to $717 million compared to just 686 grants totaling $44.5 million in 1983, the SBIR's first year.

What's ahead? The government still wants our help to research the topics of interest such as life sciences, behavioral science, training projects, software, engineering, instrumentation, physical science, chemistry, and electronics.

How can we obtain further information on the particular agency topics? The easiest way is to write or call our state representative or regional Small Business Development Center. Alternatively, write to the SBA and ask to be placed on their master mailing list. This will ensure that we receive information about the SBIR program in general.

To get specific topic information, write separately to each agency and ask to be placed on its mailing list.

What are the actual mechanics of the program? SBIRs are competitive award programs and operate as follows:

- Each government agency in the program publishes annual solicitations describing its areas of research interest together with the proposal format it will accept and an application deadline.

- Companies or individuals submit written proposals for research projects on one or more of the published topics.

- Each agency prescreens the proposals and follows up with peer group reviews and funding recommendations.

- Grants are then awarded to the proposals considered to provide the best R&D investment and commercial opportunity.

The whole process takes about 6 months from proposal submittal until obtaining a Phase 1 grant with a further 6-month lag for Phase 2 approval. Be patient. The bureaucratic process takes time.

Before deciding whether or not to compete for these funds, consider how closely the company's capabilities match those required to undertake the announced SBIR topic; if the company has the required people on staff, especially an experienced investigator; and

whether or not the company possesses the resources that are necessary to prepare a winning proposal.

Frankly, the hardest part of participating in the SBIR program is writing the proposal. Proposal writing is an art, but an art that has been mastered by the Silicon Valley companies. Typically, successful proposals are those that follow the prescribed format, emphasize experience on similar projects, discuss the company's plan and capabilities to successfully accomplish the project, identify experienced people to work on the research, and demonstrate the commercial potential of the proposed research. Keep it simple and eliminate jargon. One final point—the proposal must be 25 pages or less.

Successful proposals follow the prescribed format and demonstrate the commercial potential of the proposed research.

How will your proposal be evaluated? A Department of Health SBIR solicitation published the following criteria:

- Soundness and technical merit of the proposed R&D—40%
- Qualifications and experience of investigators—30%
- Potential for technical innovation—20%
- Facilities and equipment available—10%

How can the company obtain the rights to any inventions it develops if it is using the government's money to innovate? The pay-off under the SBIR program is that the company may retain the commercial rights to any patents and/or intellectual properties developed with SBIR funds. In exchange for the company's talent and time, the government retains a nonexclusive royalty-free license to these rights, as well as certain "march in" rights to ensure commercialization. The rest is the company's to keep, license, or sell. Rights to any technical data developed also belong to the company.

How does the company qualify? To qualify for SBIR funding, a firm must satisfy all of the following criteria at the time an award is given: be a for-profit, independently-owned and operated U.S. entity with 500 or fewer employees.

Public or privately held corporations, sole proprietorships, or partnerships may apply. Even applications from joint ventures are accepted provided the resultant entity qualifies as a small business under government regulations. These regulations are published in the Federal Register, the government's bible.

The technology needs of small business are no fewer than those of major companies, yet the risks of survival are greater. Why should we miss out on a valuable source of R&D funds to develop new products for our company? Protect the company's profits and future by letting the government help us be a winner in the technology game.

THE BANKER IS FIRST AND FOREMOST A LENDER!

Most small business people know from experience that a bank's willingness to lend money does not always correspond to the time when it is urgently needed.

Adam Smith wrote: "It is not by augmenting the capital of the country, but by rendering a greater part of that capital active and productive than would otherwise be so, that the most judicious operations of banking can increase the industry of the country." Bankers are professionals in their own right, but unlike the advice a CPA and an attorney sells us, the banker's stock-in-trade is cash, the fodder of industry. The banker's resources are indeed limited and the banker's job is to tender sound advice and to make those loans that ensure the most productive return at the least risk.

As custodians of other peoples' money, bankers' fiduciary responsibilities require them to be inherently cautious in their business activities. Contrasting this quality with the risk-taking opportunistic character of the small business person we'll understand the fundamental cultural differences. Comprehending how the banker thinks is key to establishing a professional relationship.

Ironically, most small business people choose their bank first and their banker second. Selecting our bank involves the same process used in reviewing any commercial enterprise wishing to serve us: specific services (payroll, night depository, etc.), convenient location, established reputation, and general lending policies. Selecting our banker requires just as much care.

Retaining A Banker. As an expert and experienced business counselor, the banker will play an important part in the company's future. Since the banker is going to be part of the management team, be prepared to make an investment both in time and in a long-term relationship with the banker. We should interview the banker just as we would any key employee for the company:

- Is the banker sincerely interested in the business? Is the banker eager for the company to grow and willing to grow with it?

- Is the banker familiar with the business? A lack of knowledge on the banker's part may hurt the company in several ways: a greater time commitment requires on our part to bring the banker up to speed with the business and, human nature being what it is, a natural suspicion if he or she doesn't understand the business. Can the banker's insight and experience be a valuable resource for the company?

- Is the banker progressive? Does the banker have a history of making loans to small business? Is the bank a relatively aggressive lender or is it given to excessive passivity and low loan/deposit ratios? Where does the banker sit in the bank's management chain?

- Is the banker helpful? When lending policies preclude the banker from part of the business, will the banker refer us? Will the banker provide credit information on our customers and suppliers? Does the banker have a knowledge of small business programs such as SBICs and SBIRs?

Building Collateral. Visit the banker frequently and keep him/her fully informed about the business. Invite the banker to the facilities, send new product or service announcements—remember the banker is on our team. Ask the banker to review company financial and business plans and discuss the prudence of hopes and dreams. It takes time to build a relationship, to instill confidence. Don't blow it by failing to be candid about shortcomings! Bankers don't like surprises!

Most small business people know from experience that a bank's willingness to lend money does not always correspond to the time when it is urgently needed. The balance sheet is also a candid snapshot of the company credit rating. Remember always that the bank is first and foremost a lender, not an investor. Bankers take enough heat without overlooking this very basic consideration! A strong and lasting relationship with the banker can keep the wolf from our door in a dire emergency.

Cashing In. When we do approach the banker with a loan or credit package, we must be sure that our request is sensible and reasonable both in funds sought and the risk involved. Demonstrate professionalism by putting together the package with a clear statement of how the proceeds will be used and how they will be secured and show concisely how financial projections will ensure repayment.

Bankers like and need numbers to buttress their lending decisions. Check the *Robert Morris Associates Industry Averages* for the business. Take a look at the quick ratio, sales/receivables, cost of sales/inventory, sales/payables, inventory turnover, and the aging of accounts receivables and payables. Run the numbers—the banker will!

Use a common sense approach in preparing to meet the banker to discuss business needs:

- Do schedule an appointment and mail loan packages several days in advance.

- Do allow plenty of time to discuss the proposal at length and answer the banker's questions candidly.

- Don't, repeat don't, ask how much money the company can borrow or professional credibility just flew out the window!

- Don't make promises the company can't keep.

- Don't spend money before the application is approved and don't wait until the last moment when creditors have the company in dire straits.

© **Robert Muir**

- Don't let someone else be the company mouthpiece. Remember, we must demonstrate the ability and, above all, the understanding to manage our business!!

The banker can and should be one of the company's key business advisors and supporters. Make sure the banker is a friend indeed and not a friend in need!.