START-UP FINANCING PRACTICES FOR SMALL BUSINESSES

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Abstract

This paper examines several financing alternatives for small businesses. An entrepreneur's familiarity with the available initial financing options aids in the selection of the best alternative. Financing alternatives were reviewed from the most simplistic of forms, personal, family and friends' funding, to complex methods, such as venture capital. Entrepreneurs should identify critical factors or decision variables for use in the selection of the best initial financing alternative. The weight or importance of individual factors varies with entrepreneurs and companies. The appropriate initial financing alternative should balance these critical factors. By evaluating the proposed degree of complexity with respect to the structure of the new business, and comparing it to the funds that are necessary, decision criteria for the determination of the best initial financing option is developed. Initial financing alternatives are evaluated with respect to cost, financial flexibility, availability, accessibility and alignment. A survey of a number of Southeast Texas businesses was undertaken to determine the sources of financing utilized in this area. The data will be analyzed and the results discussed when the analysis is completed in the Spring of 2005.

Introduction

National policy makers have long claimed small businesses are the backbone of economic growth and job creation in the United States. In the academic arena, courses in small business and entrepreneurship have increased in number over the last decade. There has also been an increase in academic research in this area over the last two decades. The financing, or bootstrapping, of small business has drawn some academic interest.

Landstrom and Winborg (2000) defined financial bootstrapping as the use of various methods to meet the requirements of small business financial resources without relying on long term external financing from debt and/or new equity. To determine the type of bootstrapping small businesses undertook, they surveyed business owners. From the surveys, 5 categories of bootstrapping were developed. They concluded the occurrence of financial bootstrapping needed further research.

Howorth (2001) undertook case studies to review the pecking order of preferred small business. She found the pecking order of finance to be: internal equity; short term debt; long term debt; and external equity. The reluctance to move down the list was attributed to owner concerns about losing control of the business. The analysis also found that short-term/long-term debt was closely tied to the type of asset being financed rather than a preference for either type of financing. She also found that issuing external equity initially had to be very carefully structured and priced to avoid a disproportionate transfer of value from one group of shareholders to another. The analysis indicated a wide range of bootstrapping methods was available to the small business owner through long term debt.

Small business ownership is a dream of many individuals; and they hold this dream for several reasons. Probably the most stated reason is "to be one's own boss", along with getting "rich". There is also self-gratification - a sense of accomplishment and pride from establishing a business and watching it grow over time. Some may want to own a business in the belief it will ensure a secure family future. In each situation, the potential owners have thoughts of selling a product or service in an industry where each may have specific knowledge or skills. These hopeful owners soon find the resources and formalities necessary to gain initial funding of a new business and additional funds as needed can be quite difficult to obtain. Insufficient start-up capital is a primary reason for the early failure of small businesses. An accurate determination of initial capital requirements is a critical element of the initial financing decision. A strategy for the determination of initial capital requirements and additional funding, the costs associated with this capital and the management of this capital requirement are keys to business success.

The potential owner will find there are many factors involved in the funding decision: the type of loans to apply for, amount of capital required, interest rate, pay-back period desired, type of business entity and the opportunity costs involved. This requires a clear business plan (with pro forma financial statements) and an estimated cash budget of what the new company wants to do and how it will use all acquired funds (Home Business, 2002; Shankin, 1998; Wuorio, 2002). The business budget should be treated as an estimate of cash flow but a conservative estimate. Investors (debt and equity) will want to know how the invested funds will be used and how the investor will receive a return. The estimated budget needs to be tracked with real numbers to determine where adjustments need to be made.

Alternate Forms Of Small Business Financing

There are several forms of financing available to the new business owner considering a business start up. These alternatives include personal funds, funds from family and friends, credit card advances, lines of credit, home equity loans, small business administration loans and angels/venture capitalists. Alternatively, the new owner can use life insurance cash value and retirement plans. Using retirement plans should not be considered unless there is very strong belief that the new business will be a large success. Any failure under this arrangement and the owner will not be able to recoup in time for a reasonable retirement. A final concept is seeking a partner to form a strategic alliance. The new owner must tell the potential partner

how both parties can benefit from this partnership.

Finding initial start up financing will take careful research and good negotiation skills (Mathews, 2001). As previously discussed, the first step to determining what a company's debt needs will be a comprehensive business plan. This issue is not the subject of this paper, but it is the primary function of a potential small business owner.

1. Personal Funds and Family and Friends

New business owners will find it difficult to obtain external financing during the first years of business (Lassus, 1998). What new owners soon discover is their personal finances are inextricately tied to the business. The owner will need to finance both the business and personal financial needs for three or more years. When personal funds are short, the owner frequently must approach friends and family.

Obtaining funds from friends and family requires careful treatment by the owner because this source is always risky from the relationship side. All agreements must be in writing to avoid future sour relationships. When issuing stock, the owner must be careful to comply with all state and federal rules.

The owner needs to be aware that the initial personal investment is not a loan in the eyes of the government. Each loan needs to be carefully documented. The owner needs to carefully watch the debt-equity ratio so the government won't re-characterize the claimed loan as equity.

2. Credit Cards

A personal credit card is in essence a form of using personal funds. Credit cards come in different forms for the consumer and business owner and many have options to entice their use. A credit card advance is the simplest form of financing available to start up a business, however it still requires acceptance from the creditor through the means of credit scoring (Ryman-Tubb, 2000).

Credit scoring is a decision tool used by credit managers and underwriters to decide whether an applicant, consumer or corporate, should be accepted or rejected on the basis that his behavior will resemble the behavior of similar past applicants. This tool can also be utilized to tailor product offerings to consumers, such as special annual percentage rates (Ryman-Tubb, 2000).

Credit card companies generally offer slightly lower interest rates to business cards than consumer cards, thus, corporate cards are more difficult to obtain. Lenders review the business and personal credit repayment history when reviewing the application and determining the interest rate the card will carry. Interest rates generally decline as a cardholder moves from standard to gold to platinum (and now titanium) cards. Some lenders may decline to issue corporate credit cards if a company has not been in business for several years (www.allbusiness.com).

Both consumer and corporate cards offer convenience, in terms of buying supplies and other business expenses, as well as providing a systematic way to keep track of expenses for general record keeping and tax purposes. Some credit card companies generate a detailed statement of business expenses monthly or annually. This management report of an itemized total of all expenses separated by expense category makes it easier to effectively track expenses.

Consumer and corporate cards may offer additional perks: air miles, travel insurance, warranty extensions and discounts on rental cars, hotels and gas. The true cost of having these perks and

incentives should be analyzed as there may be higher interest rates and/or fees on these types of cards (www.allbusiness.com).

Credit cards are offered with either variable or fixed rates. Variable rate cards are the prime rate plus points, which varies from lender to lender. (www.allbusiness.com). Adjustments to the prime rate are made periodically, each time the federal reserve raises interest rates (www.nsfn.com).

The major credit cards offer grace periods on purchases, usually 25 days, which means interest charges may be avoided altogether if the balance is paid in full each month (www.mbna.com). If the account balance is paid within the grace period the business has obtained an interest free loan. Otherwise, the loan interest is frequently higher than a normal bank loan.

Variable rates are different than the "teaser" rates frequently advertised. Teaser rates last for a limited time (usually three to six months), after which the issuing bank applies a higher interest rate. These rates should not be considered when making a decision about credit cards unless the owner is willing to take the time to change credit cards often enough to take advantage of a string of teaser rates.

The card holder needs to consider the use of cash advances and the transaction fees associated with them. The credit card company usually charges a minimum percent per cash advance transaction for to cardholder (www.mbna.com) Interest charges on cash advances usually start when the cash advance is taken and has no grace period.

3. Lines of Credit

Most small business owners will go to a bank in an attempt to secure short term loans. These small business owners mostly prefer the neighborhood community bank over the regional bank because of the personalized service at the community bank (Prince, 2001). One type of short term loan the small business owner tries to obtain is a line of credit.

A line of credit is a revolving loan typically used to finance short-term or seasonal expenses. A line of credit is used to borrow cash and interest is charged on the outstanding monthly balance. Each time a borrower pays back principal, money is freed up again for future loans. Credit lines can be open-ended or they can be due at the end of a specified term (www.allbusiness.com).

A line of credit can be a personal loan or a commercial loan. Many small businesses, especially start-ups, rely on personal credit lines to finance their companies. A home equity credit line is a good example of a secured personal credit. Unsecured credit lines are also available, but their interest rates are usually higher (www.allbusiness.com).

The commercial lines of credit are preferable to personal credit lines because they use company assets, rather than personal assets, as collateral. Although generally harder to obtain, commercial lines of credit typically provide greater borrowing power. Both types of loans have set borrowing limits which can vary greatly based on a company´s collateral and cash flow needs (www.allbusiness.com).

For a small business, interest rates on commercial credit lines are usually the prime rate plus points and are based in part on an evaluation of business venture risk. Interest rates are usually negotiable and the borrower should shop around before accepting a line of credit from a particular lender (Mochari, 2000).

Commercial banks are not the only source available to a small business for a line of credit. Investment bankers, such as

Merrill Lynch, also offer lines of credit along with possible additional advantages; for example, a bank may require monthly financial reports, while an investment banker may only require quarterly reports (Mochari, 2000).

Lines of credit should be established in advance of their need. The time to obtain credit approval is before the company requires the funds. Establishing this line of credit is likely easier while the applicant is still holding a job than after the applicant becomes self-employed (Anthony, 2002A) Once established, credit lines are easily accessed by requesting a transfer of funds into a business checking account and some banks allow Internet transfers. Banks may allow the account to automatically draw from a line of credit as needed to help manage cash and keep the interest payments down (www.allbusiness.com).

Home Equity Loans As Lines of Credit

Two-thirds of all households own homes making home equity the largest net wealth for most individuals. The Tax Reform Act of 1986 increased the popularity of home equity lines of credit and home equity loans by making some types of interest deductible on the consumers' income tax return. (Niemira, 1998). This has provided an alternative source of financing for a new business. Though the interest rates on home equity loans and home equity lines of credit are typically lower than credit cards and consumer lines of credit, they are similarly tied to the prime rates.

A home equity line of credit is a revolving credit agreement with a fixed credit line in which the borrower can write checks up to that limit. Home equity loans are lump sum amounts borrowed at a variable or fixed interest rate and the loan is paid off in installments (Niemira, 1998). Even though these are not first mortgages, they are still related to real estate and must also meet the strict lender requirements, state law, Real Estate Settlement Procedures Act (RESPA) and Truth In Lending criteria (Bielski, 1999).

Interest deductibility rules state that if a home equity loan is not used for the purpose of home improvement then the interest is only deductible to the extent that the combined amount of the home mortgage does not exceed the fair market value of the home. Any funds in excess of the fair market value of the home do not have deductable interest (Napach, 1999). However, if this loan is for the purpose of business expenses, all of the interest is deductible against the business income and would not be reported as an itemized deduction with the original mortgage interest. Basically, it is treated no differently than if it were interest from a business loan or line of credit (IRS, 2000).

4. Small Business Administration Loan

When many small business owners go to a bank to make a loan, they frequently have in mind an SBA loan. The Small Business Administration (SBA) is designed to help small businesses get the financing needed to begin operations via several lending programs. The overlying program offered by the SBA is the 7(a) Loan Guaranty Program. This program reduces the risk to lenders by guaranteeing a substantial amount of loans made available to small businesses.

The SBA's loan programs are basically designed for longer term loans; however, the actual loan maturity will depend upon the borrower's ability to repay, the purpose of the loan proceeds, and the useful life of the assets financed. The SBA offers two basic types of business loans which are determined by the length of the note: short-term and long-term (www.sba.gov).

A short-term loan is deemed to have a maturity of one year or less and includes working capital loans, accounts receivable loans and lines of credit. A long-term loan is typically from one to seven years while a loan for real estate or equipment can have a maturity up to 25 years. The purpose of long-term loans is for major business expenses (www.sba.gov).

The interest rates available to a borrower can be either fixed or variable and are no more than 2.25 percent over the lowest prime rate for a loan that has up to seven years to mature. For loans with maturities of seven years or more, the interest rate is no more than 2.75 over the lowest prime rate (Anthony, 2002C; Wichmann, 1999). A nominal fee is charged by the SBA to the lenders which is usually passed on to the borrower and is based on the loan maturity and amount the SBA is guaranteeing. A borrower must pledge a sufficient amount of collateral to secure an SBA loan. In addition, a personal guarantee and liens on personal property may be required from the principal owners of the business (www.sba.gov). Although the borrower must generally qualify under the bank's lending requirements, the SBA may consider cash flow more important than collateral, thus giving less weight to collateral than the bank. The SBA will want to know if there is sufficient cash flow to cover regular operations and repay the loan (Anthony, 2002C). The basic eligibility requirements state that the business must be operated for a profit and it must fall within specific size standards established for the borrower's trade or business.

5. Angels And Venture Capital

Out of the alternatives available to small businesses, venture capital is the most difficult form of start-up financing to obtain and start ups are rarely candidates for venture capital (Shankin, 1998). This option is used for projects that require a substantial amount of funding up front, typically at least $500,000, and the venture capitalists finance a project in return for an equity portion of the company. This process usually begins with angel investors (www.sba.gov).

Most angel investors are successful business leaders or professionals who make significant investments in other companies, usually early-stage startups. They typically invest in businesses within their particular area of experience and expertise and usually invest from twenty-five thousand to half a million dollars. The most important role of an angel investor is to infuse the startup with cash after banks decide there is too much risk and before there is enough profit potential for venture capitalists. Unlike other types of financing — such as bank loans — angel investors often take a hands-on advisory or consulting role in the company during the start up phase (Ricadela, 2000).

An angel can assist an entrepreneur acquire future rounds of financing, build an executive team, choose advisory board members and meet potential business partners. Angel investors expect to turn a profit by owning a part of the company and the business owner should have a business plan for providing a reasonable return to the angel. Typically, a cash return within five to seven years is considered reasonable by angels and is often achieved by selling the company or taking it public (Ricadela, 2000).

In addition to angel investors aiding in the search for potential partners, consultants can be helpful in locating a venture capitalist. They can also assist the venture capitalists with research of

various factors of the company before deciding to invest. These factors include: strong management, a growing market, a unique product, initial price offering (IPO) candidate or acquisition target, sound business plan, significant gross margins, and "home-run" potential.

Venture capitalists are interested in companies with more than 25 million dollars in revenue, a large national or international market and a management team with a successful track record. Thus, venture capitalists usually get involved after the angel investors have invested as much as they can for the risk that is involved. There are several stages that a venture capitalist might progress a company through. The first stage usually consists of an investment in the range of a couple million dollars, thereafter moving up in stages to five million dollars or more (Ricadela, 2000). With this type of investment, the greatest amount of risk is shifted to the venture capitalists; therefore, they generally require returns of 80 percent to 100 percent on their investments (Adler, 2000).

Financing Options And Decision Variables

Awareness of available small business financing options enable entrepreneurs to make better decisions in selecting the most appropriate course of action. An accurate determination of initial capital requirements is a critical element of the financing decision and is tied to a comprehensive business plan and cash budget. The appropriate initial financing alternative should balance the following critical factors or decision variables:

1. *Cost* of the capital alternative.
2. Capital alternative's effect on the organization's *financial flexibility*.
3. Capital's *availability* given the company's operation, industry, market segment, etc.
4. Capital's *accessibility* given specific entrepreneur criteria.
5. Capital alternative's *alignment* with the organization's strategic direction.

Determination of Capital Requirements for Initial Financing

Insufficient start-up capital is a primary reason for the early failure of small businesses. An accurate determination of initial capital requirements is a critical element of the initial financing decision and this requires a sound business plan. A strategy for the determination of initial capital requirements, the costs associated with initial capital and the management of initial capital requirements must all be covered in the business plan.

Derived from cash flow projections and the company's initial financial requirements, start-up costs (one-time costs) and working capital requirements provide an indication of a company's initial financing requirements. One-time costs and working capital are two categories of costs associated with any new business venture (www.allbusiness.com). One-time costs are expenses associated with the planning, establishment and opening of a business. Working capital is the monetary requirement necessary to cover operating expenses until these costs can be covered out of revenue.

As a benchmark, working capital requirements requested during initial financing should cover a minimum of one full business cycle, defined as a period of

time, usually one year or less, during which complete turnover of the company's inventory base occurs (www.morebusiness.com).

Working capital management is critical to the survival of a start-up business venture and adherence to a responsible working capital management strategy can increase the long-term financial success of a company. One such strategy requires the separation of initial capital from deposited income. Under this strategy, the company uses initial capital to pay current cycle expenses while saving the current cycle income. The next cycle expenses are paid with this cycle's income and this process is repeated each cycle (www.morebusiness.com). This strategy incorporates responsible initial and working capital management.

Selection of the appropriate financing alternative follows the determination of initial capital requirements for a start-up business venture. A comparison of major initial financing alternatives with respect to cost, financial flexibility, availability, accessibility, and alignment will now be discussed.

1. Personal, Family and Friend Funding

This is usually the first funds available to the small business owner. Conventional lenders, e.g., banks, want small business owners to hold an equity (risk) position in the company.

1.a. Cost

The financial cost can be lower than the other sources of available credit or loans. Owners' funds are typically under priced because most owners do not realize there is a true cost of the funds – an opportunity cost. Funds from family and friends have varying financial costs. Debt funds may be priced closer to actual market rates. Equity funds may be priced too low as the owner again does not realize the true cost of those funds. The non-pecuniary cost of family and friend funds can be quite high. Failure to keep the transaction at arms length and well documented can create friction between the parties when time comes to repay the funds or if the business fails.

1.b. Financial Flexibility

Use of personal, family and friend funds allows the most financial flexibility. Other investors will make those funds subordinate to their investment via collateral and other contract restrictions.

1.c. Availability

Availability is usually higher than with other fund options especially for small start ups. As previously discussed, small start ups have few if any other options for funding.

1.d. Accessibility

This source of funds is highly accessible.

1.e. Alignment

This source will be most closely aligned with the company's strategic direction.

2. Commercial Banking Loans

Commercial banks are the second source for funding the small business owner will normally approach. Commercial, personal, and home equity loans from commercial banks are viable long-term and short-term debt financing alternatives for small businesses. Commercial financial institutions possess individual and unique capital resources, loan criteria, balance requirements, service charges and interest rates.

2. a. Cost

Commercial banks are regulated lenders of capital. Users of depositor's money, these institutions possess an inherent responsibility to lend at a lower risk, therefore, requiring a lower return on investment (ROI). Short-term debt is usually for less than 180 days and the

entire principal and interest is due at maturity. The long-term debt under this financing alternative is a loan in which interest and principal is repaid in equal installments over its life. Small business home equity loans require the personal guarantee of the business owner. Of the funding alternatives, commercial bank financing provides the best available interest rate and the most cost-effective source of capital outside of the owner's direct funds or family and friends. However, collateral in the form of the owner's family home represents a high risk for the entrepreneur in the event of default. Commercial banks often require entrepreneurs to risk up to 25 percent of their own finances in the business venture (www.allbusiness.com).

2. b. Financial Flexibility

Accompanied by the obligation of interest and principal payments, the use of commercial bank loans decreases a new company's financial flexibility. This serviceable debt pressures the limited cash flow characteristic of most start-up companies.

2. c. Availability

Banks are unlikely to finance business ventures characterized by high risk and unpredictable profitability. Commercial bank loans are most often available for moderate-risk small business ventures. Smaller-scale commercial banks, aggressively seeking new customers, often make their funds more available to entrepreneurs. However, the Fed has tightened the money supply since 2000 and even many established businesses are having difficulty obtaining short term bank funds.

2. d. Accessibility I

Initial financing consideration, under the commercial bank alternative, is often based on the entrepreneur's personal financial strength and resources. Creditworthiness is determined by personal debt repayment history. Initial capital may be inaccessible to newly-formed companies, lacking operating histories and acceptable collateral for the securing of commercial bank loans. For initial financing, commercial banks require the business owner to have equity in the company to secure the loan. Loan structure and collateral requirements are based on an examination of all facets of the borrower's comprehensive business plan

2. e. Alignment

Commercial banks do not require equity in the business or company control as an element of the initial finance agreement. In an effort to aid the business in achieving its financial goals, many banks now provide such strategic financial and management services as cash management, payroll assistance, investment products, credit counseling and industry intelligence. Commercial banks can also provide access to non-traditional financing sources through the investment bank/capital markets that arrange private debt and equity placements (www.allbusiness.com). Communication between company management and the banking institution facilitates reciprocal confidence. Confidence in company management allows for an increased risk tolerance by the bank.

3. Angels And Venture Capital

A form of private equity financing focusing on future company prospects rather than past performance. Venture capitalists offer initial financing in exchange for company equity. However, the collapse of the technical sector after 2000 has reduced venture capital financing.

3. a. Cost

Costs associated with venture capital financing arrangements are characterized by a loss of company equity, interest and control with a resultant potential loss of owner independence. A venture capitalist typically receives convertible preferred company stock in the initial financing agreement. Capital appreciation is the primary goal of the venture capitalist, and is usually realized through a sale of the company to a strategic buyer or an IPO, where the venture capitalist converts his shares to common stock (www.allbusiness.com). Preferred company stock provides the investor preference over common shareholders in the event of a company liquidation or merger and potentially represents a significant dilution of existing shareholders. The venture capitalist often requests a seat on the company's Board of Directors (BOD) and other rights and restrictions to the venture capitalist by the entrepreneur per a customary financing agreement.

The venture capitalist typically expects an annual dividend yield of 8 – 12 percent on his investment (www.allbusiness.com). Venture capital financing required internal rate of return (IRR) of approximately 30 percent makes this form of funding a relatively expensive financing alternative.

3. b. Financial Flexibility

The venture capital financing alternative allows entrepreneurs to acquire capital without the fixed expense of debt service. This alternative allows a company to maintain financial flexibility. Venture capital investments are sometimes *staged*. Under the staged investment structure, an initial investment is made. Investments are subsequently made corresponding to critical milestones (www.morebusiness.com).

3. c. Availability

Private equity, in the form of venture capital, is generally utilized by companies without the operating histories necessary to obtain lower cost capital alternatives. Possessing stringent investment criteria, venture capitalists are primarily interested in companies characterized by high-growth potentials, operating in high-growth industry segments, emerging markets and/or emerging niches in mature markets. Sustained growth and profitability beyond a five-year horizon is essential to create a premium exit value and liquidity in a public offering or sale. Venture capitalists seek to earn between five and ten times their initial investment within a five to eight year investment horizon (www.morebusiness.com).

3. d. Accessibility

Venture capitalists conduct a due diligence investigation and assessment of the company's management team which includes an evaluation of management maturity, creativity, commitment, and leadership. Critical is the entrepreneur's business principles, business concept timeliness and display of vision and determination. Initial financing is difficult to obtain for the inexperienced entrepreneur. Of interest to venture capitalists is management's execution of introducing a product or service to market.

3. e. Alignment

Venture capitalists provide industry knowledge, experience and expertise to a start-up organization. Venture capitalists often introduce other investors, establish strategic partnerships with vendors and customers, reinforce the entrepreneur's business concept and strategy and discover further financing sources. Taking an active role on the company's Board of Directors, investors can push a specific strategic agenda focused toward the goal of an IPO within the desired

investment horizon. The desired IPO serves as a convenient exit strategy for the venture capitalists.

The selection of the venture capital initial financing alternative can also serve strategic purposes. A contemporary global business environment, characterized by increased competition, requires decisiveness, broader relationship networks and abundant financial resources to effectively compete. Companies acquire venture funding to establish credibility or access resource networks developed by the investing partners. Consistency between management's and investor's goals and objectives is critical in a venture capital financing situation. Both a corporate business structure and IPO ambitions must be primary elements in the organization's strategic direction, for the selection of venture capital financing to be a feasible alternative. Once the owner loses control to the venture capitalist, the original strategic direction may change.

4. SBA Loans

SBA loans are regarded as the most flexible long-term debt financing alternative for initial financing of small businesses. Although having no funds for direct lending or grants, the SBA guarantees up to 75 percent of individual loans granted by commercial banking institutions (www.sba.gov). Because SBA loans are granted by commercial banking institutions, specific decision variable factors are similar to those of the commercial banking category.

4. a. Cost

The SBA guarantee does not allow the banking institution to disregard standard commercial loan underwriting principles. Entrepreneurs are obligated to collateral requirements and personal guarantees associated with customary commercial bank loans. Costs associated with this alternative are comparable to the commercial banking financing option. The SBA guarantee allows the bank to provide greater amounts of financing, extend longer terms and approve loans to less mature businesses (www.sba.gov).

4. b. Financial Flexibility

Accompanied by the obligation of interest and principal payments, the use of SBA loans decreases a new company's financial flexibility. This serviceable debt pressures the limited cash flow characteristic of most start-up companies. The maximum SBA loan maturity is 25 years with smaller loans typically having shorter maturities (www.sba.gov). The longer maturities allow for greater financial flexibility.

4. c. Availability

For this financing alternative to be available, entrepreneurs must illustrate that it is impossible to obtain conventional financing at reasonable terms. SBA loans must be used for new financing. Refinancing or debt restructuring is prohibited under this alternative. Eligibility for the SBA loan alternative is dependent on strict loan criteria (www.sba.gov).

4. d. Accessibility

More relaxed than the customary commercial bank financing alternative, entrepreneurs are primarily required to illustrate projected cash flows for debt repayment.

4. e Alignment

Strategic financial and management services (offered by both banks and the SBA) common in the customary commercial bank financing alternative are available to business owners under the

SBA financing alternative. This initial financing alternative is preferred if it is not in the strategic direction of the company to go IPO or sell.

5. Credit Cards and Lines of Credit

5. a. Cost

Although a simple way to acquire capital, the use of credit cards can be the most expensive initial financing method over the long-term. Interest rates for this method are typically one to three percent higher than commercial bank loans (www.morebusiness.com). Commercial lines of credit use company assets and are, therefore, preferable to personal credit lines, which use personal assets as collateral. Interest rates for unsecured credit lines are usually higher than secured credit lines. Negotiable, yet varying with venture risk, interest rates for credit lines are greater than, or equal to, those of commercial loans.

5. b. Financial Flexibility

The debt and principal repayments resulting from the use of credit card financing decreases the company's financial flexibility.

5. c. Availability

Both credit cards and lines of credit are readily available and commonly used options for a wide array of initial small business financing.

5. d. Accessibility

Both forms of initial financing have set borrowing limits. These borrowing limits vary depending on the entrepreneur's personal credit history, collateral and projected cash flow needs.

5. e. Alignment

Both initial financing methods can be used regardless of organization's strategic direction.

Methodology and Data Analysis

1. Methodolgy

A survey of businesses in Southeast Texas was undertaken to determine the sources of financing utilized in this area. A total of 67 business executives, owners and managers, primarily in Walker, Montgomery and Harris Counties, Texas, were interviewed.

2. Data Analysis

The survey data is currently being compiled for analysis. As the data is in the compilation stage, the exact percentage of good data responses and compilation is being determined. The survey results will be analyzed and prepared for presentation during Spring 2005.

Conclusion

This paper examined several financing alternatives for small businesses. An entrepreneur's familiarity with the available initial financing options aids in the selection of the best alternative. These alternatives were reviewed from the most simplistic of forms, personal, family and friends' funding, to more complex forms, such as venture capital.

Entrepreneurs should identify critical factors or decision variables for use in the selection of the best initial financing alternative. The weight or importance of individual critical factors varies with entrepreneurs and companies. The appropriate initial financing alternative should balance these critical factors. By evaluating the proposed degree of complexity with respect to the structure of the new business, and comparing it to the funds that are necessary, decision criteria for the determination of the best initial financing option was developed. Initial financing alternatives were evaluated with respect to cost, financial flexibility, availability, accessibility and alignment.

Insufficient start-up capital is a primary reason for the early failure of small businesses. A comprehensive business plan should assist the new business owner in avoiding this problem. Entrepreneurs should accurately determine the initial capital requirements as an integral element of the initial financing process. Selection of the appropriate financing alternative should follow the determination of initial capital requirements for a start-up business venture.

Analysis of survey data will be presented and related to the various methods small business utilizes to obtain financing. This analysis will be completed for presentation during Spring 2005.

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