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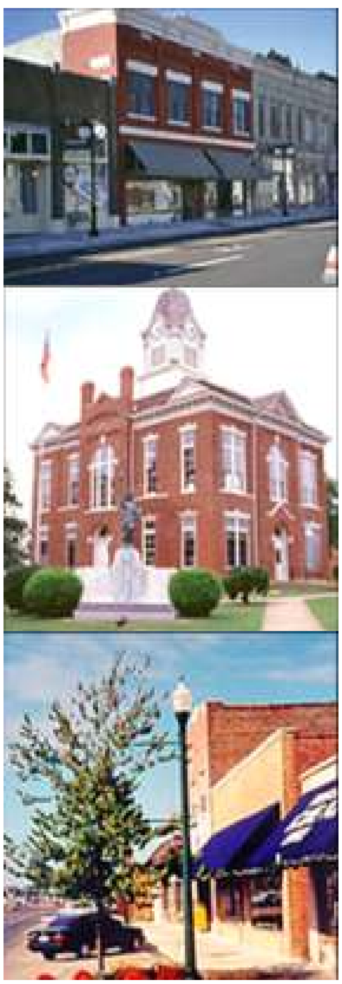
Linking

Business Support and Capital

for

Business Growth and Success



Making a Case for Small Business

There are numerous statistics on jobs created by small businesses based on the size of the business and the focus of the research. But in almost all reports, small businesses provide between 60% to 90% of all *net new* jobs. With daily reports on corporate layoffs, it is becoming increasingly clear that small businesses are critical to our new economy and our future.

One such report issued by the University of Alabama "Economic Crisis: Story Ideas and Expert Commentary,"[1] notes that small businesses are more likely to adapt to current economic circumstances because they do not have the bureaucracy or the heavy layers of management that slow adaptation.

However, statistics indicate that anywhere from 3 in 5 to 4 in 5 businesses fail within the first 5 years. Imagine how many jobs could be created if more small businesses succeeded and grew. *They can with the right resources!*

Why do small businesses often fail? Most studies indicate inadequate business and management practices and a lack of systems and planning. This is followed closely by a lack of either access to capital or appropriate capital tools.

Written by Ines Polonius and Deborah Slayton

How can more small businesses succeed? Based on research, studies and our on-the-ground experience, there are three key ingredients of a successful small business that are too often viewed independently.

1. A well thought out business model
2. Strong financial and management systems
3. Appropriate capital tools

Forging a new future for small businesses, their owners and their communities requires linking these three ingredients.

The following discussion focuses on traditional methods for financing business development and why those methods are not effective in low-wealth or rural communities. We then introduce a new strategy that manages the risk for the lender and the borrower by focusing first and foremost on business growth and success through upfront Managerial Assistance.

Recent research by the Edward Lowe Foundation[2] and SBA looks at the impact of small businesses in smaller and more rural regions throughout the entire decade of the 1990s. Regions with the most entrepreneurial activity demonstrated that:

- The rate of new firm births was 78% higher
- Employment growth was 73% higher
- Wage growth was 14% higher

In a report by the SBA Office of Advocacy[3] dated September 2008, small firms represent 99.7% of all employer firms and employ about half of all private sector employees.

Since the mid-1990s, small business have created 60% to 80% of the net new jobs.

Traditional Lending Policies

Historically, loan policies focus on managing risk associated with business loans by clearly stating collateral guidelines, credit requirements, key ratio guidelines, personal guarantee requirements and sometimes the use of government guarantees. These methods provide a fast and easy way to assess a large volume of loans. In practice, however, this approach results in an inordinate focus on secondary repayment methods rather than on the success of the business, which needs to generate profits and cash to repay debt.

As a result, many small businesses borrow too much money because they have the necessary collateral to secure a loan but do not have the appropriate capital structure or management systems to grow at a rate that allows them to repay the debts. Other businesses able to service debt cannot secure it, because they lack the appropriate collateral.

Traditional Lending – Challenges for Banks and Other Lenders

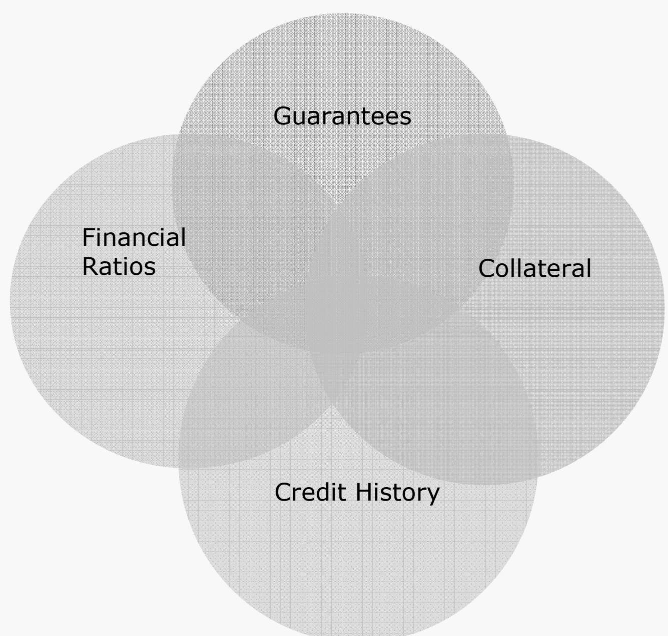
It is imprudent for anyone to lend or invest money without exercising clear risk management strategies. Why does the traditional lending model represent a challenge for lenders in rural and/or low-wealth communities?

- Collateral—While collateral is a strategy for reducing losses and managing risk, it does not indicate that a business is viable or that it will be well managed. Collateral only becomes important when a business is failing, and at that time the value has declined and liquidation of the collateral is expensive and time consuming.
- Guarantees—Personal and/or other guarantees are required and they are important.
  - Personal guarantees demonstrate a person's commitment to the project, but they do not indicate that the individual is or will be a good manager.
  - Government guarantees are generally based on traditional guidelines such as collateral, net worth, etc., and not on the capacity of the business owner.
- Credit Scores—It is easy to look at a credit score and make quick decisions. But are they good decisions? Credit history is very important and provides insight into how an individual manages his/her finances. Has the score changed due to recent events such as health problems or divorce? Is there a lack of history that reduces the score? Or does the credit score reflect a true long-term history of late payments and/or non-payments?
- Financial Ratios—There are key financial ratios that are very good indicators of how well a business is being managed and they can alert the lender to some problems early if

A January 2009 report by the Southern Legislative Conference entitled "Capital Access in the Black Belt"[4] found:

- Rural areas have a marked deficiency in access to capital for all purposes, but particularly for business and community development.
- Changes in banking regulations over the past few years have reduced the community reinvestment requirements for mid-sized banks, further reducing the flow of capital to rural areas.

Traditional Loan Decision Matrix



Traditional Lending – Challenges for Entrepreneurs

Small businesses, particularly those in rural and/or low-wealth areas, have a harder time accessing the capital they need based on the traditional model because:

- Low Real Estate Values—Generally, real estate is the preferred collateral for business loans. In low-wealth and rural areas, real estate values are historically low and offer minimal collateral coverage. In the current economy, this problem is magnified as liquidating the real estate often leads to significant losses.
- Business Collateral—With much of manufacturing having moved overseas, many of the remaining small businesses are service, technology or retail businesses, which do not offer significant or 'valuable' collateral for the lender.
- Credit Scores—In many low-wealth and rural areas unemployment is high. Without jobs, many individuals operate on cash and do not have health insurance, both of which results in credit problems. With a lack of available start-up loans or investments, most entrepreneurs are forced to resort to utilizing credit cards to get their businesses started. From the outset, those entrepreneurs' credit scores are doomed.

The Federal Reserve's Senior Loan Officer Survey for the third quarter of 2008[5] reflects an environment in which the supply of credit for small firms is lower than it has ever been in the history of the survey. Specific examples of the survey are:

- *Over 65% of respondents reported tighter credit lending standards for small businesses. This compares to 50% in the previous survey and 7% at the same time one year earlier.*
- *The volume of SBA small business loans has decreased 38% since last year. FY 2008 reflected the largest decline in total loans in program history, some 30,000 less than in 2007.*

In the early 1990's, the Community Development Financial Institution (CDFI) movement set out to create access to capital for small businesses in rural and low-wealth communities. A report dated January 2009 by the Federal Reserve Bank of San Francisco states that despite impressive growth, the industry has failed to reverse the growing economic inequality or the ravages of predatory financial institutions[6].

As CDFIs face declining subsidies and pressure to be sustainable, many have adopted the traditional lending model described on page 3. As these funds move toward market models and methods, CDFIs will be under growing pressure to modify their missions and the nature of their activities, diminishing their ability to serve low-income communities[7].

In this economic environment with restricted credit through private banks and challenges in the alternative lending community, it is time to re-think the traditional lending model and consider a new model as presented on the following pages.

A New Strategy For Small Business Growth

Strong Business Model
+
Strong Internal Management and Financial Systems
+
Appropriate Capital
=

Successful Business with Profits and Cash to

This new model focuses first on the business's success with traditional lending components playing a truly secondary role in the lending decision.

> A 2008 report to Congress by the Committee on Small Business[8] concluded that:
> "At a time when the economy is slowing and investor appetite for risk remains modest, policies must spur entrepreneurship. They must promote innovation, provide seed capital for those with new ideas and retrain workers."

The proposed new strategy recognizes the importance of managing risk for the lender and for the business owner. It is built on the premise that a business owner or individual should never be put "at risk" just because they have a high net worth, collateral or positive history. Nor should a lender assume undue risk in meeting lending goals.

If the biggest risk is in systems, business model and capital, then the focus should be on addressing that risk by providing the resources that businesses need to succeed. While credit and existing collateral should be considered to reduce exposure, they should not be the primary determining factors in the lending decisions.

It is critical that the small business entrepreneur develop or be actively involved in the development of the model in order to understand exactly what will be required to make the business work and grow.

Strong Business Models

Developing a business model or a business plan does not mean filling in the blanks or hiring someone to develop a nice package. A business plan is not just for start-up businesses.

Every business needs a strong business model that clearly articulates every aspect of the business from the structure and ownership to the capital structure to the market and management systems. This business model should be updated at least annually in our rapidly changing economic environment.

> Checking the results of a decision against its expectations shows executives what their strengths are, where they need to improve and where they lack knowledge or information.
>
> *Peter Drucker*
>
> Unless you have definite, precise, clearly set goals, you are not going to realize the maximum potential that lies within you.
>
> *Zig Ziglar*

Start-up Businesses - By fully understanding the business model, entrepreneurs will know if a business is not feasible and they will know why. Walking away from one business idea is not giving up, it is being smart and looking ahead to other feasible business opportunities.

Existing Businesses – For existing businesses a good business model provides critical guidance and benchmarks that tell the business owner when it is necessary to make adjustments or changes.   If sales are not as high as projected or if they are better than projected, the entrepreneur has a tool he/she can use to help guide business decisions.

Financial modeling identifies the amount of capital needed and the ideal terms that are needed. Many small businesses start on credit cards or they invest all of their savings without a plan for securing additional funds. The inability to secure the additional capital can result in a business not growing, and in some cases it can cause a business to fail.

Strong Management and Financial Systems

Entrepreneurs generally start businesses around a certain technical expertise they possess, but often fail to recognize the importance of financial and management systems.

- A business can grow too fast. The business owner focused on success fails to recognize the cost of growth until he/she is out of money and cannot buy the needed inventory or supplies.
- A business may not grow as fast as expected. With the right systems in place, the business owner will recognize this immediately and make the necessary adjustments before reaching a cash crisis and having to liquidate inventory or immediately reduce staff.

In the examples above as well as many others, the key to surviving is clearly not collateral or guarantees. In either of the examples above, if the business borrows funds based on collateral without making the required adjustments in its business model, the loan does not help the business at all and just delays the inevitable problems. Collateral, guarantees and credit do not solve these problems. Yes, they are important pieces of a business but they do not automatically lead to business growth and/or success.

Cash repays loans. Small businesses have to understand and manage the cash flow of their business if they are to succeed, grow and repay their loans.

Appropriate Capital

Small business success is not only contingent on having enough capital but the right capital structure or "appropriate capital."

Many small businesses cannot borrow the working capital they need to grow because they do not fit the "traditional" requirements. Some businesses *can* borrow working capital because they have the collateral, historical performance or personal net worth even though they may not have a strong plan, systems or adequate cash flow to repay the loan.

With a good management plan and good financial systems in place, a business owner knows how much debt he/she needs, the type of debt and how the debt will be repaid through increased sales and profits. Without the plan and systems in place, a business owner will often accept any loan amount or terms, thinking that they can "make it work."

Appropriate Capital has 3 key components:

1. Loan Amount—The amount borrowed is determined by the business needs and projections rather than the available collateral. Too much debt is just as detrimental as not enough debt.
2. Loan Structure—Match the sources of capital with the uses of capital. Fixed, long-term assets are financed with long-term debt and short-term working capital needs are financed with current assets.
3. Loan Leads to Profits and Cash—Business demonstrates how the loan will lead to increased sales and profitability, which will be used to repay the loan.

Short Case Studies:

1. An entrepreneur was moving from a "hobby" into a formalized business. He had real estate and some equipment he had purchased. He secured a small loan using all of his collateral. As sales grew, he was unable to secure the additional working capital he needed for inventory. Although loans were paid as agreed and well collateralized, the lender was unwilling to advance more funds and the business was unable to grow.

2. Another entrepreneur started her business using her credit cards. As the business grew she quickly recognized the need for additional working capital. However, she did not have financial statements that would demonstrate her ability to repay the loan. With only inventory as collateral, she was unable to secure a working capital loan to support her continued growth.

3. Another business had a successful history and based on that history was able to continue to borrow from its local bank. Neither the business owner nor the lender saw that the industry was changing. Now the borrower is over-leveraged and the lender is under-secured. If the business had implemented good financial and management systems, they would have borrowed less and they would have recognized the changes earlier and implemented a plan before it was too late.

Think it can't happen to you? That is what they thought as well...

Putting it All Together to Generate CASH to Repay Loans

The secret to effectively linking a successful small business model, strong financial management systems and appropriate capital is managerial assistance. This is especially true for small businesses in low-income and/or rural communities.

The "Capital Access in the Black Belt"[9] report differentiates managerial assistance from technical assistance:

"Managerial assistance builds relationships of trust between the provider of services and the client, and places the provider in a strong position to guide changes in a measured and appropriate manner."

New Loan Decision Matrix

Traditional technical assistance often ends when the loan is made. Lenders sometimes call technical assistance providers when a business is already in default. Strong managerial assistance comes before a loan is ever made and accompanies the business through its growth.

Under this new model, the managerial assistance provider works with the business owner to develop a model—financial, marketing, human resources, strategic—that projects the business growth and success. The model defines the amount of capital required as well as the type of loan needed, ensures that the business has an internal accounting system and that management understands how to read the resulting statements and manage cash.

This type of managerial assistance also facilitates the due diligence process and saves the loan officer time in gathering the necessary information to make a good loan decision.

Under this new lending model, policies are based on the clearly demonstrated link between good business models, strong systems, appropriate capital and success. Credit decisions are based on the owner's proven ability to manage his/her business and finances to generate profits and cash flow, which will enable him/her to repay future debts. With a strong business model in place, the entrepreneur can recognize problems and/or opportunities quickly and be able to respond appropriately.

"Noticing small changes early helps you adapt to the bigger changes that are to come."
From the book, *Who Moved My Cheese?*

Cost/Benefit Analysis

What is the cost of this new strategy? On average, securing managerial assistance to develop a stronger business model and implement financial management systems requires an average up-front expense of $2,500 to $3,000, which pales in comparison to legal and other liquidation costs and is comparable to most closing fees.

It is harder to measure the benefits in dollars and cents. Let's look at one simple example:

A small minority-owned business did not fit the traditional loan model and could not secure a small equipment loan from a bank due to insufficient credit. After working with alt.Consulting to implement internal financial management systems, develop detailed financial model and loan package, the business was able to secure a loan from a CDFI lender. With the new equipment, the business doubled its sales. With good systems in place, it is now in a position to bid on a sizable city contract and continue to build on its business model. The business has always been current on its equipment loan.

Benefits to Lenders

◊ Lenders are able to work with a broader customer base without assuming unreasonable risk
◊ Managerial assistance facilitates the due diligence process
◊ The "up-front" investment of time builds the lender/borrower relationship and trust,
◊ Borrowers have the tools in place to allow the lender to monitor and recognize when a business can be saved as well as when it cannot
◊ By reducing the number of loans needing to be liquidated, the lender saves the high costs associated with a liquidation.

Benefits to Community

◊ Entrepreneurship is encouraged
◊ More local businesses are started, providing local jobs
◊ Existing businesses can take advantage of growth opportunities
◊ Fewer businesses fail
◊ Successful businesses add to the tax base in a community
◊ The community can access a broader set of services through its base of businesses.

Small businesses in low-income and/or rural areas can succeed and grow with the right resources. The new *Assistance Based Lending Model* for financing small business development is an exciting new alternative for small businesses that do not fit the traditional loan guidelines or policies.

Now is the time to focus on supporting and growing small businesses. This new lending strategy provides a viable model.

"alt.Consulting worked with one of our key suppliers. They dove in with both feet, researched and familiarized themselves with the industry and came up with a sound and practical financial plan, which gave our company the confidence to loan this supplier significant dollars for needed capital to get back on track.

alt.Consulting was very open and honest with the client and put in tireless and countless hours. While this has been a success story, what sticks in my mind is, wouldn't it have been great if this supplier had worked with alt.Consulting before encountering financial troubles."

Bob Bradley
Koppers, Inc.

Who is alt.Consulting?

alt.Consulting is a 501c3 nonprofit economic development organization serving 60 of the poorest counties in the Arkansas Mississippi Delta, which is also a part of the Black Belt. In 2008, it celebrated 10 years of intensive managerial assistance with minority-owned, women-owned and rural-based businesses located in our target market.

Over our 10-year history, we have provided one-on-one assistance to at least 1800 businesses, helping them to implement the financial and management systems they need to grow and succeed. Too many times we have seen businesses stagnate or close because they could not get the working capital they needed. At the same time we worked with businesses who have borrowed too much money because they could but did not have the tools in place to manage their cash. Either scenario is devastating for the business owner and the lender as well as the community.

We are more than "consulting." Our team is experienced and passionate. Management Specialists who work on-site with clients have MBAs and entrepreneurial experience. They choose to do this work at below-market salaries because they want to see entrepreneurs like themselves succeed.

alt.Consulting has grown from 2 employees in 1998 to 10 today. We work with a variety of partners including banks, CDFIs, the SBA, USDA, economic development agencies, state agencies, the mayor's office in many small towns and community groups invested in economic development. We have grown by working with partners to make sure that clients have easy access to all resources and by adding programs and products that are needed.

Much of our work is conducted on-site with the client learning about the business and observing how it operates. This promotes a high level of trust between the client and the Management Specialist. The Management Specialist develops solutions and systems for the issues encountered in the business. alt.Consulting charges clients for services on a sliding scale.

In 2004, alt.Consulting was asked to become a Technical Assistance provider for the SBA Community Express Loan program. Working with various partners over the next 3 1/2 years we assisted 134 businesses in obtaining $1.6 million in unsecured working capital loans.

In 2007, alt.Consulting piloted the Assistance Based Equity (ABE) product providing small equity investments of $25,000 to businesses that had completed one technical assistance engagement, demonstrated their ability to grow and met other investment criteria. One investment has been made and that client has exceeded projections. Another investment was approved and is pending. ABE was used as a model by a local community group to create the first community-based equity fund in Arkansas.

In 2009, we are launching a loan fund built on the model presented here: Providing the skills, tools and resources first and then the working capital loans that allow small businesses in rural and low-wealth communities to meet their full potential.

For more information about our work, please visit our website at www.altconsulting.org.

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