PART

One

Survey of Funding Small Business

CHAPTER 1

How Small Businesses Are Funded

"Small" business is the category still used to classify more than 99 percent of the 27 million business entities in the United States (although 75 percent of them have zero employees). Representing approximately 40 percent of all commercial sales, 50 percent of the U.S. gross domestic product, and over 55 percent of the nongovernment work force, small business is really *big* business.

This sector is credited for having created two out of every three new jobs in the United States for the past two decades, yet obtaining capital financing continues to be a challenge for most small business owners and entrepreneurs. And opposing logic, capital funding gets more challenging as the loan size decreases, rather than increases, at least as far as commercial banks are concerned.

DEFINING SMALL BUSINESS

Part of the ongoing confusion around small business financing is that there is no clear, absolute definition of the question, what is a small business? The federal government delegated the task of defining small business to the U.S. Small Business Administration (SBA) and they have stratified the response to make it necessary for anyone seeking an answer to that question to flip through a 46-page list of industrial codes to determine the agreed upon answer.

SBA defines small only according to the agency's determination of business size relativity. And even that size relativity gets subdivided into different determinants used according to their classification. Each distinct business category defined by the North American Industry Classification System (NAICS) is assigned a limitation by SBA, usually expressed as either the maximum annual revenues or the maximum number of employees, to determine whether they are officially deemed a small business.

As defined by the SBA's Table of Small Business Size Standards, *small* to some companies can be defined as maximum annual revenues of $750,000 (dry pea and bean farming) while for other companies that limit can be as much as $35.5 million (marine cargo handling). But other companies are adjudged small by a maximum of 100 employees (tire & tube merchant wholesalers) while some others can employ as many as 1,500 (aircraft manufacturing) and still be considered small.

All distinctions in this table are not as gaping, as is illustrated by Table 1.1, which highlights the range of income difference in one single category (Subsector 541—Professional, Scientific and Technical Services). In this group of industrial sectors, maximum allowable income to be defined as small ranges from $7 million to $35.5 million. And for some reason, in the middle of this list is one business defined small as having no more than 150 employees.

And still other sectors are determined to be small by metrics such as annual megawatt hours (power generation) or assets (credit intermediation).

There are about a thousand categories broken down among 19 sectors and 90 sub-sectors in the table, which inevitably offer capital providers one more barrier to navigate on the road to deploying resources. But since there is much non-lending public policy riding on the outcome of this definition, the SBA has an impressive Size Standards Methodology[1] that is used to guide these determinations; this is published and available on their website, and makes any category subject to review at almost any time for a variety of reasons.

Not lost on many persons trying to distribute capital is the additional confusion created by simply getting a business adequately categorized. The starting point, at least for existing companies, might be to check the federal tax return of the subject company to see what they have defined themselves to be in the eyes of the IRS, which requests business filers to add the "business activity code" in forms 1120 and 1120S, and a listing of these same NAICS codes is found in the respective instructions for both forms.[2]

But that category, which is usually declared by either the business owner or the tax preparer, is sometimes wrong. Many business owners simply don't want to be bogged down reading a long list of business categories and will choose the first reasonable sounding category they find. Many high-volume discount tax preparers simply speculate, based on a one-time engagement or limited history with the client and take a guess at what the business as named really does.

The confusion that surrounds the definition of what a small business is comes amid the massive communication streams in our digital society and the role public policy and advertising play in encouraging economic growth, regulating the financial sector, and trying to find a source of capital.

TABLE 1.1 Small Business Size Standards

NAICS Codes	NAICS Industry Description	Size Standards in Millions of Dollars	Size Standards in Number of Employees
Subsector 541—Professional, Scientific, and Technical Services			
541110	Offices of Lawyers	$10.0	
541191	Title Abstract and Settlement Offices	$10.0	
541199	All Other Legal Services	$10.0	
541211	Offices of Certified Public Accountants	$19.0	
541213	Tax Preparation Services	$19.0	
541214	Payroll Services	$19.0	
541219	Other Accounting Services	$19.0	
541310	Architectural Services	$7.0	
541320	Landscape Architectural Services	$7.0	
541330	Engineering Services	$14.0	
Except,	Military and Aerospace Equipment and Military Weapons	$35.5	
Except,	Contracts and Subcontracts for Engineering Services Awarded under the National Energy Policy Act 1992	$35.5	
Except,	Marine Engineering and Naval Architecture	$35.5	
541340	Drafting Services	$7.0	
541350	Building Inspection Services	$7.0	
541360	Geophysical Surveying and Mapping Services	$14.0	
541370	Surveying and Mapping (except Geophysical) Services	$14.0	
541380	Testing Laboratories	$14.0	
541410	Interior Design Services	$7.0	
541420	Industrial Design Services	$7.0	
541430	Graphic Design Services	$7.0	
541490	Other Specialized Design Services	$7.0	

(*Continued*)

TABLE 1.1 (*Continued*)

NAICS Codes	NAICS Industry Description	Size Standards in Millions of Dollars	Size Standards in Number of Employees
541511	Custom Computer Programming Services	$25.5	
541512	Computer Systems Design Services	$25.5	
541513	Computer Facilities Management Services	$25.5	
541519	Other Computer Related Services	$25.5	
Except,	Information Technology Value Added Resellers		150
541611	Administrative Management and General Management Consulting Services	$14.0	
541612	Human Resources Consulting Services	$14.0	
541613	Marketing Consulting Services	$14.0	

Source: "Table of Small Business Size Standards," U.S. Small Business Administration, 21. www.sba.gov/sites/default/files/files/Size_Standards_Table.pdf.

Megabanks are notorious for massive marketing campaigns targeting small business clients, who they seek for a myriad of banking services like checking accounts, merchant processing, and payroll services, as well as credit products. But no one ever clears these campaigns with the credit underwriters ahead of time and they often lead to a surge in loan applications that wind up declined.

Likewise, when politicians offer grandiose legislation intended to encourage stronger business growth or more capital funding, there is confusion around exactly who they are targeting. For example, national debates in recent years around income tax reductions have cited the need to relieve the onerous tax burdens on "small business owners."

That phrase may conjure up visions of the neighborhood café or convenience store owner and hence gain valuable popular support for the proposal. But that politician may actually be working at the behest of a hedge fund operator earning $50 million annually. Since that manager is organized as an S-corporation or LLC (limited liability company), he or she has every right to claim title as a small business owner, but obviously it's a mask used to hide the fact that a very wealthy person is pressing for a tax reduction.

Many larger banking companies, under pressure from politicians, regulators, and business advocates to increase lending, can easily mask how well they are stretching the limits to offer more funding to the small business sector simply by exploiting differences in what the Federal Deposit Insurance Corporation (FDIC) quarterly call report considers a small business loan (loans under $1 million) and how it's defined by the SBA. Technical default seems to be fair game in today's public relations communications.

In any case, those most often impacted by all the labels and confusion are the small businesses themselves. Often the average small business owner is woefully unprepared for the financial management of his or her company, much less acquainted with how or where to source third party funding.

For a staggering percentage of business owners who cannot read a financial statement or tax return beyond numbers disclosing their cash balances and taxes owed, targeting the appropriate funding source based on the business use is often beyond their recognition skills. Hence, when they see or hear "business financing," they flock to anyone.

And therein lies the most fundamental dilemma for borrowers and lenders: the lack of cognitive financial literacy on the part of business owners wanting to access third party financing. A very large percentage of the small business sector drives what might be surprisingly large companies on only their reading of a bank account statement. Many mistakenly think that "if there's money in the bank at the end of the year, they must be profitable."

These business people can't read basic financial statements. Typically limited to looking at the cash balance and net profit, they're content to let their tax preparers drive most financial strategies with the singular goal of reducing the impact of federal income taxes. At the expense of potential future business growth, they avoid business profits, retained earnings, and development of stronger financial metrics—what bankers want most—just to avoid paying taxes and accountants.

Plenty of lenders don't mind such an unsophisticated participant, so long as the fundamental conditions exist for a prudent lending transaction. But there is a natural limit to how much capital these less-informed entrepreneurs can access (see Figure 1.1), which is reduced by the quality of financial information they produce.

It's unlikely that business owners would ever pay for audited financial statements that they can't read. And they will never grow large enough to

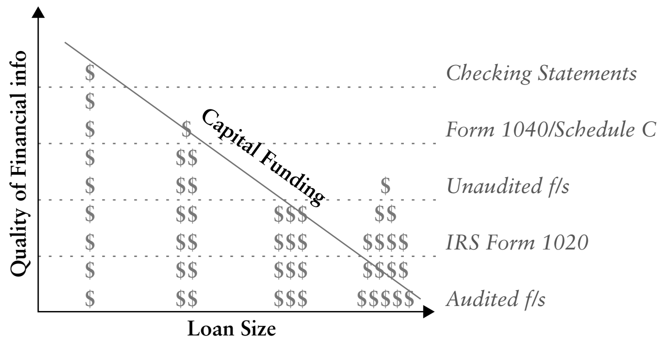

FIGURE 1.1 Quality of Financial Information versus Loan Size

need them anyway, so long as they rely only on internally prepared financial statements and annual tax returns to measure their financial progress.

ABCs OF SMALL BUSINESS FUNDING

Depending on the nature of a company and its balance sheet, and to some extent the planned use of funding proceeds, lenders seem to have an insatiable appetite for information. Banks in particular are sometimes intense in the volume and breadth of information they require even to decline a loan application.

Part of the banking sector burden is rooted in other regulatory concerns—some overzealous regulators at times seem to be applying many consumer loan protections to small business owners, so banks tend to look under every stone to ensure they have complied with many possible interpretations of the regulations.

In banker-speak, they concern themselves with gathering a healthy list of documentation and information with which they can assess loan applicants against the five Cs of credit: capacity, capital, credit, collateral, and character.[3]

The standard repertoire for general business lending requires at least three previous years of financial statements and tax returns, a personal financial statement from all business owners, credit reports, business plans, financial forecasts, detailed asset schedules, collateral appraisals, and a litany of business information provided on an application form or one question at a time.

As illustrated in Figure 1.2, the sometimes exhausting degree of application examination deters many qualified borrowers who would ultimately get funding. They can sometimes be simply too busy with the endless duties required to operate a business or overwhelmed by the administrative burdens required to gather and present what many banks required to consider a loan request.

Unfortunately, banks have not provided many solutions for mutual benefit. Too many banks are stuck in methodologies of the 1960s when it comes to gathering and analyzing application information. Very few companies have embraced integrated technology that could simplify the transfer and examination of borrower information for both borrower and lender.

And, it's fair to say that the analysis burden suggested by the regulators can also be out of proportion to the degree of safety it may actually add to lending, compared to the cost burden on lending in a hyper-competitive economic period with fewer deals deemed qualified to fund.

Outside banking, many companies have reformed their credit criteria and changed their outlook on risk, based on the nature of their lending or theories on funding risks. For example, non-bank working capital lenders long ago stopped obsessing over credit reports and other information for a simple reason—their lending relationships gave them control of borrower cash accounts. Late car payments and medical bills of the business owner were inconsequential as to whether they would be repaid.

Likewise, in the growing innovative funding sector, participants are looking at seemingly unthinkable borrower attributes and a range of other metrics (or semi-metrics) to define borrowing risks, measure repayment capacity, and price funding.

For many business owners, the essential information and strategies needed for small companies to be fundable are changing. The climate in which business owners now search for funding has been altered by an expanding number of capital sources that are more sharply delineated by the kinds of situations they fund. Most new capital providers are funding a narrower and more distinct business profile as a means of containing risk and targeting their marketing.

In light of the movement away from small business lending by the banking sector, many small business owners needing funding now elect to accept funding that in other times would have been considered to have outrageous borrowing terms, just to get the money and get their business going. But they often enter a financing arrangement without really understanding the true costs of funds. Sometimes such a leap works out well, even if it's unnecessarily expensive or restrictive. Sometimes things don't go so well.

These conditions will change and improve over time as the broader market discovers rich opportunities in meeting these credit needs, particularly

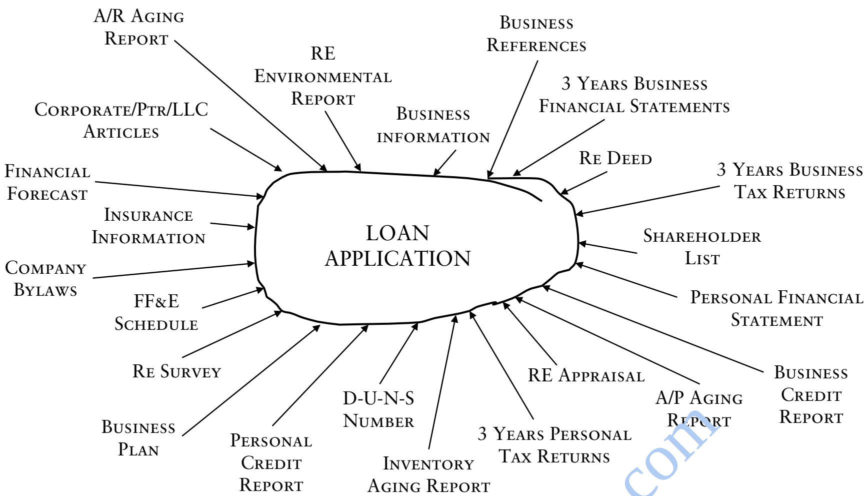

FIGURE 1.2 Common Loan Application Requirements

as technology assists in the delivery of capital. New funding strategies and underwriting methodologies will also change as a path to scaling more, smaller loans that have targeted uses and shorter repayment terms.

Traditional capital providers have not risen to the challenges presented by the information age fast enough, to provide sufficient funding for opportunities created by utilizing new technologies or meeting consumer service demands. This circumstance is likely to change.

USUAL SUSPECTS PROVIDING BUSINESS CAPITAL

Banks are sources that the general population, businesses, and non-businesses, assume will provide the majority of their business capital funding. Often, without considering the nature of their funding request or what should be well-known limitations as to what a bank can or will provide financing for, newly minted entrepreneurs and business owners flock to bank branches in every nook and cranny to get money.

According to the SBA Office of Advocacy, in 2010 approximately 90 percent of the $1 trillion of annual small business borrowing is sourced from banks ($652 billion), finance companies ($460 billion), and the SBA[4] (see Figure 1.3). They note that the sum of outstanding small business loans was higher in 2010 than in 2006. All other sources of financing (mezzanine, angel capital, and venture capital) account for less than 10 percent of small business funding.

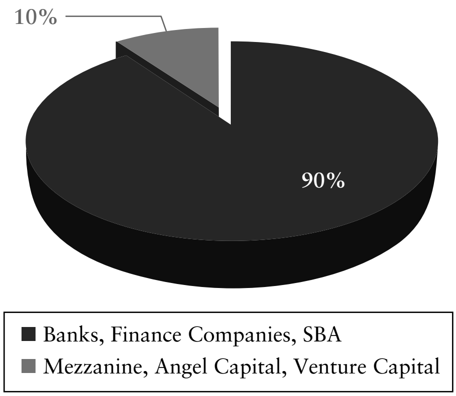

FIGURE 1.3 Sources of Small Business Financing

Pepperdine University's Graziadio School of Business and Management produces a quarterly economic survey titled "The Pepperdine Private Capital Access Index" (PCA). This index measures the demand for, activity, and health of the private capital markets. The purpose of the PCA Index is to gauge the demand of small and medium-sized businesses for financing needs, the level of accessibility to private capital, and the transparency and efficiency of private financing markets.

According to their PCA Index dated June 30, 2013, among those companies with annual revenues of less than $5 million that attempted to obtain financing during the previous quarter, most often banks were targeted, reported 59 percent of the respondents. The next highest responses were business credit cards (57.2 percent) and personal credit cards (49.9 percent), which are both also primarily funded by banks. Less than one-half of the respondents sought out personal loans (48.4 percent) or assistance from friends and family (44.2 percent)[5] (see Figure 1.4).

But the financing success among these businesses was found to be in the opposite order. Most often, funding was provided by friends and family (71 percent), followed by personal credit cards (58 percent), trade credit (57 percent), and business credit cards (54 percent). Bank loans trailed far behind at a miserable 27 percent.[6]

Yet despite this reality, 63 percent of survey respondents still think their likely source of business financing will be a bank, which is almost 1.5 times the number of companies expecting to rely on business credit cards (44 percent).[7] Telling, though, may be another statistic reflecting that 67.7 percent of respondents expect it will be difficult to raise debt financing in the next six months.[8]

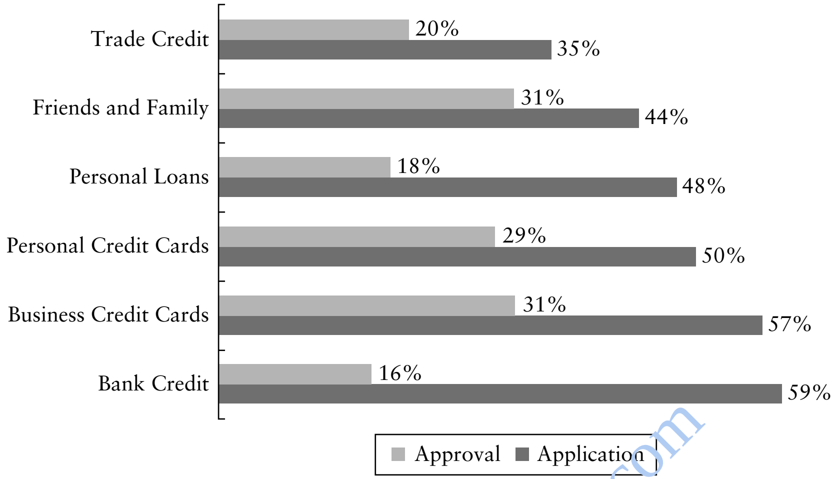

FIGURE 1.4 Small Business Financing Applications versus Approvals

These conditions parallel a similar study conducted by the Cleveland Federal Reserve Bank, which concluded, "The 15-year-long consolidation of the banking industry has reduced the number of small banks, which are more likely to lend to small businesses. Moreover, increased competition in the banking sector has led bankers to move toward bigger, more profitable, loans. That has meant a decline in small business loans, which are less profitable (because they are banker-time intensive, are more difficult to automate, have higher costs to underwrite and service, and are more difficult to securitize)."[9]

THE RISE OF ALTERNATIVE FINANCING

Part of the constantly changing landscape for business financing is rooted in the business prerogatives of the capital providers themselves. Over the years, the kind of businesses served and exact funding uses that banks would lend for changed frequently as several variables changed within the industry. Many factors led to such changes, such as economic trends, perceived risks, administrative costs, and profitability.

In decades past, many banks provided working capital loans to businesses of all sizes in the form of monitored lines of credit. These credit lines, called asset-based loans (ABL), required the bank to monitor daily or weekly company shipments and capture company payments directly from their customers. An agreed formula between bank and borrower defined how much the bank would advance against outstanding invoices that were monitored regularly with a borrowing base report.

ABL lending is provided to companies that are asset-intensive and require plenty of cash flow to meet the demands of a constant turnover of inventory and receivables. Known by some in the corporate sector as the lender of last resort, by its nature, ABL is expensive due to the many hands employed to supervise and manage lending and collections. Finance charges for ABL lending are usually presented to the borrower as a function of prime plus, but the real cost is obfuscated with a variety of fees and charges for every manual function provided to administer the loan and often includes contractual costs associated with the actual volume of use and annual commitments.

To be sure, there is plenty of non-bank competition for this kind of financing. ABL is used extensively in the manufacturing sector to allow companies to keep workers converting raw material into goods while payment is floated for 30, 60, or 90 days from buying retailers and wholesalers. Companies like CIT and former legacy lenders Textron and Heller have been strong competitors to banks over the years, though their costs of funds were generally higher and accordingly they took higher risks than banks.

Many bank and non-bank finance companies in this area also engaged in a different type of funding to provide working capital—that is they *factored* or bought a company's receivables rather than advancing loan funds against them. In a true factoring arrangement, the selling company (seller) sells the cash obligation of their customer to pay for goods they have shipped, and the factor (buyer) purchases it for a discount from its face value with no recourse to the seller. In other words, the seller can only collect the debt from the obligor and not the selling company.

With the constant communications required between borrower and lender on a daily basis during years devoid of personal computers, application software, or even fax machines, the company monitoring process required highly trained bank employees. These costs could not be scaled easily and eventually became significant enough for banks to question the profitability of this lending if they did not capture sufficient market share.

By and large, only larger banks offered asset-based lending as a product line because of the significant expertise required. And with the relative high cost involved, most banks were not interested in serving smaller companies that might be requesting less than $1 million. Besides generally being weaker credits, the banks needed to focus on more profitable accounts to cover the overhead of running a well-managed ABL operation.

These conditions gave rise to smaller, non-bank finance companies that formed with an eye to serving smaller borrowers who needed lines of credit ranging from $250,000 to $1 million. These companies were started with private equity that was usually augmented with a local bank line of credit. A broader range of smaller, regional banks generally are willing to fund these companies to provide lending capital for covering loan portfolios or to *re-lend*.

Today, the list of loans funded indirectly by banks has grown to include many other high-risk, high-priced lending categories, like payday lenders that advance money to consumers against the proceeds of their next paycheck. Whether it's due to our fear of bad publicity to fund these kinds of loans or to circumventing regulations to get higher yielding assets, lender financing adds to the complexity and costs of capital for consumers and small business owners alike.

The non-bank finance company sector has long been dubbed the alternative financing sector and was principally comprised of ABL and factoring companies. Over the years, though, this label seemed to be applied to any funding source that was not a bank. Today, it is even applied to funders ranging from micro lenders to municipal and state lending programs and to a broad group of technology-powered funding companies.

The alternative financing category is overdue for a makeover and, as indicated in the introduction, this book suggests defining technology-powered, data-centric small business funders and lenders as the *innovative funding* sector. It is an alternative of a different stripe, and hopefully the distinctive name will help business owners and other capital providers distinguish it from the usual suspects and factoring crowd as well.

Notes

1. U.S. Small Business Administration, "Size Standards Methodology," www.sba.gov/content/size-standards-methodology (accessed September 1, 2013).
2. Internal Revenue Service, "Instructions for Form 1120S," www.irs.gov/pub/irs-pdf/i1120s.pdf (accessed September 1, 2013).
3. Charles H. Green, *Get Financing Now* (New York: McGraw-Hill, 2012): 31.
4. U.S. Small Business Administration, "Frequently Asked Questions about Small Business Finance," www.sba.gov/sites/default/files/2014_Finance_FAQ.pdf (accessed June 29, 2014).
5. The Pepperdine Private Capital Access Index, June 30, 2013, Graziadio School of Business and Management, Pepperdine University, 24.
6. Ibid., 23.
7. Ibid., 41.
8. Ibid., 40.
9. Anne Marie Wiersch and Scott Shane, "Why Small Business Lending Isn't What It Used to Be," Federal Reserve Bank of Cleveland, www.clevelandfed.org/research/commentary/2013/2013-10.cfm.