

**Financial and
Legal Management**

Chapter 9
Small Business Finance

Small Business Finance

- Initial Capital Requirements
 - Identify the short-term and long-term assets.
 - Determine how to pay for these assets.
- Sources of Financing
 - Owner-provided funds (equity)
 - Borrowed funds (liabilities)

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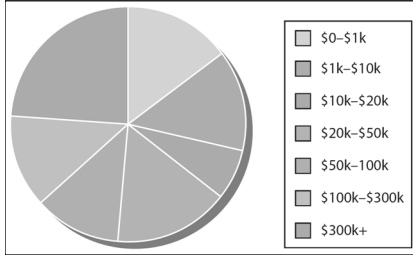
Defining Required Assets (cont'd)

- Steps to Determining Required Assets
 - Prepare asset "wish list".
 - Review the list to determine essential ("bare-bones") assets.
 - Determine the costs for assets under each scenario.
 - Determine financial requirements: subtract the total dollar value of owner's equity from the total dollar value of the required assets.

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Figure 9.1: Kick-off Dollars



4 SOURCE: "Crunching the Numbers," Inc. 500, 2004, 111. Hatten, Small Business Management, 4th Edition

Additional Considerations of Credit

- Personal Managerial Skills
 - Show that you are a competent manager with a track record of prior business success
- Oversight and Guidance
 - Have an informal board of directors whom you may contact for assistance
- Proof of Business Activities
 - Provide audited financial statements showing a solid record of earnings
- Personal Financial Investment in the Business
 - The extent of your invested equity in the business

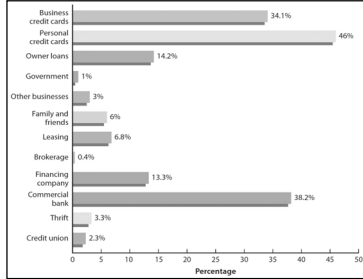
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Table 9.1: General Approximation of Different Forms of Collateral Valuations

Collateral Type	Bank	SBA
House	(Market value × 0.75) – mortgage balance	(Market value × 0.80) – mortgage balance
Car	Nothing	Nothing
Truck and heavy equipment	Depreciated value × 0.50	Same
Office equipment	Nothing	Nothing
Furniture and fixtures	Depreciated value × 0.50	Same
Inventory: perishables	Nothing	Nothing
Jewelry	Nothing	Nothing
Other	10% – 50%	10% – 50%
Receivables	Under 90 days × 0.75	Under 90 days × 0.50
Stocks and bonds	50% – 90%	50% – 90%
Mutual funds	Nothing	Nothing
IRA	Nothing	Nothing
CD	100%	100%

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Figure 9.2: Where Capital Comes From



7 SOURCE: U.S. Small Business Administration, "Patterns of Small Firms," September 2003, www.sba.gov/ADVO

Basic Financial Vocabulary

- Debt (Liabilities)
 - Are funds borrowed from a creditor.
- Leverage
 - Is the ability to finance an investment through borrowed funds.
 - Can increase the potential returns on personal equity.
- Repayment of Debt
 - Can constrain future cash flows and magnify losses.
 - Can cause technical insolvency.
 - Can lead to bankruptcy.

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Basic Financial Vocabulary (cont'd)

- Principal
 - The original amount of money borrowed from a lender
- Interest Rate
 - The amount of money paid for the use of borrowed funds
- Factors affecting the interest rate on a loan:
 - Prime rate
 - Effective rate of interest
 - Compensating balance
 - Compounding
 - Fixed or variable interest
 - Maturity

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Basic Financial Vocabulary (cont'd)

- Equity
 - Is funds supplied by investors in exchange for an ownership position in the firm.
 - Does not have to be repaid.
 - Does not constraint cash flows of the firm.
 - Can reduce management's autonomy.
- Equity Financing
 - The sale of common stock or the use of retained earnings to provide long-term financing.

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Basic Financial Vocabulary (cont'd)

- Other Loan Terminology
 - Loan security
 - Is assurances to a lender that a loan will be repaid.
 - Is provided by endorsers either as co-makers or as guarantors.
 - Loan restrictions
 - Spell out what the borrower cannot do or what he or she must do.
 - Negative covenants preclude additional debt or limit dividends.
 - Positive covenants can set minimum work capital requirements, require loan insurance and financial reporting.

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How Can You Find Capital?

- The Loan Application Process
 - Credit scoring
 - Financial statements supplied by the applicant
 - Local or regional credit associations
 - Credit interchange bureaus
 - Applicant's bank

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Commercial Banks

- Short-Term (Unsecured) Loans
 - Uses: inventory, cash flow, and monthly expenditures
- Types of short-term loans
 - Line of credit
 - Demand note
- Long-Term (Secured) Loans
 - Uses: Land, machinery, buildings, and renovations
- Types of long-term loans
 - Installment loans
 - Balloon notes
 - Unsecured term loans

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Commercial Finance Companies

- Floor Planning
 - A business holds and pays interest on high-priced ("big-ticket") inventory owned by lender until it is sold to repay the lender for the inventory-secured loan.
- Leasing
 - A finance company purchases goods and rents them to a business for a specific period of time.
- Receivable Factoring
 - A business either sells its accounts receivable at a discount to a finance company outright or uses the discounted receivables as collateral for a loan.

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Insurance Companies

- Policy Loan
 - Is a loan to a business by an insurance company, using the business's whole-life, variable-life, or universal-life policy insurance policy as collateral.
 - Is based on the cash surrender value of the policy.
 - Is typically limited to 95% of the cash surrender value.
 - Has a low interest rate because the default risk is zero.

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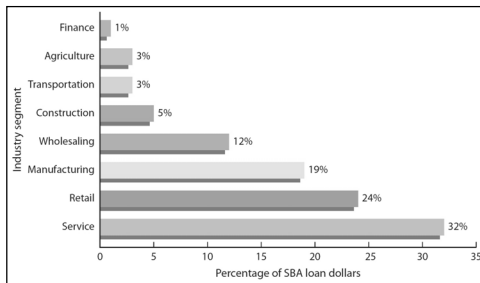
Federal Loan Programs

- SBA Guaranteed Loan
 - Is a small business loan through a commercial bank.
 - Has a portion of the loan amount guaranteed by the SBA 7(a) program.
 - Cannot be made to businesses engaged in speculation or real estate rental.
 - Requires 20-30% owner equity investment.
- SBA 504 Loan
 - Provides 40% loan guarantees for fixed assets through certified development companies.

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Figure 9.3: Who Gets SBA Loans?



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SOURCE: U.S. Small Business Administration, www.sba.gov

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Other Loan Sources

- State and Local Government Lenders
 - Certified Development Company
 - Assists with the acquisition of fixed assets
 - Other state and local programs
 - Are tied to economic development goals
 - Have lower interest rates than conventional loans, often with longer maturities.
- Trade Credit
 - Is the purchase of goods from suppliers who do not demand payment immediately.
 - Helps cash flows of small businesses.

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What If a Lender Says “No”?

- Thank the lender for the time spent reviewing your package.
- Ask what specific information—or lack thereof—counted against you.
- Ask the lender for specific, personal recommendations.
- Understand that business loans are turned down for sound reasons.
- Ask whether the bank can rework your application so that it fits with the institution’s lending criteria.
