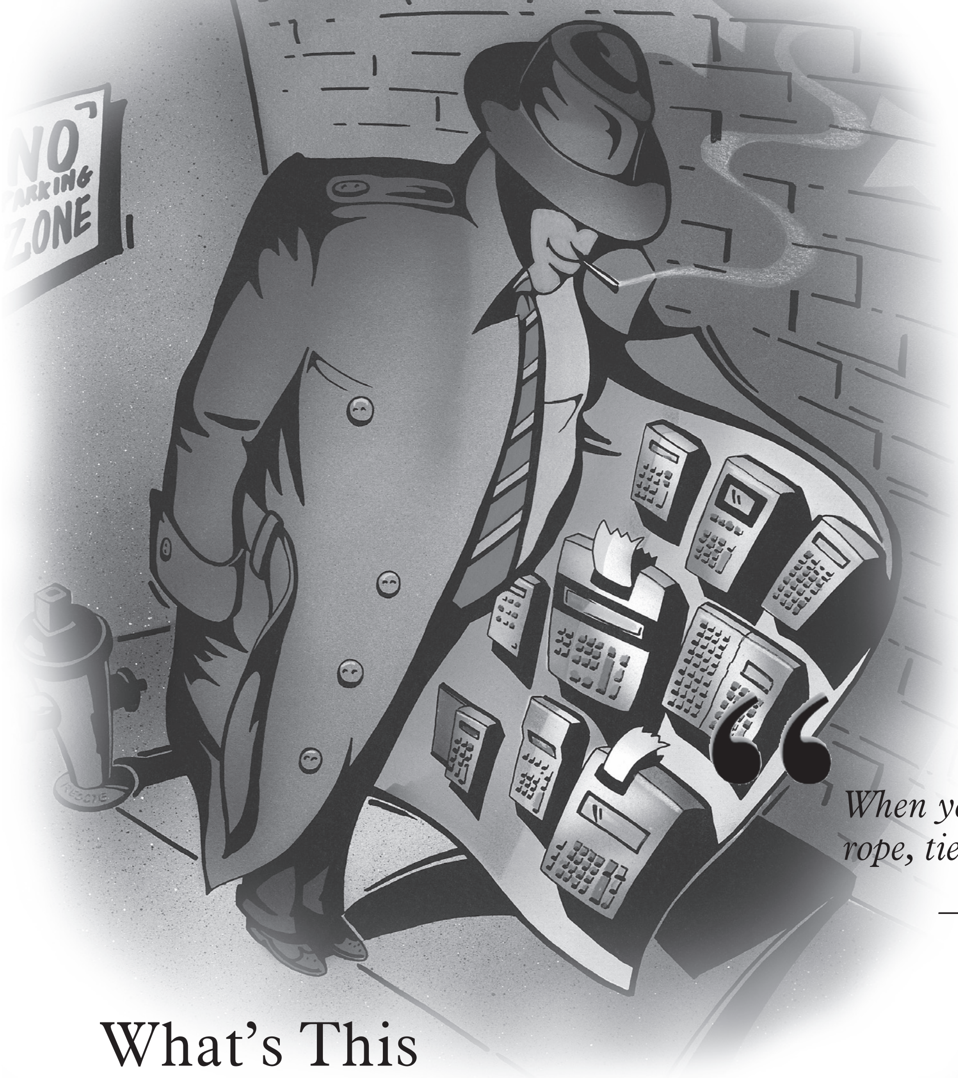
FINANCIAL TIPS AND TOOLS

Bank On It!



Highlights

> *When you get to the end of your rope, tie a knot and hang on.*
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> *—Franklin D. Roosevelt*

What's This Session All About?

This session will discuss financing options, with a special focus on the options available to micro-entrepreneurs. We'll also talk about ways of tracking financial information, which will help you to make better financial decisions.

In this session, we'll look at the following topics:

Financing your business. This part of the session explores sources of money to run your business. However, no matter where you choose to get financing, it is important to establish a business relationship with potential lenders. This section explains how and why you should establish a healthy working relationship with these people.

Money sources. Micro-entrepreneurs have a wide array of financing sources from which to choose. There's plenty of help out there for you…all you have to do is find out where it is, and what you have to do to get it. This section will make both tasks a lot easier!

Preparing to seek financing. In this section, we discuss the loan process—what has to take place in order for a lender to give you financing. We also explain how to prepare a financial proposal. Seeking financing is a lot of work, and can be an emotional rollercoaster ride, so this section also describes how to prepare yourself emotionally for requesting a loan.

Understanding financial ratios. One way to understand how your business is doing is to analyze its performance with financial ratios. We'll define some common financial ratios, and explain how you can use them to measure your business's health.

Credit and collections. As your business grows, customers will expect you to extend credit, or to accept credit cards. This presents an opportunity for more sales, but it also poses a serious risk. This is something you need to plan for in advance, both by choosing the right credit policies, and knowing how to collect when people don't pay you.

Financing Your Business

Entrepreneurs often think only of banks when they look for financing, but there are plenty of other options. This chapter provides information about the alternative money sources available to microbusinesses.

And there are many, many such sources…far more than we can list here. In fact, one of the most remarkable things about microbusiness lending is that it's consistently underutilized. In other words, the people who are eligible for loans and grants often fail to ask for them.

Don't be afraid to take full advantage of these resources! There are many types of financing available to you, and you may be able to get more than one at the same time. The people who offer microbusiness financing and assistance understand the different sorts of financial trouble people can get into, and the different backgrounds they come from. That's why there are loans you can get despite bad credit, no credit, or a lack of collateral.

Research your options carefully, and get help from professionals. Understanding your options—and the requirements for financing—can be confusing, but there are plenty of people whose job it is to help you. And no matter how hard seeking financing is, it's not as hard as trying to start a business without the capital you need!

Financing Sources

- Personal savings
- Friends, family
- Personal loan/line of credit
- Second mortgage on your home
- Business loan from:
  - Bank, credit union
  - Government programs
  - Community loan funds
  - Alternative lenders
  - Investors
  - "Angels"
  - Suppliers, vendors

Personal Funds

National studies show that four out of every five new businesses are launched with the personal funds of the owner. Personal funds include:

- **Savings**. This could be money in a savings account, a certificate of deposit, or even a shoebox under the bed.
- **Investments**. Besides stocks and bonds, this includes stamps, coins, jewelry, and precious metals.
- **Life insurance**. Many life insurance policies allow you to borrow against the cash surrender value of the policy.
- **Second mortgage**. You may be able to borrow a percentage of the equity you have in your home; this includes refinancing your house or taking a second mortgage loan.
- **Credit cards**. Credit-card financing is risky at the best of times. Changes in 2005 to bankruptcy and lending laws have made it extremely dangerous. We don't recommend it!

Debt or Equity Financing?

Businesses can be financed either by debt capital or equity capital, each of which has its advantages and disadvantages.

Debt capital

Debt capital is money that you borrow. No matter what happens with your business, you'll have to pay this money back.

In addition to paying back the amount you borrowed (which is called the **principal**), lenders will make you pay for the use of the loan by charging **interest**. The amount of interest you pay depends on the amount you borrowed, the length of the loan, and the interest rate.

Debt financing requires you to make scheduled loan payments. During start-up and early growth, this can be difficult! The more debt financing you use, the greater your monthly charges will be. This increases the risk that your cash flow won't cover your debt payments.

Here are some common forms of debt capital:

- **Short-term loans** are for less than one year. The most flexible form is called a **line of credit**. It allows you to borrow money as needed, up to an approved limit. This is like having a credit card that expires in a year, but with a much lower interest rate.

- **Accounts receivable financing** is a specialized line of credit. If you have Accounts Receivable (money owed to you for things you've sold), you may be able to get financing by pledging the Accounts Receivable against the loan. Your inventory may also be included in the loan. Typically, the lender allows a certain percentage of your Accounts Receivable (up to 80%), and your inventory (up to 50%), to determine how much you can borrow.

- **Bullet loans** are short-term loans that usually come due in 30-90 days. One purpose of a bullet loan might be to cover the initial costs of doing a job for someone.

- **Supplier financing** means you don't have to pay immediately for the supplies you use in your business. Instead, your supplier extends credit to you for a short period of time. All agreements of this type should be in writing.

- **Term loans** usually run from three to fifteen years, and are typically used for equipment and real estate. The loans are usually at a fixed interest rate, and may include a penalty for early repayment.

Almost every bank loan is a **secured loan**. This means that the business, or the business owner, must offer **collateral** for the debt. Collateral is something valuable that the lender can take as repayment if you can't repay the loan. For example, if you pledged your home as collateral for a loan, the bank can take your house if don't pay back the money you borrowed.

Equity capital

Equity capital is money invested by the owners of the business. This isn't a loan, so you don't have to pay it back. However, getting equity financing usually means you must give up part of your ownership in the business, and share profits (or losses) with the investor.

If you want to be the only person who has control over your business, you may have a hard time working with an investor. On the other hand, if you can see a positive side to having another voice in management, you may welcome the right investor. In that case, it's important to have a carefully written partnership agreement, and a method for cashing out a partner's share if he or she chooses to leave.

Raising equity capital takes good sales and communication skills. Basically, you're selling your business's promise of profitability, and selling yourself as a qualified manager of your business.

Angel Money

If you get financing from friends or relatives, it's often referred to as **angel money**. About 65% of small businesses start with financing from personal capital and angel money. Angel money can be debt financing (e.g., a loan from your sister, which you must repay), or equity financing (e.g., your brother invests money and gets partial ownership of the business in return).

If you want to borrow angel money, you should handle it the same way you'd handle a regular loan. Give your angel a copy of your business plan and explain it thoroughly (especially the cash flow projections and profitability projections). After receiving the money, give your angel a promissory note stating the amount of money he or she is loaning to you, the interest rate you've agreed upon, and how soon the money must be paid back. The note should also say when the first payment is due, how many payments there will be, and how much each payment is.

If the angel money is equity financing, you should have a legal document stating the conditions of the investment. Once it's signed, the angel will own part of your business, and have a legal right to a share of your profits.

Remember: It can be risky to borrow money from people you know. Will they meddle in your business? Even if they give you the money as a gift, they may feel as though they should have some say in how you run your business. This can lead to friction.

And what if you can't pay them back as soon as they'd like? How will your lender react if he or she loses the money? Remember, no business is a sure thing! You already have a lot riding on your start-up business…do you really want to gamble your personal relationships on it, too? Think very carefully before borrowing from friends and family! As a general rule, you should never borrow more money than the lender can afford to lose.

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We go back seven generations in this valley. For all the improvement I can see, we might as well have been living at the bottom of the mine. It's gone on like this long enough, and I feel like it's on me to do something.

Dad always wanted me to get an education. He wanted me to have options, so I could leave if I wanted to, or stay and make things better. But I got married young—17 years old—and then I had a family to raise.

When my daughter Mary turned 17, I made a promise to myself that she was going to get the education I never got…that no one in the family ever got. She was going to be the first one. I was going to make it happen, for her sake and for Dad's too.

Ella Thompson has lived in Hamlin, West Virginia all her life. Her husband Don died in a mining accident when she was 34, leaving her with three children and a small house.

The house had a trailer out back. Her 18-year-old daughter Mary used it for her bedroom. Mary was a really bright girl. She'd just graduated from the local high school. She liked to read—she'd read just about everything in the local library at least once—and Ella wanted to see her get away to college.

But where was the money going to come from?

She looked around and saw that most of her neighbors and friends were in the same boat. They wanted their kids to get a good education, but they really didn't know how to go about it.

Ella started to wonder if there were some way she could help herself, and help her neighbors at the same time.

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Money Sources

This section looks at sources of debt and equity financing.

Banks

Different banks serve different markets. Small community banks focus on serving local businesses. A large commercial bank with hundreds of branches operates differently, and will usually take a conservative approach to small-business lending.

It's important to understand that banks usually don't make loans to start-ups. They prefer to make government-guaranteed loans. (Government-guaranteed loan programs are discussed later in this chapter.) Smaller community banks are likely to remain a better bet for conventional financing.

As a microbusiness, you're less likely to be able to get a loan from a bank. However, as your business grows, the odds become very good that you'll have to seek financing from a bank. That's why it's a good idea to learn now about how bank loans work, and what's expected of people who apply for them. If possible, you should also cultivate a relationship with a banker, so that someone who knows your business will be ready to help you when the time for a bank loan comes.

That said, some banks *do* offer microloans. Therefore, it pays to research the policies and terms of banks in your area, and find out what's available.

Credit Unions

Credit unions are started and managed by employees of a company, members of a labor union, or other groups. They may offer better interest rates and other terms than a conventional bank, but they tend to offer smaller loans.

Microlenders

Microlenders are private investors who specialize in lending to small businesses like yours, which may not have access to traditional bank loans. Microlending is an increasingly popular form of investment, partially because of its social benefits, and partially because of its relative safety. Studies have shown that loans made to poor and disadvantaged borrowers actually tend to have a higher rate of repayment than traditional loans!

Here are some well-known microlenders:

- **ACCION USA** (http://www.accionusa.org) is one of the best-known microlending networks. It has loaned money to more than 15,000 entrepreneurs since 1991. Its loans typically range from $500 to $25,000. You can reach ACCION USA at (866) 245-0783, or e-mail them at loans@accionusa.org. Their simplified loan applications take about an hour to fill out, and you'll usually receive a response to your request in less than a week.
- **Prosper Marketplace** (http://www.prosper.com) is an online "person to person" loan system, in which people who need microloans are matched with private lenders who bid for the privilege of lending to them. The bids with the lowest rates are combined into a single three-year loan for the borrower. You can get individual loans of up to $25,000. You can also join groups of borrowers, which can result in better rates. This is a fairly new concept in the United States. It's similar to a successful British firm called Zopa (http://zopa.com), which as of this writing has over 50,000 members.
- **Trickle Up Program** (http://www.trickleup.org/us-program/o.html) has been giving seed capital grants of up to $700 to very low-income start-ups since 1994. According to their data, "Approximately 40 percent of Trickle Up's US entrepreneurs are in the process of moving from public assistance to self-reliance, and 75 percent of our entrepreneurs are women."

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There are many other microlenders out there! For more information, visit http://www.community-capital.org or http://www.cdfi.org. Your instructor or mentor may also be able to help you find microlenders.

Peer group lending

This is a form of microlending in which entrepreneurs join together to seek favorable loan terms. It's increasingly common among immigrants and other disadvantaged communities, where members may have few assets and references, but are willing to band together for the common good.

The way it works is that the members co-guarantee each other's loans. In other words, if you borrow $500, the members of your group pledge that they'll come up with the money if you default. As each member pays off his or her loan, the group's rating gets better and it becomes eligible for more credit. Since the group's rating goes up or down according to how each member behaves, the group itself screens new members, and assesses their creditworthiness. Some groups also create a fund to cover defaults (such a fund is required by some lenders).

Consumer Finance Companies

Consumer finance companies make small personal loans (usually a few thousand dollars). These loans are 100% secured by collateral. CFCs charge much higher interest rates and processing fees than banks and credit unions, but are more flexible about approving financing requests, and more lenient about bad credit. Be very careful when considering loans from CFCs.

Community Development Loan Funds (CDLFs)

These loans are intended to aid with community renewal, by promoting business growth and economic independence in disadvantaged communities.

Organizations that offer these loans are called **Community Development Financial Institutions (CDFIs)**. These range from small, local nonprofits to large banks with millions of dollars in assets. The most famous financial institution involved in this type of lending is South Shore Bank in Chicago.

Comparison of CDFIs That Lend to Microentreprenuers

CDFI Type	Community Dev't Credit Unions	Community Dev't Loan Funds	Microenterprise Dev't Loan Funds
Purpose	To promote ownership of assets and provide affordable retail financial services to low- and moderate-income people	To re-lend capital from social investors to support housing, businesses, and social services in lower income communities	To foster social and business development among low-income and those unable to access conventional credit
Borrowers	Individual credit union members	Nonprofits, social service providers, small businesses	Low-income individuals
Capital Sources	Members' deposits, limited deposits from social investors, government	Foundations, banks, religious organizations, individuals, companies, government	Foundations, state & federal government, corporations
Financial Products	Savings/checking accounts, personal loans, home rehab loans	Loans for construction, facilities development, business start-ups and expansion	Peer group and individual loans to microbusinesses
Notes	The amount of microenterprise lending credit unions do is difficult to determine given that their popular consumer loans are often invested in businesses	Loans to individual microentrepreneurs are only part of a larger portfolio invested in a wide range of community development projects	Often housed in larger institutions such as Community Development Corporations and Community Action Agencies

Source: Coalition of Community Development Financial Institutions, 620 Chestnut St. Suite 572, Philadelphia PA. www.cdfi.org

These institutions lend money to businesses that most banks avoid. Currently, about 300 CDFIs provide loans to disadvantaged American communities at below-market rates.

To find out who makes community development loans in your area, call the Community Capital Association at (215) 923-4754, or visit the Website of the Coalition of Community Development Financial Institutions (http://www.cdfi.org).

Small Business Administration Loan Programs

The U.S. Small Business Administration (SBA), which was created in 1953 to assist small businesses, offers both direct and guaranteed loans.

The term **direct loan** means that the SBA makes the loan directly to the small business. A **guaranteed loan** is where a bank makes a commercial loan to a small business, and the SBA guarantees it. This helps small businesses who need long-term credit, but can't afford the usual terms.

To be eligible for any SBA loan, you must meet the following basic requirements:

- You must be a for-profit enterprise doing business in the United States or its possessions
- Your business must be independently owned and operated
- Your business must have applied for, and been denied, a conventional loan by a private lender
- You must have a reasonable amount of equity in the business
- You must have exhausted other means of financing, including personal assets

There are additional eligibility restrictions, which vary based on the industry in which you operate. Visit the SBA online at http://www.sba.gov for more information, or call toll-free at 800-8ASK-SBA, to research the current availability and terms of SBA programs.

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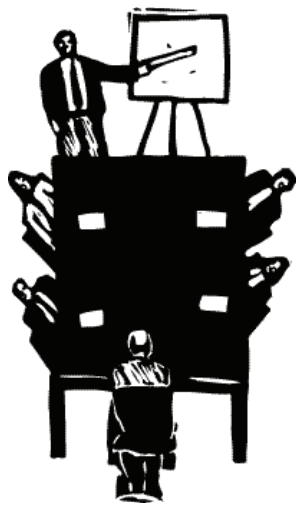
I worked in an office, so I had some computer skills and could go online. That gave me access to information that a lot of my neighbors didn't have. I started to think that was really what people in my part of the world needed: access to information. That's what it all came down to, whether you're talking about going to college, or learning about ways to get a student loan.

I decided I wanted to offer an education placement service. I wanted there to be a friendly local place where families could come to hear about options for educating their kids. I wanted them to be able to hear about it in plain English, without all the bureaucratic talk that scares people off.

I felt like I knew what people needed, because I needed it myself. So many times in my life I wanted help, and wasn't sure where to turn. Now, I'd find my way by helping other people find theirs. I felt good about that idea. I didn't need much money to live on, so feeling like I was making a difference was the main thing. I had three bright, beautiful kids depending on me, so I had to stay optimistic while doing everything I could to make sure things would work out.

Ella had come up with a great service, and people in her area needed it badly. There was a huge amount of help in America for poor and disadvantaged areas, but the people who needed it most often didn't know how to find it or apply for it.

When Ella had her idea, there were over 700,000 nonprofits offering loans, grants, part-time jobs, scholarships, information, and tutoring. A small business that could provide information—and be a clearinghouse for loans, grants, jobs, and school openings—would be a godsend in her community. She wouldn't make a lot of money, maybe, but what she made would make a big difference at home. And what she learned on the job could make all the difference in the world to her kids.



Ella's overhead would be low. All she'd need was a computer with a powerful database program; a speedy DSL connection to the Internet; a subscription to the Lexis/Nexis search service, which would give her access to information that wasn't easily available elsewhere; and a small office.

She checked on what a designated service line (DSL) would cost. Then, she called every legal aid and rural assistance agency she could find, and made appointments to come in and talk. She made a careful list of everything she'd need, and got a total for both fixed and variable costs.

She estimated that with the computers, the software and any reference books she may need, and an office space, she'd have to come up with four thousand dollars.

The question was, where would she get the money?

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SBA MicroLoan Program

The SBA MicroLoan Program provides very small loans to start-ups. Under this program, SBA makes funds available to nonprofit local lenders. These lenders then make loans to eligible borrowers. The maximum amount available is $35,000, and the maximum time for repayment is six years.

The local lenders—which act as middlemen between borrowers and the SBA—have different requirements in terms of collateral, credit, documentation, and so forth. In most cases, you'll need to provide personal financial statements. You'll also have to submit a business plan, to show that you've researched your market and competition. Loan requests for less than $5,000 are usually processed within a few days. Larger loans may take up to month to be processed. All lenders are required to provide training and technical assistance to borrowers.

To find participating microlenders in your area, go to http://www.sba.gov/financing/microparticipants.pdf, or contact your local SBA office.

7(a) LowDoc program

This "low documentation" version of the popular SBA 7(a) program makes it easier for small-business owners to get SBA guarantees on commercial loans under $150,000. Since its creation in 1993, nearly 90% of LowDoc applicants have gotten loans.

As its name implies, the paperwork involved in LowDoc is minimal. You complete the front of a one-page SBA application, and the lender completes the back. (Supporting financial documentation is required, of course.)

You must offer collateral. However, the loan won't be turned down if inadequate collateral is the only problem with the application.

Best of all, you'll get an answer to your request within 36 hours!

Prequalification Program

This program assists low-income borrowers, disabled business owners, new and emerging businesses, veterans, exporters, and rural businesses.

When seeking a guaranteed loan, you work with an intermediary who makes sure your application is in good order. Once the intermediary feels your application is ready, he or she sends it to the SBA. If the SBA finds the application has merit, it issues a letter declaring its willingness to guarantee your loan.

To find out whether there's a prequalification intermediary in your area, contact your local SBA office.

U.S. Community Adjustment and Investment Program (CAIP)

This loan program was created in 1993, in order to help U.S. communities that suffered significant job losses as a result of the North American Free

Trade Agreement (NAFTA). As of this writing, over 230 counties in 29 states are eligible for this loan, as measured by job losses and unemployment rate.

CAIP can be used with both the 7(a) and 504 SBA loan programs. Note that CAIP loans include a job-creation requirement. For 7(a) loans, the borrower must create one job for every $70,000 that the SBA guarantees. For 504 loans, the borrower must create one job for every $50,000 that the SBA guarantees.

Small Business Investment Company (SBIC)

The SBIC Program is the only venture-capital program sponsored by the federal government. The SBA licenses private venture-capital firms, and these SBICs have a portion of their financing guaranteed by the SBA. They provide equity capital and long-term debt to small businesses with significant growth potential. The cost of loans and debt securities is regulated by the SBA.

Specialized Small Business Investment Company (SSBIC)

SSBICs are much like SBICs, but have additional financial leverage. This is provided by the SBA in return for agreeing to invest in, or loan to, small businesses with socially or economically disadvantaged owners.

Other Government Loan Programs

The loan programs offered by state and local governments vary greatly from state to state. Many regions, counties, and cities have microbusiness development funds; check for such programs in your area. Local governments may operate the program themselves, or through another agency.

Rural Economic & Community Development Administration

The USDA's Rural Economic & Community Development Administration (RECDA) offers loan programs for small businesses in rural areas. You can visit http://www.rurdev.usda.gov for up-to-date availability and terms.

Intermediary Relending Program

The Intermediary Relending Program (IRP) makes loans to small businesses in cities with a population of less than 25,000. The loans are made by intermediaries such as CDCs, or other nonprofit organizations. The loan can finance up to 75% of a project, with a maximum of $150,000. Loan recipients must document their inability to finance the project through commercial credit or other government programs. This program often appears locally under the name Rural Development Fund.

Community Development Block Grants

These grants were originally offered by the Department of Housing and Urban Development (HUD) to aid with neighborhood revitalization. In the mid-1990s, the regulations were relaxed so that CDBGs could also be used for microbusiness development. CDBG funds are awarded either through city and county governments, or—in the case of rural areas—through state governments. For more info, visit http://www.hud.gov/offices/cpd/communitydevelopment/programs.

Business & Industry Loan Guarantee Program

The Business & Industry (B&I) Loan Guarantee Program encourages commercial financing of rural businesses. The business owner applies through a commercial financial institution, and together they submit an application to RECD. Most types of businesses in cities with a population of less than 50,000 are eligible. There's no official minimum loan, but loans typically begin at the SBA 7(a) maximum and can be as high as $10 million.

Revolving Loan Funds

Local and regional revolving loan funds were originally capitalized with grants from the Economic Development Administration, the HUD Community Development Block Grant Program, and other sources. These loans take a subordinated security position to a loan from a private lender. Loans are limited to eligible borrowers in particular counties or cities. Standards and rules vary from region to region.

Equity Financing

If you decide to seek equity capital, remember that you're selling a portion of the ownership of your business. If your business is presently a sole proprietorship, it will have to become either a partnership or corporation. This is a complex issue, for which you should seek legal help.

If your business is a partnership, the provider of equity capital will become a partner. How much of your business the investor will own is a matter of negotiation. You should have a written partnership agreement that thoroughly details the rights and obligations of each partner. Most partnerships are general partnerships. Limited partnerships have specific accountability and tax considerations; if you intend to form a limited partnership, you must consult an attorney who is experienced in these issues.

Preparing to Seek Financing

Here are five factors lenders and investors consider to be very important when evaluating a financing proposal:

- The growth potential of your business
- The risk of your business venture
- The length of time you need the money
- The kind of money you need (debt or equity)
- The amount of interest you can pay (debt), or the amount of ownership you'll give up (equity)

As a micro-entrepreneur, you'll probably find that banks don't want to loan money to you, because they think you're likely to default. As for investors, they put their money in businesses only when they believe they'll earn a good return. In other words, they want to get back their original investment, plus a profit, in a relatively short time (e.g., five years) You must meet certain criteria in order to convince investors to risk their equity capital with you.

The best way to overcome these doubts is to prepare a thorough business plan, and make a confident presentation to potential lenders or investors.

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Of course, it wasn't hard to find an empty storefront in Hamlin. That was the easy part! I called around and looked at some places, and it seemed like for a few hundred a month, I could have my own little office.

I thought hard about working out of my home. It wouldn't cost a thing, after all, and I thought people might feel more comfortable there.

But it didn't take me long to find problems with that notion. For one thing, I didn't have the lines for DSL at home, and dial-up would be too slow *for my needs. Also, we were cramped together in our little house as it was.*

But I think the most important thing was that I wanted to look like a real, honest-to-goodness business. Not just for whoever was going to lend me money, but also for myself. I wanted to leave the house each day, and go to my own office. I liked how that idea felt in my mind.

Ella had no illusions about the level of income she'd be dealing with. Her neighbors weren't exactly rolling in money, but she assumed that there'd be enough revenue to keep her up and running.

When she approached her local bank for a loan, she found out that she was wrong. Her banker explained the problem: If she charged what her target customers could afford, she wouldn't bring in enough money to stay afloat. If she charged enough to keep her doors open, no one would be able to afford her services! Although the banker liked her idea, his responsibility was to make safe loans that would earn money for the bank; making a loan to a business like Ella's simply wasn't economically feasible.

However, he did give her some good advice. He told her that he thought nonprofit status was the way to go, but cautioned her that she'd need to prepare herself to jump through some hoops. He recommended that she contact the National Association of Women Business Owners (NAWBO), and get advice on researching and applying for grant money.

Ella joined NAWBO, and got access to their information and counseling services. Through them, she learned about the grants that were available for projects like hers, and the requirements of the agencies that offered them. Susan Finney, her NAWBO counselor, suggested that her best bet would be the Appalachian Enterprise Council. They made grants to nonprofit groups that were working to increase local opportunities, and they had a special interest in higher education. Ella's idea fit their mission perfectly.

Susan explained that the AEC program was unusual. Unlike most regional grant-making organizations, it actually provided tech grants for computers, software, and networks. If they determined that her idea was worthwhile and viable, they'd provide her with start-up and operational money. They'd assess her program regularly, and as long as it remained successful, they'd renew the funding.

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Determining How Much You Need

Start-up owners are often unsure about how much financing to request. The amount is based on future projections, and we're all rather uneasy about predicting the future!

There are two things to consider when deciding how much funding to request.

First, the amount you ask for depends on how your business will use the funds, and the type of collateral you can offer. For instance, the amount available for financing the purchase of a piece of equipment may be determined by a bank rule limiting such loans to 75% of the purchase price. The financing of real estate and fixed assets is usually limited by a maximum percentage of the transaction.

Second, your cash flow projections define the amount of money you need to borrow, and demonstrate the monthly payments that your business can afford. The number of years required to repay a loan depends on the length of financing being sought.

WHERE TO GO FOR FINANCING? HOW MUCH MONEY DO YOU NEED?

If you need less than $20,000, look close to home:

Your wallet (personal savings accounts you can tap)
Home equity loans
Credit cards
Loans from personal sources
SBA Microloan
Equipment leasing
Loans from friends and family
Microlenders
Peer group lending
Asset financing
Customers
Suppliers

If you need $20,000 to $100,000, go for:

Bank loans
Bank lines of credit
Home equity loans
SBA Low-Doc loan program
Equipment leasing
Factors and suppliers
Loans from personal sources
Strategic partners
Friends and family
Customers and suppliers
Asset financing

If you need over $100,000, but less than $1 million, look into:

Bank loans
Bank lines of credit
SBA 7a loan program
Equipment leasing (for large equipment)
Angels
Strategic partners
Private placement
Venture capital

HOW MUCH TIME DO YOU HAVE?

"None! I need the money now!" then try:

Credit cards (but beware of high cash advance fees and interest rates)
Friends and family

"Don't need it today, but will in a couple of weeks." Go for:

Bank line of credit
Bank loan
SBA LowDoc bank loan
SBA Microloan
Loans from friends and family
Home equity loans
Equipment leasing
Loans from personal sources
Customer or supplier financing
Asset/Receivables financing

"I'll definitely need money this quarter." Complete your business plan and look at:

Strategic partners
SBA Microloan
Investments from friends and family
Bank loan
Community fund loan
Equipment leasing
Loans from personal sources
Customer or supplier financing
Asset/Receivables financing

**"I've got months."
Good planning! You have time to reel these in:**

Venture capital
Strategic partners
Private placements
Banks

Getting Debt Financing

Lending relationships are built on trust, confidence, and open communications. Keep your lenders informed of the positive and negative aspects of your business. If you're honest with them, they'll be more willing to work with you if you run into problems.

If you decide to apply for a loan, most lenders will want the following information:

- **Business loan application form**. Available from the lender.
- **Business plan**. Use your NxLeveL® Micro-Entrepreneur Business Plan.
- **Cash flow projections**. Depending on lender requirements, you should either have monthly cash flow projections for 2 years, or monthly ones for the first 12 months and then quarterly for the next two years. Many lenders and investors also ask for projected Income Statements and Balance Sheets.
- **Personal financial statement (PFS)**. Your PFS will be required for a start-up business loan, in part to determine what collateral you have.
- **Personal tax returns**. Some lenders will want to see copies of your personal tax returns to verify the income you stated on your personal financial statement.

Lenders ask for personal financial information to assess whether you'll be able to repay the loan if your business fails. In most cases, they'll probably ask you to pledge your personal assets as collateral. This is a personal guarantee that you'll repay the loan, even if you go out of business.

The Five Cs of Credit

Here are five factors that lenders will consider when evaluating your financing proposal.

Credit

As we discussed in Session 1, your credit history is a record of the way you handled your debts in the past. Good personal credit is one of the most important factors in acquiring a start-up loan. If you have a history of missing loan payments, or have filed for bankruptcy, the lender will be more concerned about lending to you.

Do you know what a credit check will reveal about you? If not, have a credit company perform a check, so you'll know what to expect!

You can order a copy of your personal credit history by contacting TCI Credit Bureau or EQUIFAX, who will send you a copy of your credit report for a small fee.

Credit problems don't automatically disqualify you from getting a loan, but they may slow the process down. If your credit problems stem from a specific situation, include information on the situation and explain the steps you've taken to fix it.

Character

The soundness of a small-business loan is often dependent on the trustworthiness of the owner. Your reputation in your area is important, so you should provide excellent local business and personal references!

Capacity

Lenders expect a business to be able to make loan payments from its profits. "Capacity' refers to your business's ability to repay the loan with cash generated from operations. Your financial projections should address this concern, by explaining how you expect to repay your loan. If your projections are too optimistic, you may have difficulties convincing a professional lender that they're realistic.

Before applying for a loan, take these simple steps:

- **Do a little investigating.** Speak with the bank or lending institution, and find out what kinds of companies they lend to. Some banks shy away from certain industries, companies in trouble, or small companies. If you don't fit the profile of companies they lend to, don't waste your time.
- **Check your credit history.** If you have a blemished credit record, try to clean it up before you start applying for new credit. If you have a marginal credit record, only apply for loans from lending institutions that accept companies or people with marginal credit. Expect to pay higher interest rates.
- **Get your business records in order.** Most lending institutions will want to see your books and tax returns. If you haven't opened your business yet, they'll want to see your Cash Flow Projections and Personal Financial Statement.
- **Find a lending institution that regularly lends to small business.** Many banks don't know how to assess the viability of a small-business loan.

Collateral

If your business can't make its loan payments because of poor sales or low profits, the lender may satisfy the debt by taking title to your collateral. Items most valued as collateral include (in order): cash, marketable securities, Accounts Receivable, inventory, equipment (including automobiles) and real estate (including your home). Before approaching a lender, evaluate your collateral and be prepared to pledge it as security for the loan.

Conditions

This refers to the overall economic situation in the area where you live and the nation as a whole. If economic conditions are depressed, it affects all levels of the business community.

Cleaning Up Your Credit

Do you have bad credit? If you do, don't give up! It's possible to rebuild your credit history. It may take a while. But if you have the knowledge and willpower, you can do it!

One of the best ways to keep yourself out of credit trouble is to monitor your credit report. Get a professional credit report done every year, and before any major purchase. This lets you see yourself the way lenders, insurance companies, and other businesses do. It also gives you a chance to correct any false information in your report.

Your Financing Presentation

Your business plan and presentation are the most important tools you have when looking for outside financing. To develop an effective presentation, keep these hints in mind:

- **Preparation**. Be thorough in preparing your business plan, and in preparing yourself to approach lenders and investors. Think about all the questions you might be asked, and have answers ready. If you don't know an answer, don't guess! Tell them you'll get back to them with an answer, and then do it.
- **Practice** with friends, family, and your mentor before you make the actual presentation to lenders or investors.
- **Positive attitude**. Confidence and enthusiasm can be contagious! Show your confidence in yourself and your business. You build this through preparation, practice and a belief in your ability to succeed.
- **Persistence**. Persistence is often the biggest factor in your ability to get financing. If you're turned down, ask the lender his or her opinion about the strengths and weaknesses of your plan and your presentation. Before you leave, ask whether the lender will reconsider your application if you make the needed changes. Then, act on that advice.

Getting Ready Emotionally

Seeking money will test your stamina, your patience, your sense of humor, and your self-confidence. Ask yourself these questions to test if you're ready to go through with it:

- Are you ready to hear "No"? Not all businesses get financing the first time they make a presentation!
- Are you ready to hear "Yes"? Are you prepared for success? Are you ready to swing into high gear and actually open the business?
- Are you ready to make the necessary changes? Most loans are denied for specific reasons—you need to address them before you try again.

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One thing Susan made very clear to me was that a grant isn't just free money that they give you for nothing. I'd have to work very hard to get it, and I'd have to work even harder to keep it. I couldn't just sit in my little office collecting checks. I had to be able to do what I said I would, and prove that it was really working.

That meant keeping track of what happened to people after they came to me for help, and doing everything I could to make sure they succeeded. They don't want to pay to send kids to school who'll just drop out a month later. Nonprofit or not, I'd still have to run things like a business.

It started to seem like a really big job. Too big for me, maybe. But Susan said "A big job is just a bunch of little jobs." If I just plugged away at the little jobs one after another, I'd get the big one done in the end. That made sense, because that was how I'd been living for years. I thought, "I can do that. I've always done that!"

Ella knew she needed to put a lot of work into her business plan and financial projections before she could make a pitch to AEC. And with Susan's guidance, that's just what she did!

She wrote up an executive summary of her business plan, and a cover letter in which she clearly outlined how much funding she needed for her educational clearinghouse. She had Susan doublecheck her spelling and grammar, and—finally!—sent the package to the AEC.

After several meetings with Ella, the AEC decided to approve her grant request. They were very impressed with her business plan. They thought the idea was sound, and that her cost projections were on target. And they also recognized that as a local person who was a potential consumer of education grants, she was in an ideal position to understand and help other people like her.

Their only concern was that Ella was a sole proprietor. They knew that partnerships had a higher rate of success, and were generally more stable. Fortunately, one of the resources they offered was a program that matched mentors with start-ups. They introduced Ella to Katie Frazer, a 31-year-old business development manager for a firm in Charleston, who'd volunteered to help Appalachian microbusinesses. Ella's clearinghouse was exactly the kind of project she'd been hoping to mentor, and she and Ella hit it off right away.

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Understanding Financial Ratios

Financial ratios can tell you a lot about your business's strengths and weaknesses. They can tell you whether your financial condition is getting better or worse, and help you to identify and remedy problems before they spiral out of control. They can also tell you whether you're holding too much or too little inventory, or collecting receivables too slowly.

All companies and bankers use financial ratios, which help them get to know your business better. In addition, these ratios are used as a measure of your ability to repay loans.

Ratios are not a day-to-day task of your business. You'll use them each month when you review your financial statements and are anxious to see how you are doing, and also when you apply for loans. When you begin to look at all those numbers, what are they telling you? Is it good news or bad news? What things should you plan to do differently?

While there are numerous ratios, there are a few that micro-entrepreneurs find especially helpful:

Current Ratio

This is the standard measure of a firm's financial health. It's a good idea to look at your current ratio every month.

To see your company's Current Ratio, divide total current assets by total current liabilities:

Current Assets / Current Liabilities

Example: Suppose your company has $32,000 in current assets, and $14,000 in current liabilities:

32,000 / 14,000 = 2.3

A ratio of about 2 is usually healthy. It means that your business has two dollars of assets for every one dollar of debt. A ratio of 1 or less usually means you have financial problems. A ratio over 3 may mean you're not making the best use of your assets.

Gross Profit Margin

This ratio indicates the margin you earn on sales. To calculate it, divide Gross Profits by Sales, and multiply the result by 100.

(Gross Profits / Sales) x 100

Gross profit is the amount of sales dollars left after you deduct cost of goods sold. Your GPM should remain stable over time. A decline in your gross profit margin may mean that your product costs are rising faster than your prices. A high margin is usually good, but it can also indicate overpricing, which may mean that your goods aren't competitive.

Net Profit Margin

The higher your net profit margin is, the better your company is at turning sales into profit. If your business is having cash flow problems, calculating your net profit margin can help you set prices that generate an adequate profit. If this ratio declines, it may signal serious financial trouble! Here's how to calculate your net profit margin:

(Net Profits / Net Sales) x 100

Example: Your Income Statement shows that your net profit for this year is $5,000 and your net sales are $20,000. This is a ratio of 25% ($5,000 / $20,000 = .25, or 25%). In comparison, your last year's Income Statement showed a net profit of $3,000 and gross revenues of $18,000. This is a ratio of 16% ($3,000 / $18,000 = .16, or 16%).

This tells you that your company became more profitable (16% for last year and 25% for the present year). A decline in profitability, of course, would be a danger signal.

Debt to Equity

This ratio compares what your company owes (debt) to what it owns (equity).

(Total Debt / Total Equity)

Example: Suppose your Balance Sheet shows $10,000 of total debt (short-term liabilities plus long-term debt). And the equity amount totals $5,000 (this is the cash you invested up front).

(10,000 / 5,000) = 2

This means your ratio of debt to equity is 2 to 1. In other words, for every dollar you invested, you borrowed two. Lenders and investors usually consider 2 to be a safe level for this ratio. The higher the number is, the more financially risky your business is.

If necessary, you can improve this ratio by paying off debt, or retaining a higher amount of earnings in the business until after the balance sheet date. Another option is to repay revolving debt (e.g., a line of credit) before the balance sheet date, and borrow it again after the balance sheet date.

Debt to Assets

This ratio reveals the proportion of your company's assets that are financed through debt.

(Total Debt / Total Assets)

If the ratio is less than one, most of your assets are financed through equity. If the ratio is greater than one, most of your assets are financed through debt. A high debt to asset ratio may indicate a serious danger of bankruptcy.

Inventory Turnover

This ratio tells you how often your inventory turns over (is sold) in the course of a year. To calculate it, simply divide net sales by inventory.

Net Sales / Inventory

A high ratio is usually a sign of business health. But it can also mean that you're not keeping enough inventory on hand, which could be a problem if there's a sudden demand for your product. On the other hand, if you sell something perishable, like a food product, you'd expect to have a high turnover.

A low turnover is always a problem. It could mean that your prices are too high, or that there's not enough demand for your product.

Payables turnover

How quickly does your company pay its bills? The payables turnover will tell you.

(Accounts Payable / Purchases for Year) x 365

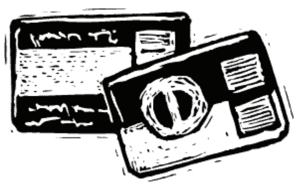
A high ratio means there's a relatively short time between your purchases and payments. A low ratio may indicate cash flow problems.

Credit and Collections

A credit and collection policy is something a lot of small businesses put off developing until they have no choice. This is a bad idea! When you don't plan ahead, you often end up spending a lot of time fixing problems you could have avoided. Developing a well-thought-out credit policy early on may make the difference between your business's success or failure.

There are three ways you can offer credit.

- **Credit cards**. If you decide to accept credit cards, you'll have to choose which ones you want to accept: Visa, Master Card, Discover, American Express, or any of the others. Each credit-card company has different policies for its members, but the charge you pay to the credit-card company will normally vary with your sales volume and amount. The average fee usually runs between 2.5 percent and 5.5 percent. Some, like American Express, charge a higher rate. Accepting credit cards is the least risky of your options, because most of the risk is on the credit-card company. Businesses that deal with customers primarily over the telephone, through the mail, or online usually need to accept credit cards.
- **Checks**. Although checks are usually considered to be cash rather than credit, they're included here because they do involve some risk on your part. When you accept a check as payment, you're bearing the risk that the check will be good.
- **Credit terms**. In some cases, you may want to offer credit terms to your customers. This is the riskiest option, because you're forced to rely completely on the creditworthiness of your customers. When you extend credit terms to your customers, you'll want to have them sign a sales contract that explains the terms clearly (e.g., payment is due in 30 days)



Credit Cards

The typical credit-card transaction begins when your customer hands you the credit card. What you do with the card depends on which system you have in place. You'll either manually imprint the card onto a paper draft (if you use the older technology), or swipe the card through an electronic terminal (if you use the newer technology).

If the transaction is handled over the telephone or Internet, or through the mail, it begins when the customer gives you the credit-card number. In that case, you'll either fill out a paper draft, or key in the number at your computer.

The next step is for you to obtain permission from the credit-card company to process the sale. If you're using the older technology, you'll have to call a special number to get an authorization code (this is usually required with sales over a certain amount, such as $50). If you're using the newer technology, the authorization code will be obtained automatically. Once you have the authority, the last step is to obtain the customer's signature on the receipt (phone and Internet sales don't require a signature).

Then, you'll send the credit-card sales receipts to the bank so that you can get paid. If you use the older technology, you'll have to take the receipts to your bank. If you use the newer technology, you can send the receipts electronically. This process is done at the end of the day, and is called "settling your accounts."

Your bank will authorize the charge, and notify the credit-card company (or some company acting on its behalf) of the charge. That company will collect the money from the bank that issued the card, send it to your bank, and bill your customer. Once your bank has the money, it will put it in your account, minus a processing fee (called the discount rate), which is split between your bank and your credit-card company.

When your customer pays the bill, the credit-card company sends the money to the bank that issued the card, minus another processing fee.

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I met up with Katie every other week, and we talked on the phone a lot too. One thing she really helped me with was figuring out how to use my money. Like with the computer, she explained that I had two options. If I used loan money to buy the computer, I'd have a new asset, but I'd also have a new liability. Plus, I'd have to maintain the computer, and depreciate its value on my balance sheet over time.

Katie looked at Ella's cash flow projections, and felt like leasing was the way to go. First, Ella could record the cost of the computer equipment as an expense, thus lowering her net taxable income. Second, the computer supplier would provide service and technical assistance, allowing Ella to focus on her work. Third, the lease would allow Ella to upgrade her computer when better ones came on the market.

In her first six months of business, Ella met with Katie every couple of weeks, and got valuable guidance on staying organized, promoting her services, and setting up effective databases to help match clients with resources.

As a condition of the grant, the AEC required Ella to offer a standardized tutorial to applicants for education funding, which would help them prepare for college. After studying training methods recommended by Susan at NAWBO, she was able to teach her applicants to do research, take tests, and complete homework assignments. She also explained the ins and outs of college registration, and the importance of choosing and working towards a specific educational goal.

She offered a two-hour class once a week, and taught six to eight students at a time using videotapes and overheads. The cost of these classes was included in the flat fee she charged for her placement service.

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Looking for the best rates

Shopping for the best merchant account rate is like shopping for anything else. You want the best value at the lowest price. Don't make the mistake of assuming you'll get the same rate at every bank!

Here are the things you should consider:

- **Discount rate**. The discount rate is the sum that is deducted and paid to the credit-card company and the issuing bank. It usually ranges from 2.5 percent to 5.5 percent of your credit sales, depending upon the volume of your sales and the typical transaction size.

- **Transaction charge**. The transaction charge is the profit that the processing network makes. It's usually included in the discount rate, but it may be charged separately. The transaction charge is really the only element of the discount rate that you can negotiate. Ask each bank you visit about its transaction charge and then compare the numbers. If one bank has a transaction fee higher than another bank, ask the bank why the fee is higher. You should find out if you get any additional services for the higher fee.

Check Policies

Here are some things to consider when setting your check policy:

- **Call the bank first.** If a check is large, and you're doubtful about it for any reason, you can call the bank that issued the check and ask if there are sufficient funds in the account to cover it. You can also ask for a rating on the account, or any history of bad checks.
- **In addition to identification, obtain the individual's phone number.** Also, look closely at the picture on the driver's license, and jot down the license number on the check. This will confirm that the person is who he or she claims to be, and it will also help you to collect if the check turns out to be bad.
- **Decide what checks you will take beforehand.** The SBA recommends never accepting checks that are undated, postdated, or more than 30 days old. Checks should be written and signed legibly in ink, with no erasures or written-over amounts. Also, be careful of checks without a printed address or sequence number.
- **Use a company that verifies checks**. More and more businesses are using the services of check-verifying companies. There's a fee for the service, and you'll need to get online to use it. But if you follow the procedures, the verifying company assumes the risk if a check doesn't clear the bank.

Collection strategies for bounced checks

No matter how careful you are, you'll get a bad check sooner or later. You'll get a check that bounces because of nonsufficient funds (NSF), a closed account, or no account. Most checks returned because of nonsufficient funds will clear the second time you deposit them. A check can only be re-deposited once, however. So if it's for a large amount, you may want to telephone the person who wrote it, to make sure there will be sufficient funds to cover it the second time around.

If the check bounces again, you can send a certified letter notifying the recipient that you intend to put the matter into the hands of an attorney if you don't receive payment within a specified time. (You may not have an attorney, but the recipient of your letter won't know this!) A formal, typed letter on good stationery will strengthen your demand for payment.

Another option for collecting on a bounced check is to take it to your bank and ask them to try to collect for you. There may be a small fee for this. Normally, the bank sends the bounced check back to the originating bank, with instructions to pay you as soon as funds have been deposited to the account. However, if a deposit isn't made during this holding period—usually a month—you're out of luck.

Hang onto the bad check as proof of the customer's indebtedness to you. If you believe there has been intent to defraud, you may wish to send a copy of the returned check (along with notes about your efforts to collect the money) to the District Attorney's office. Another choice is your local police department. When you get a bad check from an out-of-state customer, your police department may be able to work with the police in your customer's city to get action. They can't actually collect the money, but since it's a crime to write a bad check, police intervention might throw a good scare into your customer.

Credit Terms

Many microbusinesses accept only cash. Of those that offer credit, most limit what they accept to checks and credit cards because the risks are fairly low. However, microbusinesses that sell to other businesses may need to offer credit terms of 30 or 60 days to their customers.

If you need to offer credit terms, here are some basic guidelines:

- Base your credit decisions on the individual customer's creditworthiness.
- Realize that the credit terms you offer might differ from one customer to the next. Your best customers deserve more generous terms! (The reverse is also true: your worst customers deserve less generous credit terms.)
- If a customer is late on payments, you may have to reduce or eliminate the credit terms you offer that customer until he or she re-establishes a good payment record.
- Expect to achieve your ideal credit policy only through trial and error. You'll inevitably make some errors about who's a good credit risk, and who isn't.
- Consider your policy in relation to your cash flow. Your policy should not endanger the cash flow needed to operate your business.
- Remember that your credit policy will change over time, along with your business's growth and economic conditions. You should re-evaluate your policy every so often to make sure it still meets your needs.

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I'm not the most exciting speaker in the world. But when I come to people and say, "I can help your kids get an education," they hear me loud and clear.

A big part of it is that I have my own experiences to share with them, so they know that I've really lived through what I'm talking about. I'm nobody special, and my story is a lot of people's story in these parts. What it comes down to is, I speak their language. There's a lot of help out there for people like us, but it seems like some of us need to hear about it from one of our own before we understand that it's a real option.

People here have a lot of pride, and that can be an issue. But when it comes to your kids, a lot of that falls by the wayside, thank heavens. I know one man who wouldn't take a nickel from anyone for himself. But when he found out I could help him get his daughter's tuition paid…well, he told me what mattered most to him in the world is that she get the best she could out of life.

At the end of her first year, Ella had thirty families involved, with a total of 42 kids from sixteen to nineteen. Her personal filing system was up to 370 contacts, and she was constantly making new contacts with schools and agencies looking for gifted, disadvantaged students.

She found that as a depressed area, Hamlin was eligible for help from an enormous number of nonprofits. She also found that the joy of local parents who suddenly see a brighter future for their kids is very infectious!

I'm not getting rich, but I'm making more than I did before. I'm building up some savings, too. The best thing is that Mary will be starting at a regional *community college in September. If I make the people I've helped anywhere near as happy as Mary going on to college makes me, then I've got as good a job as I could ever want.*

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What You've Learned

This session dealt with obtaining the financing you need to get your business up and running. It explained sources of financing, the importance of establishing a good working relationship with your lender, the lending process itself, and the importance of making yourself emotionally ready to seek financing.

In this session, you learned:

1. Debt capital is money you borrow, and equity capital is money you get in return for a share of ownership in your business
2. Sources of capital can include your own funds, angel money from family and friends, and other lenders and private investors.
3. Before you talk to a possible source of financing, you must know exactly how much money your business needs, and what its projected revenues and expenses are.
4. Just as you spend time getting your financing proposal ready, you must also be emotionally ready. Prepare to be successful!
5. Whether you're seeking financing, or simply managing your business day to day, it's important to test the financial health of your business with ratio analysis.
6. A well-thought-out credit policy will save you time and trouble, and may make the difference between success and failure.