

GUIDE FOR
SMALLER BUSINESSES
AND ENTREPRENEURS

FINANCING YOUR BUSINESS

Price
Waterhouse

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SMALLER BUSINESSES
AND ENTREPRENEURS

**FINANCING
YOUR
BUSINESS**

FOREWORD

This Guide is one of a series for smaller businesses, entrepreneurs and their advisors. It deals with financing the business, getting funds either for a start-up situation, for the operations of a going concern or for expansion. It tells you where to go to get the funds, what you must know about your business to get it, how you can prepare to get it and what it will cost. It answers the basic questions, leading off with a self-assessment chart rating your business's ability to get funds.

This Price Waterhouse series is the result of pooling our experience and knowledge in helping thousands of smaller businesses, entrepreneurs, and their advisors over the years.

For further information or assistance, please write or call me or any one of the partners listed at the back of this Guide.

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INTRODUCTION

Financing is an essential and continuing need for any business. The degree of need and how it can be satisfied will vary with the economic times and the individual situations you face. Day to day needs can generally be satisfied through familiar sources and methods. However, there are urgent times, so critical as to make the difference between success and failure, that will require you to seek out very unfamiliar sources. Some of these critical times are natural occurrences in a developing business.

These natural occurrences may be described as "rites of passage" through which your business must be guided. The number and titles vary by economist. It is safe to say that there are at least three: start-up, growth, and maturity.

At start-up there are significant costs that must be incurred before any business can open its doors. You will face inevitable losses until sufficient revenue levels can be achieved. Until then, the needed financing must come from outside your business. You must convince others that your business concept is sound and likely to be viable.

Growth is generally perceived as good. Sometimes it is a necessity; otherwise a critical advantage or important opportunity will be lost. Even though your business has achieved some level of success, the costs and risks associated with growth can be beyond your present resources. Funding sources must again be convinced, this time, that growth is achievable and your business is likely to succeed.

Maturity does not mean financial independence. Plant and products must be modernized or replaced. Markets change and so must your business. Success has been achieved but you may not want to risk everything on a new undertaking. Others must be sought to share in that risk. Funding sources must be convinced of the benefits and of your business's ability to successfully retrench if the new undertaking fails.

Businesses must compete in order to survive. Competition is not limited to sales markets but extends to all resources used by the business. Money is among those resources and it too is in limited supply. You will face extensive competition for available funds not only from other businesses but also from the government sector.

When you find that old familiar sources are unwilling or unable to provide the needed funds, a new and increasingly complex process begins. New sources must be actively sought. You will not be able to casually ask for the funds; you must formally request them, justifying both the need and the business itself.

You may be surprised that funding sources cite lack of management, not lack of financing, as the main reason for business failure. Simply, it is your responsibility to assure that financing is available as needed and on an

economic basis satisfactory for your business. Smaller businesses generally lack the in-house financial managers present in larger businesses. You may not have the time or expertise to personally deal with complex financial matters. Instead, you may use a number of legal, accounting, or financial advisors to assist you. Assistance cannot replace management.

IT IS ESSENTIAL THAT ALL FACTORS CRITICAL TO THE SUCCESS OF A BUSINESS BE MANAGED AND THE PROCESS OF GETTING FINANCING IS CHIEF AMONG THEM. THIS GUIDE IS INTENDED AS AN AID TO MANAGING THE CRITICAL PROCESS BY WHICH BUSINESS FINANCING NEEDS ARE TO BE SATISFIED. THE INTENDED READER IS THAT INDIVIDUAL BUSINESS OWNER OR ADVISOR WHO HAS ALREADY IDENTIFIED THE GENERAL NEED AND IS READY TO SEARCH FOR AND EVALUATE ALTERNATIVES.

This guide outlines the facts of life in financing a smaller business as experienced by thousands of smaller businesses each year. A self-assessment questionnaire helps you rate your business's ability to get funds. We tell you where the funds are, the process of preparing, requesting, and getting them, what you can do and who can help, the costs, the pitfalls, and the benefits.

HOW DO I RATE?

• a self-assessment

The self-assessment questionnaire which follows is a rough and ready way to assess those elements in your business that lenders and investors will look at in considering whether to lend money or invest. Self-assessment is a never-ending task. You will be seeking money at the best possible terms at every stage of your business's development.

We have assigned point scores rather arbitrarily. If your business does not score well, all is not lost. You can quickly see where you need help and improvement. By working on bringing your score up, your chances of getting funds will be greatly improved.

Self-assessment Questionnaire Rating Your Business's Ability to Get Funds

	Points
What is the purpose for the funds?	
Expanding the business (growth capital)	20
Operating the business (working capital)	10
Starting a new business (seed money or risk capital)	0
How long have you been in business?	
Three or more years	20
One to three years	10
Start-up	0
Do you have any established banking or other fund source relationships?	
Several connections with banks and other sources	20
Account at local bank	10
None	0
Are you known in your community?	
High profile	20
Known to some extent	10
Unknown	0
How does your business's return on investment, profitability, compare with the average for your industry?	
Above average	20
Average	10
Below average	0
Does your business have a history of and prospects for continued profitability?	
Strong trend	20
Steady	10
Inconsistent or losses	0

How does your business's current ratio (current assets divided by current liabilities) compare with others in your industry?	
Above average	20
Average	10
Below average	0
Do you have a business plan?	
Formal	20
Informal	10
None	0
How many of these key functions do you directly manage yourself: production, marketing, finance, administration, policy, personnel?	
Two	20
Three or four	10
Most or all	0
Do you have adequate business insurance?	
On all important areas, including "key man" coverage	20
Average for your industry	10
Little or none	0
How are your financial and internal accounting controls?	
Formal	20
Informal in some areas	10
Little or none	0
How would your business's key employees be evaluated as to loyalty, competence and experience by an objective outside observer?	
Above average	20
Adequate	10
Below average	0
What is your personal and business general credit standing?	
Good	20
Fair	10
Poor or not rated	0

If you scored 200 points or more in this questionnaire, your chances of securing the kind of funds you need and at a reasonable cost are above average. A score below 100 means you will have difficulty. There are other aspects of your business and its prospects that funding sources will consider but those indicated are the ones commonly evaluated. This Guide's chapter "What Are My General Alternatives" discusses these and other factors in greater detail.

WHERE ARE THE FUNDS?

- **major funding sources**

The sources of debt and equity financing described in this section are the major funding sources for smaller businesses and entrepreneurs. We provide two summary charts which will give you a bird's eye view of all of these sources together with the kind of loans or investment they make, the purposes for which they will lend or invest, amounts available, applicable regulations, cost factors, other terms (covenants, guarantees or security), required documents and whether they will deal with start-ups or other stages of business development. We have also included a listing of organizations that provide information on potential funding sources.

EQUITY FUNDING ALTERNATIVES*

	Wealthy Individuals	Venture Capitalist (Institutional Risk Takers)	Government Assisted Sources	Public Securities Markets	R & D Partnerships	Other Institutions (Long-term)
Frequent uses	Start-ups or early growth	Start-up (specialty sources) or growth (pre-public by 3-5 years)	Start-up, growth or mature (especially for new locations or expansion)	Late growth or rapid growth depending on market conditions or maturity	High-Tech, usually involves a mature business contracting for R&D services	Mature
Devices/structure preferred	Common stock and secured loans	Combination of equity (including preferred stock), and debt (with warrants, etc.)	Prefer loans with equity features	Common stock, preferred stock, and certain debt securities	Tax shelter limited partnership providing services by contract with a sponsoring company	Loans with equity features and preferred stock
Amounts generally available	Varies by individual	Over \$1,000,000	Usually under \$1,000,000 varies significantly by provider	Amount varies but initial issues of \$5-10,000,000 and 500,000 to a million shares preferred	Varies, can be a public issue	Over \$1,000,000
Cost	Varies, criteria is not formal; current distributions of interest or dividends to the individual are commonly required	3 to 10 or more times investment over 5 or fewer years; requirements for current distributions of interest or dividends are minor with capital gains potential preferred	Varies by source; could be based on tax free yields obtainable by source or SBA debentures; current distribution frequent	15-20% of issue amount and additional continuing costs; current distribution and capital gains sought	Varies, less than debt and more than equity; continuous funding may be required	Varies, but comparable to public market indices; current distributions frequent; middleman fees of 1-4% of funds requested
Ownership required	Significant minority position; 50/50 or 60/40 are common; criteria is not formal	Minority positions 40% or less by direct ownership or future rights; pricing criteria is formal	Future rights to acquire minority positions; generally 25% or less	Varies, majority or very significant minority position preferred	Owned by limited partners; business contracting for services may or may not have ownership interest	Varies, future rights to minority position of 25% or less are common
Documentation	Informal	Formal and extensive business plans and implementing agreements	Formal and extensive business plans and implementing agreements; significant aid in preparation may be available	Varies by registration type or allowed exemption, usually very complex and formal	Formal and extensive, terms for future use of technology developed are significant	Formal and extensive business plans and implementing agreements

Financial Statements	Audited preferred	Audited preferred	Audited preferred	Audited required	Audited preferred	Audited preferred
Other	Active management involvement directly or on Board; personal tax considerations are important	Passive or active management involvement varying by stage of growth; control or influence through Board of Directors seats; control of going public decision or "put" rights; can offer significant management assistance	Frequent public policy requirements; control influences are passive except in default	Significant continuing responsibilities and control influences; including state regulation	Very little management influence; may have financial statement impact on contracting business	Passive management influence through agreement provisions; potential sources include: insurance companies, pension funds, and savings banks
Preferred or principal method of contact	Direct or by referral	Referral	Direct through coordinating agencies such as SBA or state or local agencies; or other financial institutions	Investment bankers and underwriters	Direct; or investment bankers	Middlemen (mortgage and investment bankers)
For further information see page	11	12	15	15	52	25

* Various state and federal security laws will also apply. Consult your lawyer before any solicitation of equity funds is made.

DEBT FUNDING ALTERNATIVES

	Commercial Banks		Savings & Loan Associations		Commercial Finance Companies (Asset Based Lenders)		Leasing Companies		Long Term Lenders		Government Assisted Sources		Industrial Revenue Bonds	
	Commercial Banks		Savings & Loan Associations		Commercial Finance Companies (Asset Based Lenders)		Leasing Companies		Long Term Lenders		Government Assisted Sources		Industrial Revenue Bonds	
Loan types:														
Demand	Frequent		Occasional		Rare						Rare			
Short term (5 yrs. or less)	Frequent		Occasional		Frequent		Operating and financing leases				Frequent			
Intermediate (5-15 yrs.)	Occasionally up to 10 yrs.		Occasional		Occasional		Operating and financing leases		Occasional		Frequent		Frequent (Sale-leasebacks)	
Long term (over 15 yrs.)	Rare		Frequent		Occasional		Operating and financing leases		Frequent		Occasional		Frequent (Sale-leasebacks)	
Revolving credit	Occasional		Rare		Frequent						Occasional			
Uses:														
Working capital	Frequent		Occasional		Frequent				Occasional		Frequent			
Growth capital:														
Machinery and equipment	Frequent		Occasional		Frequent		Frequent		Frequent		Frequent		Frequent	
Real estate	Occasional		Frequent		Occasional		Frequent		Frequent		Occasional		Frequent	
Acquisitions or general expansion	Occasional		Rare		Frequent		Occasional		Frequent		Occasional		Occasional (expansion not acquisition)	
Risk capital	Rare		Rare		Rare				Rare		Occasional to frequent (Varies by provider)			
Amounts available	Varies by institution		Varies by institution		Varies by collateral provided		Varies by asset leased		Usually of substantial amounts over \$1,000,000		Varies by provider (usually less than \$1,000,000)		Varies by issuer and user	
Interest rate base	Prime rate plus 1-4 points		Long term AAA or government bonds indices plus risk premiums varying in the circumstances		Prime plus 2 to 6 points		Prime plus 2 to 6 points		Various bond indices plus risk premiums varying in the circumstances		Varies by provider, SBA debentures or other government securities		Tax free government bonds yields of issuer	

Other terms
Covenants:
Affirmative

Always	Always	Only as to leased asset	Always	Always	Always
Negative	Occasional	Frequent	Frequent	Only as to leased asset	Always
Guarantees	Occasional	Frequent	Frequent	Occasional	Generally
Security	Frequent	Frequent	Frequent	Title retained	Always
Other	Frequent	Fees and other costs, extensive default provisions	Fees and other costs	Provisions on taxes, insurance and maintenance	Very extensive tax and regulatory compliance provisions

Financial statements

Audited preferred	Audited preferred	Audited preferred	Audited preferred	Audited preferred	Audited preferred
Request documents	Generally not complex; more detail required for longer terms; varies at times by security	Generally not complex, but requires extensive appraisals of securing assets	Generally not complex, but requires extensive supporting documents and appraisals of some securing assets; significant preparation aid furnished	Complex and extensive; business plans and financial data required in detail	Complex and extensive, significant legal and tax compliance documentation

Borrower stage of development:
Start-up

Occasionally with guaranties and security	Infrequent	Infrequent	Rare	Frequent	Occasional
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Growth

Frequent	Occasional	Frequent	Occasional	Frequent	Frequent
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Maturity

Preferred	Preferred	Preferred	Preferred	Occasional	Frequent
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For further information see page

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Organizations Providing Funding Source Information

*National Association of Small Business

Investment Companies
618 Washington Building
Washington, D.C. 20005
202-638-3411

*National Venture Capital Association

1655 North Fort Myer Drive, Suite 700
Arlington, VA 22209
703-528-4370

Office of Chief Counsel for Advocacy
U.S. Small Business Administration
1441 L Street, N.W.
Washington, D.C. 20416
202-653-6533

Office of Small Business Policy
U.S. Securities and Exchange Commission
450 Fifth Street N.W.
Washington, D.C. 20549
202-272-2644
202-272-7460 (Publications Section)

* Membership directories are available with investment size and other objectives indicated.

For information about various government programs you can obtain a copy of Price Waterhouse's *Guide for Smaller Businesses and Entrepreneurs — Getting Government Help*. A copy may be obtained for \$5 from any of the Price Waterhouse offices listed in the rear of the Guide.