CHAPTER 9

Debt Financing

INTRODUCTION

Bill Gates has a rule that Microsoft, rather than incurring debt, must always have enough money in the bank to run for a year even with no revenues.[1] In 2007, Microsoft had $23.4 billion in cash on its balance sheet.[2] Unfortunately, 99.9 percent of entrepreneurs will never be able to emulate this financing plan. Therefore, they must be willing to pursue and accept debt financing.

Debt is money provided in exchange for the owner's word (sometimes backed up by tangible assets as collateral as well as the personal guarantees of the owner) that the original investment plus a predetermined fixed or variable interest rate will be repaid in its entirety over a set period of time.

As we saw in Chapter 8, banks have been by far the biggest source of capital for entrepreneurs on an annual basis. In June 2004, commercial banks had a total of $1.4 trillion in business loans outstanding (in other words, total loans, not just the notes written that year). Of that, 38 percent, or $522 billion, was in small-business loans (loans of less than $1 million).[3]

In today's environment, lenders want to see a company's capital structure with debt equivalent to no more than 4.3 times EBITDA.[4]

TYPES OF DEBT

There are basically four types of debt: senior, subordinated (sometimes called sub debt), short-term, and long-term. The first two refer to the order of entitlement or preference that the lender has against the debt recipient. Senior debt holders have top priority over all other debt and equity providers. The senior holders are the "secured creditors," who have an agreement that they are to be paid before any other creditors. If the company is dissolved, the senior holders are entitled to be paid first and "made whole" as much as possible by selling the company's assets. After the senior debt holders have been completely repaid, the remaining assets, if there are any, can go to the providers of subordinated debt.

A lender does not automatically get the senior position simply because he made the first loan. The lender must request this position, and all other present and future lenders must approve it. This can sometimes be a problem because some lenders may refuse to subordinate their loan to any others. If the other lenders will not acquiesce, then the loan is generally not made.

Sub debt, also referred to as mezzanine debt, is subordinated to senior debt but ranks higher than equity financing. The term *mezzanine* comes from the theater, where there are often three levels, with the middle level being called the mezzanine. Both types of debt are used for financing working capital, capital expenditures, and acquisitions. Mezzanine financing usually occurs after senior lenders exhaust their lending capabilities. Finally, because it is in a subordinate position, mezzanine debt is typically more expensive than senior debt.

Mezzanine and senior debt, in addition to equity, constitute a company's capital structure, which describes how the company finances itself. Therefore, when a company's capital structure is said to be highly leveraged, this means that it has a large amount of long-term debt.

Debt that is amortized over a period longer than 12 months is considered long-term debt (LTD). It can be senior or mezzanine. It is found in the balance sheet in the long-term liabilities section. Loans for real estate and equipment are usually multiyear, long-term debt obligations.

In contrast, short-term debt (STD) is that which is due within the next 12 months. STD comes in two forms: revolver debt, which is used for working capital, and current maturity of long-term debt. It is found in the balance sheet in the current liabilities section. This debt typically has a higher cost than does long-term debt. Short-term debt is usually used to buy inventory and to fund day-to-day operating needs.

Let's look at the strengths and weaknesses of debt financing.

Pros

- The entrepreneur retains complete ownership.
- The cost of capital is low.
- Loan payments are predictable.
- There is a 5- to 7-year payback period.
- It can involve value-added lenders.
- It provides tax benefits.

Cons

- Personal guarantees are required.
- The lender can force the business into bankruptcy.
- Amounts may be limited to value of the company's assets.
- Payments are due regardless of the company's profits.

SOURCES OF DEBT FINANCING

The major sources of debt financing are personal savings, family and friends, angels, foundations, government, banks, factors, customer financing, supplier financing, purchase order financing, and credit cards. Let's review these sources in more detail.

Personal Savings

An entrepreneur often uses her own money to finance the company. This is especially true in the early stages of a start-up. The Global Entrepreneurship Monitor's "2006 Financing Report" showed that 62 percent of the funds available to start-ups across the globe came from the entrepreneurs themselves.[5] The primary reason for this is that banks and other institutional debt providers do not supply start-up capital because it is too risky. Start-ups have no history of cash flow that can be used to repay the debt obligation.

Using the entrepreneur's own capital is commonly referred to as "bootstrapping." This is how, for example, Ernest and Julio Gallo started their wine business in a rented warehouse in Modesto, California, in 1933, at the heart of the Depression. After researching the industry at the local library, they decided to start their business using what little capital they had, and they convinced local farmers to provide them with grapes and defer payment until the wine was sold. They also bought crushing and fermenting equipment on 90-day terms. Today, the company started by these two bootstrappers enjoys annual worldwide sales of more than $900 million. Other examples of bootstrapping include Domino's Pizza, Hallmark Cards, Black & Decker, and Ross Perot's EDS.[6]

Often the start-up investments are made in the form of equity instead of debt. But there are no rules that require such an equity investment. An entrepreneur's ownership stake does not have to come from his capital investment. In fact, it should come from his hard work, called "sweat equity." My advice is that all investments that the entrepreneur makes in his company should be in the form of debt at a reasonable interest rate. The repayment of this debt allows the entrepreneur to receive capital from the company without the money being taxed because it was simply the return of the original investment. The interest payment would be deductible by the company, reducing its tax liability. The entrepreneur would be required to pay personal taxes on the interest earned.

All of this is more favorable to the entrepreneur than if the capital were invested as equity. In that case, if it were repaid by the company, it would be taxed at the investor's personal tax level, and any dividends would also be taxed. Unlike interest payments, dividends paid are not tax-deductible. Therefore, the company would receive no tax reduction benefits.

Family and Friends

As stated earlier, it is virtually impossible to procure debt financing for start-ups. Therefore, an obvious viable alternative is family and friends. The benefit of raising debt capital from this source is multifold. Raising money may be easier and faster because the lenders are providing the capital for emotional rather than business reasons. They want to support the family member or friend. That was the case with Jeff Bezos's first outside lenders, who were his parents. Another benefit, especially with debt, is that if repayments cannot be made, these lenders may be more conciliatory than institutional lenders. Unlike the latter, they are not likely to force the entrepreneur into bankruptcy if he defaults on the loan.

The negative aspects of procuring money from family and friends exceed the positives, however. First, these are typically not value-added investors. Second, they may not be "sophisticated investors," which we will discuss in more detail later in this chapter. They may not understand either the risk of the investment or its form. Regarding the first point, they may not really comprehend the fact that such an investment might be completely lost, yielding no capital return at all. They expect to be repaid no matter what happens. They also may not realize that as debt investors, they are not entitled to any ownership stake, only a predetermined interest payment and the return of their original investment. This usually becomes an issue when the entrepreneur is extremely successful in increasing the company's value. In such a case, many family members and friends may not be content with simply having their principal returned and earning interest on that money. They expect to share in the firm's value appreciation. In essence, they expect their debt to be treated as equity. If it is not, they feel that they have been cheated by their own child, grandchild, niece or nephew, or childhood friend.

This final point leads to the greatest problem with raising debt capital from family and friends: there is a risk of irreparably damaging or losing important personal relationships. As one professor said, "Remember these are people whom you eat Thanksgiving with, and it may not be safe to sit next to your uncle if you have lost all his money and he has sharp utensils in his hands."

In closing, my advice is to refrain from raising debt capital from family and friends. If this cannot be avoided, adhere to the following recommendations:

- Raise money only from those who can afford to lose the entire amount. Do not get money from a grandparent who has no savings and lives on a fixed government income.

Make it clear to the family members that they are putting their entire investment at risk; therefore, there is a chance that it may not be repaid.

- Write a detailed loan agreement clearly highlighting the interest, the payment amounts, and the expected payment dates.
- The agreement should give the investor the right to convert any or all of the investment into company stock, thereby giving the investor an ownership stake if desirable.

  Alternatively, the agreement should be that the investment is mezzanine financing, which is debt with equity. The investor receives all of the investment back, interest, and an equity stake in the company.
- Personally guarantee at least the amount of the investment and at most the investment plus the amount of interest that the investment could have gained had it been put in a safe certificate of deposit. Today that would yield approximately 4 percent.

Angel Investors

Angel investors are typically wealthy individuals who invest in companies. (The term was originally coined to describe individuals who were patrons of the arts.) They are different from family and friends in that they usually do not know or have a relationship with the entrepreneur prior to the investment. In addition, they are sophisticated investors who thoroughly understand the risk of the investment and are comfortably able to absorb a complete loss of their investment. Angel investors are typically former entrepreneurs who focus on industries in which they have experience. Prominent examples of companies that received angel investing are the Ford Motor Company, The Body Shop, and Amazon.

With venture capital increasingly looking toward later-stage investments, money from angels has provided the bulk of seed and start-up capital in the United States, with some estimates placing that percentage at as much 90 percent of all early-stage capital provided in the country.[7] A University of New Hampshire study estimated that in 2006, there were 234,000 active angel investors in the United States who annually provided $50,000 to $500,000 per deal in debt and equity to entrepreneurs. In 2006, angels funded 51,000 businesses at a cost of $25.6 billion. These numbers grew 10.8 percent and 3.0 percent, respectively, from 2005.[8] While increases in available capital from angels obviously delight entrepreneurs, they generate the opposite response from many in the institutional venture capital community, since they create more competition for deals and increase valuations. Some venture capitalists call money from angels "dumb money," alleging that it is far less than value-added money. In my opinion, such insulting comments are simply sour grapes.

For many years, angel investing has been an important part of the financial support and mentoring available to entrepreneurs that assists them in bridging the financing gap between the individual investments of friends and family members and the institutional venture capital provided by traditional VC firms. Increasingly, though, angel investors are formalizing into angel investor groups in order to attract better deals; provide infrastructure and support for the tax, legal, and other issues that arise from angel investing; and provide more formal support systems that allow them to increase their real and perceived "value added."[9] In 2006, there were nearly 250 formal angel investor groups in the United States, up from just below 100 groups in 1999.[10]

While most angels demand equity for their investments, there are some who have invested debt in companies that had "shaky credit" and had been dumped by their banks. In those instances, the angels restructured the loans at significantly higher interest rates.

The positive aspect of getting debt financing from angels is that they can be more flexible in their terms than an institution like a bank. For example, the angel can make a 10-year loan, whereas the maximum term of a bank's commercial loan is typically 5 to 7 years. Also, angel investors, unlike banks, make their own rules for lending. A bank may have a rule that a loan will not be provided to any applicant who has declared personal bankruptcy. The angel, on the other hand, uses her own discretion in determining whether she wants to make a loan to such a person.

On the negative side, the cost of debt capital from angels is usually higher than that of institutional financing. It is not unusual for these investors to charge entrepreneurs 2 percent per month, which equals an astounding annual rate of 24 percent. Not only is such a rate higher than the 2 to 3 percent over prime that banks usually charge their best customers, but it is also greater than the 18 percent that some credit cards charge their customers. The other negative is that, unlike banks, which cannot legally interfere with their customers' day-to-day business operations or strategy, the angel typically expects to be involved. For some entrepreneurs, this may ultimately cause problems.

When most people think about formal organizations that provide debt capital, banks are the first ones that come to mind. But as stated earlier, there are other types of debt providers. Let's review and discuss a few of these nonbank sources of capital.

Foundations

Another interesting source of capital for entrepreneurs is philanthropic organizations, including the Ford Foundation, the MacArthur Foundation, the Wieboldt Foundation, and the Retirement Research Foundation. Historically, these organizations have provided grants and loans only to not-for-profit entities. But since the beginning of the 1990s, they have broadened their loan activity to include for-profit companies that provide a social good. Eligible companies are those that explicitly state their intention to improve society by doing such things as employing former convicts, building homes in economically deprived areas, providing child-care services to single mothers, or offering computer training to low-income families. Specific examples include the MacArthur Foundation's loan to a Washington, D.C., publisher that tracks the economic policies of states. The loan was used by the company to purchase additional computers. Another example is the inventory loan that the Wieboldt Foundation made to a Chicago company called Commons Manufacturing that makes window blinds that go into public housing.[11]

Foundations also provide grants to community development corporations (CDCs), which, in turn, use the money to provide business loans. The objectives of the CDCs are the same as foundations', which is to lend capital to businesses that provide a benefit to society. An example of such a CDC is Coastal Enterprises, an organization in Maine that provides capital to companies that employ low-income people in Maine.

These loans from foundations and CDCs are called *program-related investments (PRIs)*. More than 550 organizations throughout the world provide PRIs, including those listed in Figure 9-1.

FIGURE 9-1

Program-Related Investment Organizations

Bhartiya Samruddhi Investments and Consulting Services
Hyderabad, India

BRIDGE Housing Corporation
San Francisco, California

Cooperative Housing Foundation
Silver Spring, Maryland

Corporation for Supportive Housing
New York, New York

Enterprise Corporation of the Delta
Jackson, Mississippi

MBA Properties
St. Louis, Missouri

MacArthur Foundation
Chicago, Illinois

Peer Partnerships
Cambridge, Massachusetts

Shorebank
Chicago, Illinois

Wieboldt Foundation
Chicago, Illinois

One of the attractive aspects of PRI loans to entrepreneurs is that interest rates can be as low as 1 percent with a 10-year amortization period. Another positive element is that the foundations can be considered to be value-added investors.

The David and Lucile Packard Foundation was the nation's largest PRI program in 2005, providing over $26 million in PRI investments.[12] If more information about PRIs is desired, two sources are a book entitled *Program Related Investments: A Guide to Funders and Trends* and *The PRI Directory: Charitable Loans and Other Program-Related Investments by Foundations*.

Government

Local, state, and federal government agencies have programs for providing loans to entrepreneurs. These programs are typically part of a municipality's economic development or commerce department. Some government loans are attractive because they offer below-market rates. SBA and CAP (capital access program) loans are usually market-priced, which we will discuss later. They are provided to companies that are geographically located in the municipal area, that can prove their ability to repay, and, just as importantly, that will use the money to retain existing jobs or create new jobs. Regarding the retention of jobs, entrepreneurs in Chicago have accessed capital from the city for the acquisition of a company based on the fact that if they did not buy the company, someone else might do so and move it, along with the jobs, to another city. Other entrepreneurs have procured expansion debt capital with the agreement that for every $20,000 that the city provides, one new job will be created in 18 to 24 months. Practically every town, city, and state provides such job-related debt financing.

The negative aspect of these loans on the local and state levels is that they often take a long time to procure. The applicant has to complete a lot of paperwork, and the process can take as long as 12 months.

A great periodical for identifying federal, state, and local government economic programs is *The Small Business Financial Resource Guide*, which can be received free by writing to the U.S. Chamber of Commerce Small Business Center at 1615 H Street, NW, Washington, D.C. 10062. It can also be ordered online through MasterCard's Web site at www.mastercard.com.[13]

Another drawback for some entrepreneurs is that the applicant must personally guarantee the loans. Personal guarantees will be discussed in more detail at the end of the discussion of debt.

Capital Access Programs

One local government program that does not take as long is your state or municipality's capital access program (CAP). There are presently 25 states and several cities that operate CAPs, which were first introduced in Michigan in 1986.[14] By 1998, CAPs had provided more than 25,000 loans totaling nearly $1.5 billion. While this is a pittance compared with the $19.1 billion guaranteed by the SBA, CAPs are rapidly becoming popular, as they compete with SBA loans.

The CAP loan product is a "credit enhancement" that induces banks to consider loan requests that they might otherwise have rejected because of deficiencies in collateral or cash flow. The mechanism for a CAP loan typically involves the bank and the borrower paying a fee ranging from 3 to 7 percent of the loan amount to a loan-loss reserve account held at the bank. This loan reserve contribution is then matched by state or local money, with the total reserve ranging from 6 to 14 percent of the loan. This amount is used to cover any loan losses.[15]

Banks seemingly like this state or local government–sponsored loan program because the banks, not the government agency, set the terms, rates, fees, and collateral. They do not have to get approval from any other organization or agency. Entrepreneurs like it for the same reason. The bank has the flexibility to approve a loan that may not qualify for SBA financing for one reason or another. Another attraction is that entrepreneurs have stated that CAP financing is faster than SBA loans. CAPs differ in the size of the eligible loans, the nature of eligible borrowers, and the size of the loan-loss reserve. Check with your state or municipality's economic development agency to determine if a CAP exists.

Small Business Administration Loan Program

Federal business loan programs fall under the authority of the U.S. Small Business Administration, which is the largest source of long-term small-business lending in the nation. Each year, the SBA guarantees loans totaling more than $19 billion. And since its inception in 1953, the agency has helped fund approximately 20 million businesses. There are two primary reasons for the popularity of SBA loans. First, the length of an SBA loan can be longer than that of a regular commercial loan. For example, an SBA-guaranteed loan can be for as long as 10 years for a working capital loan, compared with 1 to 5 years normally. Second, the SBA guarantees loans to borrowers who cannot get financing elsewhere.

It should be made perfectly clear that the SBA does not provide loans directly to entrepreneurs. It uses other financial institutions, banks and nonbanks, to do the actual lending. The SBA gives these approved institutions the authority to represent it as a lender and will guarantee up to 85 percent of the loan. For example, a lender, with the SBA's approval, may provide a $100,000 loan to the entrepreneur. If the recipient defaults on the loan, the lender has only 15 percent at risk because the SBA guarantees the balance of the loan.

Most of these loans go to established businesses. About one-third, or just over $6 billion, of SBA loans are lent to new businesses each year. A few start-ups that received SBA loans are Ben & Jerry's, Nike, Federal Express, Apple Computer, and Intel.

Some people foolishly believe that they can default on the loan because there will be minimal consequences. Nothing could be further from the truth. Remember, all SBA loans are personally guaranteed. Also, the lender, despite the SBA guarantee, will doggedly pursue the payment of as much of the loan as possible before requesting SBA reimbursement. The lender's reputation is on the line, and if the lender's loan default rate becomes too high, the SBA will discontinue that bank's participation in the program.

SBA lenders fall into three categories: general, certified, and preferred lenders. General lenders are those that have a small volume of deals or very little experience in providing SBA loans. Therefore, they must submit all of an applicant's loan information to the national SBA office to obtain its approval before they can approve a loan. The process can take several weeks and even months. In contrast, the other types of SBA lenders can act faster.

The most active and expert lenders qualify for the SBA's streamlined lending programs. Under these programs, lenders are given partial or full authority to approve loans, which results in faster service from the SBA. Certified lenders are those that have been heavily involved in regular SBA loan-guarantee processing and have met certain other criteria. They receive a partial delegation of authority and are given a 3-day turnaround on their applications by the SBA (they may also use regular SBA loan processing). Certified lenders account for 4 percent of all SBA business loan guarantees. Preferred lenders are chosen from among the SBA's best lenders and enjoy full delegation of lending authority in exchange for a lower rate of guarantee. This lending authority must be renewed at least every 2 years, and the SBA examines the lender's portfolio periodically. Preferred loans account for more than 21 percent of SBA loans.[16]

To find a list of the SBA lenders in any state, go to www.sba.gov or contact the SBA hotline at 800–827–5722. There is a publication available for each state that is updated at least every 2 years. It lists all the lenders and shows whether they are general, preferred, or certified. The SBA also posts a state-by-state listing of SBA preferred or certified lenders online

The SBA's most popular lending programs are the 7(a) Loan Guaranty, Micro Loan, and 504 (CDC) Loan programs. Before we look at each of these programs, let's discuss a few of the general highlights of SBA financing terms.

Depending on the program, loans can be amortized for as many as 25 years. Interest rates vary. The SBA charges the lender a fee between 3 and 3.5 percent of the loan, which is usually passed on to the loan recipient. And all investors with a stake of 20 percent or more in the company must personally guarantee the loan. Finally, if the loan is to be used to purchase another company, the seller must subordinate his financing of the company to the SBA. In fact, the SBA might require the seller to agree to "absolute subordination." In this case, no payments can be made to the seller as long as SBA money is outstanding.

To be eligible for an SBA loan, the business must qualify as a small business, be for-profit, not already have the internal resources to provide the financing, and be able to demonstrate repayment ability. The SBA uses varying requirements to determine whether a business is small; these requirements depend on various factors, including the industry in which the company operates. For example, because the SBA targets smaller companies, the applicant can't have a workforce the size of GE. If the company is in manufacturing, it cannot employ more than 1,500 people, and the maximum number of employees for a wholesale business is 100. The SBA's requirements and guidelines can be found at www.sba.gov.

A few types of businesses that are ineligible for SBA financing are not-for-profit organizations and institutions, lending companies, investment firms, gambling companies, life insurance companies, religion-affiliated companies, and companies that are owned by non-U.S. citizens.

7(a) Loan Guaranty program. The majority of SBA loans are made under this program. In 2006, $19.1 billion was guaranteed through 100,197 loans, with an average loan of $190,000.[17] (Figure 9-2 shows the top five 7(a) loan markets by state.) Essentially, the 7(a) program is a conventional bank loan of up to $2 million that receives an SBA guarantee. The SBA guarantees 85 percent of these loans up to $150,000 and 75 percent above $150,000. The proceeds can be used to purchase commercial real estate, business equipment, and machinery. They can also be used to refinance existing debt, for construction financing, and for working capital.

FIGURE 9-2

Top Five SBA 7(a) Loan Markets by State, 2001

Top States	Total Loans, in Millions
California	$1,994
Texas	$918
New Jersey	$851
Minnesota	$567
Virginia	$415

Source: Small Business Administration.

There are personal net worth eligibility criteria for 7(a) loans. For example, for a $250,000 loan, the owner's net worth must be less than $100,000.

SBA Express Loan program. Express loans allow lenders to offer revolving credit lines that are renewable annually for up to 7 years and are administered within 36 hours. They are meant to overcome the difficulties that lenders face in making smaller loans that are too expensive to underwrite as part of the traditional 7(a) program. Under this program, loans under $25,000 do not require collateral. Lenders use their own application forms. The maximum loan amount is $350,000, with a 50 percent SBA guaranty. In some areas, there are special versions of this program for veterans (Patriot Express) and those doing business in low- and moderate-income areas (Community Express).

Loan prequalification. Business applicants with needs of less than $250,000 can be reviewed and potentially authorized by the SBA before the loans are taken to lenders for consideration. The program employs intermediary organizations to assist borrowers in developing a viable loan application. Small Business Development Centers (discussed later in this chapter) provide this service for free. For-profit organizations will charge a fee. The application is expedited by the SBA after submission. Interest rates, maturities, and guarantee percentages follow the 7(a) guidelines.[18]

Micro Loan program. Nonprofit groups such as community development corporations are the primary issuers of micro loans. These are the smallest loans guaranteed by the SBA, at levels as small as $450. The maximum is $35,000, with the average loan being $13,000. Since 1992, the SBA has provided loans totaling more than $321 million to over 28,000 borrowers. Interest rates on these loans are generally between 8 and 13 percent. In 2006, the Micro Loan program provided more than $33 million in loans to more than 2,500 borrowers. There are 170 intermediaries that disburse these loans.[19]

504 (CDC) Loan program. This loan program is a long-term financing tool for economic development within a community that is offered through certified development companies (CDCs) in an area. The program provides growing businesses with long-term, fixed-rate financing for major fixed assets, such as land and buildings. The funds cannot be used for working capital or inventory, consolidating or repaying debt, or refinancing. CDCs are nonprofit corporations set up to contribute to the economic development of their community and retain jobs. CDCs work with the SBA and private-sector lenders to provide financing to small businesses.

There are 270 CDCs nationwide, each covering a specific area. Loan amounts vary, but can be as large as $4 million. In 2006, the SBA approved 9,720 loans totaling $5.61 billion under this program.[20]

Nonbank SBA Lenders

As stated earlier, the SBA guarantees loans made by both banks and other financial institutions. These other lenders compete with banks by offering lower rates and faster loan approval. The SBA refers to these firms as small business lending companies (SBLCs).

One of the largest non-bank lenders is CIT Small Business Lending, a division of CIT Group Inc., which is a publicly traded global commercial finance company. CIT has been named the top SBA 7(a) lender for nine consecutive years and is one of the top lenders to minorities, women, and veterans in the country. The following are examples of some of CIT's primary lending criteria:

- Adequate historic cash flow to cover the debt
- Business debt to net worth ratio must meet industry average
- Borrowers must be actively involved in the day-to-day operation of the business
- Satisfactory personal credit histories are required for all principals and guarantors
- No past bankruptcies or felony arrests

Other prominent large non-bank SBA lenders include the Small Business Loan Source and Loan Source Financial. Unfortunately, as of this writing, the number of nonbank lenders is decreasing. Banks have lowered their rates to a point at which the nonbanks can no longer compete. One reason that banks have been able to do this is that their cost of capital is lower than that of nonbanks. Banks use the deposits they have, whereas nonbanks must get their money from the public capital markets. Another reason is that banks are using their commercial loans as "loss leaders." They will sacrifice returns on business loans to increase the number of customers who use many of their other services, such as online banking, personal savings, loan accounts, and cash management programs. Nonbanks that have departed from or significantly decreased their loan business include Heller Financial, Transamerica Finance, and The Money Store.[21]

Banks with SBA Loan Programs

Approximately 6,000 of the 8,799 banks in the country (down from 14,000 in 1997) use the SBA's guaranteed loan program. Certified lender status is held by 850 banks and preferred lender status by 450 banks. The Small Business Administration produces an annual report on the small-business lending activities of the nation's leading commercial banks. The SBA analyzes lending patterns and ranks "small-business-friendly" banks in every state and on a national level. The SBA says that its goal is to give small businesses an easy-to-use tool for locating likely loan sources in their communities. It also aims to nudge banks to compete more aggressively for small-firm customers. The report is a great resource for entrepreneurs trying to determine which banks will be more likely to lend a sympathetic ear and, more importantly, some cash for their business. The most recent report is titled "Small Business and Micro Business Lending, 2006–2007" and can be found at http://www.sba.gov/advo/research. This report covers micro lending (under $100,000) and small-business lending (between $100,000 and $1 million).

Advice for Getting an SBA Loan

It has been estimated that the SBA will approve less than 50 percent of requested loans. Some advice for improving your chance of obtaining an SBA-guaranteed loan is provided here:

- *Clean up your personal financial problems.* Most of the rejected loans are rejected because of the applicants' poor personal credit history. Before applying, the entrepreneur should reduce his credit card debt, and also the number of credit cards he has. Financiers are aware of these numbers and view holding too many credit cards negatively. It is especially important for loan applicants to know their three-digit credit or FICO score, which ranks their creditworthiness on a scale from 501 to 990. Finally, before applying, the entrepreneur should check with the major credit bureaus and make sure there are no errors on his credit reports. The bureaus are Equifax (www.equifax.com), TransUnion (www.transunion.com), and Experian (www.experian.com). Americans are entitled to one free credit report per year.

- *Define your goals realistically.* Apply for a specific dollar amount, and identify in detail how the funds will be used. Develop realistic, logical financial pro formas that show that even under the worst-case scenario, the debt can be repaid. At a minimum, most lenders want to see that a company's annual cash flow is 1.25 times its total annual loan obligations (principal and interest). Do not plug in numbers. Do not ask for money that you cannot forecast being paid back.
- *Begin early.* Apply for financing at least 6 months before the money is needed.
- *Work with experienced lenders.* Apply to institutions that have certified or preferred lender status.
- *Submit an excellent business plan.* Follow the guidelines and advice presented in Chapter 3 regarding the development of a business plan. Make sure the entire plan, especially the executive summary, is well written, clear, and thorough. Just as important, check and recheck all numbers, making sure that they are correct and that the math is perfect. All numbers must add up.
- *Collect preapplication information.* Loans for existing and start-up businesses require much of the same information, including:
  - The personal tax returns of all investors with at least 20 percent ownership for the past 3 years
  - The personal financial statements for all investors with at least 20 percent ownership
  - The ownership documents, including franchise agreements and incorporation papers

  A few pieces of information are needed for an existing business that are not needed for a start-up and vice versa:

  For an existing company:
  - Tax returns for the past 3 years
  - Interim financial statements
  - Business debt schedule

For a start-up company:
- Business plan
- Potential sources of capital
- Available collateral

- *Do not lie.* Never lie. An entrepreneur's greatest asset is his reputation.

Other SBA Programs

Small Business Development Centers (SBDCs). There are more than 1,000 SBDCs, most of which are located in universities throughout the country. This program is a collaborative effort between the SBA, the academic community, the private sector, and state and local governments. The centers provide management and technical assistance as well as assistance in the preparation of loan applications. The services are tailored to the local economies they serve.

SCORE. This advisory group has 389 chapters and 10,500 retired and active senior executives and small-business owner volunteers. They provide marketing advice, business plan preparation, and business planning, and they handle approximately 10,000 cases per month. Information can be found at www.score.org.

Small Business Training Network. This network is an online training resource for small-business owners. The resource offers online courses, workshops, publications, information resources, learning tools, direct access to electronic counseling, and other forms of technical assistance. It can be found at www.sba.gov/training.

Banks without SBA Loan Programs

Historically, banks without SBA programs (those that use personal guarantees as their primary collateral), including some community development banks, have not been viewed as great friends to entrepreneurs. The reason is that most were asset-backed lenders that determined the loan amount using a strict formula, such as 80 percent of the value of accounts receivable plus 20 percent of inventory and

50 percent of fixed assets. Given this formula, start-ups could never get loans, and companies with tangible assets were limited to the amount mandated by the formula regardless of the true amount needed.

With the "entrepreneur generation" of the mid-1990s came the advent of an increasing number of banks that were cash flow lenders, like the SBA for small businesses. Recent research from the SBA suggests that, much like other dot-com phenomena, this type of lending has waned. A study of banking and small and medium enterprise financing by the SBA showed that 90 percent of loans under $1 million by small domestic banks required collateral.[22] The focus on small business has remained, however, and credit is generally more available to small firms than was the case many years ago. Large banks like Bank of America, Chase, Citigroup, and Wells Fargo have taken aim at the small-business market. While it is true that much of this focus is on credit lines/credit cards of under $100,000, these banks are increasingly focusing on small business.

Overall, the traditional rules of bank financing still apply. Entrepreneurs will need to pass a full credit analysis, including a detailed review of financial statements and personal finances, to assess their ability to repay. Banks will require collateral and will want to understand what kind of assets you can liquidate to pay them. They will also want to get comfortable with your business plan and how it fits within larger macroeconomic conditions. In general, the bigger your business, the easier it will be to secure financing. The Federal Reserve Bank of New York refers to this as the "Five Cs."[23] These are Capacity to repay, the Capital you have committed, your personal Commitment to the business, the Collateral you have to secure the loan, the conditions of the loan, such as economic climate and the purpose of the loan, and Character in the general impression you make.[24] As stated earlier, the SBA report on small business and micro business lending in the United States provides statistics on the top lenders to small businesses in each state and nationally.

Community Banks

Unlike the large banks, community banks have usually been seen as a friend to the entrepreneur. As Larry Bennett, director of the Center for Entrepreneurship at Johnson & Wales University, notes, "There is a huge difference in banks' receptivity to lending to entrepreneurs." The biggest difference is that local and regional banks will more readily agree to customize loans to fit entrepreneurs' needs.[25] These are typically small independent banks that specialize in certain types of targeted lending. After years of consolidation, community banks are making a comeback. There are more than 9,000 such banks in the country, some of which are listed in Figure 9-3. To find out who and where they are, contact the Independent Community Bankers of America at 1–800–422–8439 or visit www.icba.org.

FIGURE 9-3

Various Community Banks

Community Bank	Investment Focus
Mechanics and Farmers Bank Durham, North Carolina	African Americans
Michigan Heritage Bank Novi, Michigan	Equipment leasing
United Commercial Bank San Francisco, California	Asian small-business community
Legacy Bank Milwaukee, Wisconsin	Urban families and entrepreneurs
First Truck Bank Charlotte, North Carolina	Small and women-owned businesses

Entrepreneurs should choose the bank that best fits their needs. Bill Dunkelberg, chief economist at the National Federation of Independent Business and chairman of a small bank in Cherry Hill, New Jersey, explains how entrepreneurs should think about choosing a bank. He says that small businesses should "figure out if they fit better with the point scoring model [or] if playing golf with the loan officer would help." In short, Dunkelberg is saying that larger banks will look more at the numbers behind your business, whereas small community banks will get to know the entrepreneur and may be more willing to work a bit more with her.[26]

Community Development Financial Institutions (CDFIs)

CDFIs primarily provide loan financing to businesses that are generally unbankable by traditional industry standards. They are typically community development loan funds, banks, credit unions, and community development venture funds. The pricing on these loans is a bit higher to reflect the additional risk, from 0.5 to 3.0 percent above normal loan rates. There are about 1,000 CDFIs nationwide. In 2005, CDFIs funded more than 2,000 small and medium-size businesses and held $739 million in outstanding loans and investments. Another 5,800 companies received loans of $35,000 or less. CDFIs can make riskier loans because they are not restricted by regulation. CDFIs can also be value-added investors. There is no listing of every CDFI, but the Treasury Department has a partial list at www.cdfifund.gov, and more resources can be found at www.cdfi.org.

CDFIs can be useful for starting up or growing a business when bank financing is not an option and your returns are not high enough to attract the interest of angel investors or venture capital firms. CDFIs also can be useful for owners with less than perfect credit. CDFIs typically fund businesses in economically depressed or rural areas.

Personal Guarantees

One of the greatest drawbacks to debt financing from banks for many entrepreneurs is the personal guarantee, which is collateralized by all one's assets, including one's home. While such a guarantee is not required for loans from all capital sources, it is for any SBA financing. Leslie Davis, a former commercial lender, said that it is not unusual for entrepreneurs to say, "I cannot agree to personally guarantee the loan because my spouse will not let me." In those cases, she immediately rejects the loan, because, as she explains, "If the spouse does not completely believe in the entrepreneur, why should we?"

One of the greatest fears that entrepreneurs have is losing their homes. Bankers estimate that at least 90 percent of first-time business owners use their homes as collateral. These are the entrepreneurs *and* spouses who are completely committed. Should they worry? Yes and no. If the borrower defaults and a personal guarantee is backed partially or completely by his home, the lender has the legal right to sell the home in order to recoup its investment. But private banks and the SBA typically attempt to work with the entrepreneur to develop a long-term repayment plan that does not include selling the house. This point was supported by an SBA director who said, "Our position as far as personal residences is to try to work with the individual borrower as much as possible. We look at the home as collateral of the last resort. We certainly don't want to retain assets, especially not residential real estate."[27]

Therefore, it is good advice to communicate regularly with the lender after providing a personal guarantee, so that if the loan becomes a problem, it can be restructured prior to default. Loan officers have been trained to receive bad news. They do not necessarily like it, but they like surprises even less. Keep the loan officer informed. The loan officer wants you to repay the loan and succeed, and will help if you pursue the problem early. Even when default is inevitable or occurs, the loan officer will still help you as long as you communicate, are open with information, are willing to negotiate, and agree to a payment plan that could take 10 to 15 years. Most importantly, demonstrate a "good-faith effort" to work things out.

The worst thing you can do when you are facing default is to become difficult, noncommunicative, or threatening. Do not attempt to negotiate by threatening that you will declare bankruptcy if the lender does not give you what you want. Such threats usually upset the lender, and if you carry out the threat, it will be more harmful to your future than to the lender's. In such combative cases, the lender will not only pursue the home that was used as collateral, but also seek to garnish any future earnings that the entrepreneur may have to fulfill the entire debt obligation.

Try to work things out. As stated in Chapter 1, most successful high-growth entrepreneurs fail at least 2 times. Give yourself another chance by making the bad experience a win-win situation for both you and the financier. The financier wins by receiving payment, and you win by keeping a strong reputation and putting yourself in a position to receive financing from the same lender for future deals. As one bank executive explained, "If you've had some financial trouble in the past, it doesn't mean that I'll turn you down. I'll be curious about how you responded to the trouble."[28]

Nonbank Financial Institutions without SBA Loan Programs

Many nonbank financial institutions without SBA programs also provide long-term debt financing to entrepreneurs. Included in this group are national insurance companies, such as Northwestern Mutual and Prudential. Their loans can be used for working capital, business acquisitions, and equipment and machinery. These institutions tend to have higher minimum loan levels than banks that service entrepreneurs. For example, Prudential's loan level ranges between $10 and $15 million. Another difference from traditional bank lending is that if the insurance company were a subordinated lender, the loan would be for only 1 to 1.5 times EBITDA. As the senior lender, nonbank financial institutions will be similar to banks, lending as much as 3 times EBITDA. Another attraction is that these institutions are not asset lenders; they are cash flow lenders. As one supplier said, "We don't look at collateral upfront. We look at management's work history, and then the cash flow of the business. Banks don't usually do that."[29] The final significant difference is one of their main attractions: be it senior or subordinated debt, they can amortize the loan over 15 years. This compares very favorably with the maximum 7 years that banks traditionally offer.

Person-to-Person (P2P) Lending

For prospective entrepreneurs who have had difficulty qualifying for traditional commercial or SBA loan products because of poor credit ratings and/or an unproven track record, an increasingly popular alternative for start-up capital is person-to-person (P2P) lending. At Web sites like Prosper.com, Zopa (www.zopa.com), Lending Club (www.lendingclub.com), and GlobeFunder (www.globefunder.com), entrepreneurs are able to connect with people across the globe who desire to lend small sums of money to strangers for the promise of higher returns than they might see with their traditional personal banking products. P2P lending allows individuals to lend to each other at a set rate for a fixed period of time, offer built-in solutions for loan repayment and tracking, and employ social networking capabilities that allow borrowers to tell the stories associated with their need for capital.[30]

The maximum loan amount at a P2P site is typically $25,000 (although maximum loan amounts are expected to increase to as much as $100,000 in the future), with loans often syndicated among several lenders.[31] Each of the major sites employs a slightly different model, but all typically require that borrowers register on their site, submit to a basic credit check (with required minimum credit scores of approximately 640), and have a debt/equity ratio of around 30 percent. Currently, roughly 20 percent of the loans on the four major P2P sites (Prosper, Zopa, LendingClub, and GlobeFunder) are for business purposes.[32]

While rates on P2P sites can be more attractive than using credit card debt to finance a business, there are downsides to consider. These loans typically require both principal and interest to be paid down every month (whereas several types of bank loans allow only interest payments at first). Additionally, the fixed payment periods associated with these loans can often be difficult to manage for seasonal businesses. Finally, it is almost impossible to renegotiate these loans once their terms are set.[33]

P2P lending will not replace traditional commercial lending anytime soon, but it is a growing niche. Entrepreneurs are especially cautioned to carefully consider their overall debt levels and ability to repay before obtaining a P2P loan, since these products do not come with the built-in sanity checks that a commercial banker brings to the traditional bank loan process.

CREATIVE WAYS TO STRUCTURE LONG-TERM DEBT

Debt is usually structured so that it is amortized over 5 to 7 years, with interest and principal payments due each month. For the first-time or inexperienced entrepreneur, it is recommended that you ask for more lenient terms. The purpose is to give you a little breathing room immediately after you procure the loan, so that your entire focus can be on operating the company and not becoming a slave to servicing debt. The options for repaying the debt could include:

- Making payments quarterly or semiannually.
- Making only interest payments each quarter, with a principal balloon payment at the end of Year 5 or Year 7.
- Making no payments at all until three to 6 months following the loan closing; then paying interest only for the balance of the fiscal year, followed by quarterly payments of interest and principal for four to 6 years.
- With SBA loans, structuring fixed principal and interest monthly payments even with a variable rate. If interest rates go down, you pay down the principal faster. If interest rates rise, you'll have a balloon payment at maturity.

These are only a few suggestions that every entrepreneur should consider pursuing. As is obvious, these structures free up a lot of cash in the early stages—cash that the entrepreneur can use to solidify the financial foundation of the company. These options, or any variation of them, are not typically offered automatically by the lender. The entrepreneur must ask for them during negotiations.

LONG-TERM DEBT RULES TO LIVE BY

In summary, here are a few final pieces of advice relative to debt financing:

- Always take the maximum number of years allowable for repayments. Try to include a no-prepayment-penalty clause in the agreement.
- Get a fixed rather than a floating rate of interest. Know what your future payments will always be.
- Expect loan application rejection. Do not be thin-skinned.
- After getting the loan, keep your investors informed. Send them monthly or quarterly financial statements and, if possible, send out a quarterly status report. Invite lenders to visit your business at least once a year. A few of these suggestions may actually be required as stipulated in your loan documents.
- When things go wrong, renegotiate.

- Keep excellent and timely financial statements. Historical statements should be readily available at any time. They should be neatly stored in an organized filing system.
- Once the loan application has been submitted, expect to hear from a loan officer by telephone before or after normal working hours. This is one of the ways bankers evaluate the working habits of the entrepreneur. Does she come in early and stay late? Or is she an 8:00 a.m. to 5:00 p.m. person? (To prove you are not the latter, call the loan officer at 6:00 a.m. or 9:00 p.m. and leave a message on his voice mail that you are in your office and working and thought he might be doing the same, because you had a question for him.)

DEBT FINANCING FOR WORKING CAPITAL

Up to this point, the sources of capital discussed could have been used for business acquisitions, start-ups, or working capital. As stated before, most entrepreneurs find access to working capital their greatest problem. Therefore, in addition to the aforementioned sources, here are other sources of debt financing specifically for working capital.

Factors

Factoring firms, or factors, are asset-based lenders. The asset that they use for collateral is a company's accounts receivable (AR). By way of example, a company sells its AR, at a discount, to a factor. This allows the company to get immediate cash for the products shipped or services rendered. Factoring is one of the oldest financial tools available, as it dates back to the Mesopotamians. It was also a tool of the American colonists, who would ship furs, lumber, and tobacco to England. Eventually, the U.S. garment industry became a user. Today, factoring has over $120 billion in annual volume in the United States. Worldwide, factoring volume is over $1.5 trillion annually.

The usual agreement is that when the product is shipped, copies of the shipping document, called the bill of lading, and the invoice are faxed to the factor. Typically, within 48 hours, the factor deposits 70 to 90 percent of the invoice amount into the client's account. When the customer pays the bill, which is usually remitted to the factor in accordance with instructions on the invoice, the factor takes the 70 to 90 percent that it had advanced to the client plus 2 to 4 percent for the use of its capital. The balance is sent to the client.

There are two types of factors, recourse and nonrecourse. The former buys accounts receivable with an agreement that it will be reimbursed by the client for receivables that cannot be collected. The latter type takes all of the risk of collecting the receivables. If a receivable is not paid, the client has no obligations to the factor. Obviously, the fees charged by nonrecourse factors are greater than those charged by recourse factors.

Regardless of the type of factor, before reaching an agreement with a client, the factor investigates the creditworthiness of the client's customers. In most instances, the factor will "cherry-pick," or select, certain customers and reject the accounts of others. The rejected customers are those that have a history of slow payment.

The factoring industry has continued to grow for a number of reasons. First, factors provide immediate access to cash. This can be particularly helpful for fast-growing companies or companies that are in immediate need of liquidity. Alton Johnson of Bossa Nova Beverage Group used factoring to avoid giving up equity during the early stages of the firm's growth. This got the firm to profitability without giving up precious equity. In some industries, factoring is actually the most profitable way to go. For example, Roger Shorey, president of Accurate Metal Fabricators, a Florida-based kitchen-cabinet company, receives discounts for immediate payment that exceed the costs of factoring. Another force driving the growth in the factoring industry has been globalization. Factoring is an excellent way for small companies to manage the uncertainty of a new export market.[34]

On the flip side, there are some clear negatives associated with factoring, and it should almost always be viewed as a stopgap or temporary measure. The primary negative associated with factoring is that factoring is very expensive. At 2 to 4 percent per 30-day period, the annual cost of factoring is between 24 and 48 percent interest. There are very few businesses that can generate returns at these levels for sustained periods of time. Factors also typically prefer to engage in longer-term contracts. Finally, a company's existing debt covenants may forbid it from using this source of capital because it involves the selling of assets.

How can an entrepreneur find a factor? Usually the factor will find you. Once you go into business, factors will begin mailing you unsolicited requests to use their services. The postcard or letter will not call it factoring; instead, it will call it working capital or inventory financing.

There are hundreds of factoring firms in the country. Some online resources on factoring include Factors Chain International (www.factor-chain.com) and the International Factoring Association (www.factoring.org). Also, Alana Davidson, the principal of IBC Funding, a factoring broker, has written a paper entitled "Ten Frequently Asked Questions about Factoring." It can be obtained free of charge by writing to IBC Funding, 3705 Ingomar Street, NW, Washington, D.C. 20015.[35]

Advice for Using Factors

- Factors are ideal for businesses in industries with inherent long cash gaps, such as the health-care industry, where insurance companies are notoriously slow in paying claims, or the apparel industry, where producers must buy fabric 6 to 9 months before they use it.
- Factors are also ideal for companies that are experiencing or forecasting rapid growth.
- Factors are also ideal for companies that are first experimenting with exporting goods to foreign countries with unfamiliar regulations.
- They are ideal for companies that cannot get capital from anywhere else.
- However, factors should be used only by companies that have included the cost of factoring in their prices. Otherwise, the cost of factoring could eliminate all of the company's profits. In fact, one factor suggested that the only firms that should use this financing method are those with at least 20 percent gross margins.[36]
- Companies with many small customers should not use factoring, as it is cumbersome to deal with checking the credit of so many customers.
- Ultimately, cheaper forms of capital should replace factor financing. It is too expensive to use on a long-term basis.

Customer Financing

The idea that a customer could be a provider of debt may seem odd, but it is indeed possible and has happened many times. Customers are willing to provide capital to suppliers who provide them with a high-quality or unique product that they may not be able to buy somewhere else. This financing can be a direct loan or a down payment on a future order. That is the financing that Robert Stockard, the owner of Sales Consultants of Boston (SCB), an executive recruiting firm, received from his largest customer, MCI. When the telecommunications giant needed a temporary sales force of 1,200 people to launch its new calling plan, Friends and Family, nationally, it hired SCB. Rather than approach a bank for additional working capital to finance this larger-than-usual job, Stockard persuaded MCI to make a 10 percent down payment on the $2.5 million contract.[37]

Entrepreneurs like Stockard who successfully procure working capital from customers show that anything is possible if you simply ask. An investor who is also a customer is a value-added investor.

But raising capital from a customer has a few drawbacks that should be considered first. One is that you may risk losing customers who are competitors of your investor. Another is that, as an investor, your customer could get access to key information about your company and use it to become your competitor.

Still another negative is that once a customer is an investor, the customer knows more about the true state of the company's operations. This exposure to the company's internal operations may cause the customer to seek another supplier if the customer thinks the company is poorly managed.

Finally, the additional insight that a customer has may make it tough for a supplier to increase prices, since the customer now knows the cost of the product. Therefore, be careful when accepting capital from customers.

Supplier Financing

Suppliers are automatically financiers if they give their customers credit. The simplest way for entrepreneurs to improve their supplier financing is by delaying the payment of their bills. This is called "involuntary extended supplier financing." But sometimes a supplier will graciously agree to extend its invoice terms to help a customer finance a large order that, in turn, helps the supplier sell more goods.

And there are other instances where a supplier will give a direct loan to a customer. That was the case when Rich Food Holdings, a grocery wholesaler in Richmond, Virginia, loaned $3 million to Johnny Johnson, a grocery chain owner, "to buy my buildings, equipment and groceries. In exchange, I agreed to purchase 60% of my inventory from them."[38]

Like customer financing, supplier financing has a few negative aspects. The first is that the supplier may require you to purchase most or all of your products from it. This causes a problem when the supplier has poor delivery, poor quality, and higher prices.

Another problem may be that because your supplier is an investor, other suppliers that are the supplier's competitors may refuse to continue to do business with you.

Purchase Order Financing

Although they may seem alike, factoring and purchase order financing are two different things. The first provides financing after the order has been produced and shipped. The latter provides capital at a much earlier stage—when the order has been received. There are many businesses that have orders that they cannot fill because they cannot buy inventory. This working capital is used to pay for the inventory needed to fill an order. It is a great resource for companies that are growing fast but do not have the capital to buy additional inventory to maintain their growth.

That was the case with Jeffrey Martinez, the president of Ocean World Fisheries USA in Florida. His company is an importer of shrimp and crab from Latin America. His customers were giving him purchase orders at a rapid pace. He, in turn, was generating orders to his supplier faster than he was collecting receivables, which created a cash shortage and diminished the speed with which he could buy more inventory. In addition, his suppliers expected to be paid immediately upon delivery. He had to pay for inventory before he got paid. Martinez explained his working capital problem this way: "We're able to sell all the shrimp and crab we could import and more. But when suppliers put the product in a container, they expect to be paid immediately."[39] His solution? He procured inventory using purchase order financing from Gerber Trade Finance in New York, which allowed him to pay for his inventory upon delivery.

This type of financing is designed for companies that cannot get a traditional loan from a bank or finance company, perhaps because they are carrying too much long-term debt. It is ideal short-term financing for companies that do not hold inventory for long, such as importers, wholesalers, and distributors.

Like factoring, purchase order financing is not cheap. The lender charges fees that range from 5 to 10 percent of the purchase order's value, and payment is due in 30 to 90 days.[40]

Purchase order financing is riskier than factoring because the collateral is inventory, which may get damaged, be poorly produced, or get spoiled. Therefore, banks and other traditional financiers have not wholeheartedly embraced this type of debt financing.

In addition to Gerber, two additional purchase order financiers are Bankers Capital and Transcap Trade Finance. Both are located in Northbrook, Illinois.

Credit Cards

The final source of debt working capital is from credit cards. But before proceeding, let me offer a stern warning about using credit cards. *Be careful!* The abuse of credit cards can be one of the entrepreneur's easiest and quickest ways to go out of business.

Americans owe more than $2 trillion on their credit cards.[41] The top four cards are Visa, MasterCard, American Express and Discover, which collectively hold approximately 70 percent of market share. It is estimated that 88 million U.S. households have at least one credit card. In 2004, the Federal Reserve Survey of Consumer Finances found that the median balance for household credit card debt was $5,100. Americans for Fairness in Lending reports that the credit card industry is cashing in on this debt, with $36.8 billion in profits in 2006, up nearly 80 percent from $20.5 billion in 2000. Not surprisingly, with all this money to be made, the number of credit card offers has skyrocketed. The number of credit card solicitations in the mail has increased from 1.1 billion in 1990 to over 6 billion in 2005. There areapproximately 280 million men, women, and children in the entire country. This is equivalent to 21 solicitations for every person in the country!

One group that has been receptive to these solicitations is entrepreneurs. A 2007 survey done by the National Small Business Association showed that credit cards were the most common financing option that entrepreneurs used to meet their capital needs. Entrepreneurs have embraced credit card use for several reasons. First and foremost, credit cards are very easy to get, as proved by the statistics just cited. Second, the card allows easy access to as much as $100,000 in cash advances without having to explain how the money will be spent. Small businesses that don't qualify for bank loans also look to credit cards to finance their growth. The final reason is that if they are used methodically and strategically, credit cards can provide inexpensive capital. Regarding this final point, there are two ways in which the capital can be cheap. The first is by using cards that offer introductory rates as low as 3.9 percent. The second is a situation where the capital can be provided as an interest-free short-term loan. That occurs when the bill is paid off each month during the grace period.

This second method highlights one of several negative aspects of using credit cards for working capital: one large bill comes due every month, as opposed to small bills from many suppliers when you pay by check. When cash is short, it is easier to juggle the payments of a number of small bills than one large bill.

This problem leads to the next issue, and that is the assessment of expensive late-payment penalties. In 1997, the government lifted restrictions on maximum penalty charges, resulting in credit card issuers charging whatever late fee they wanted, even if the bill was paid only one day after the grace period. Until that ruling, most banks charged an annual fee of about $25, fixed rates to all borrowers, and late fees of $10 or less. Furthermore, most cards came with a grace period. Since that ruling, late fees have jumped to $39, and in some cases the grace period has been eliminated. Moreover, credit card companies have begun increasing rates on borrowers for reasons ranging from being late on a house payment to using too much of their available credit.

One thing that has not changed is the high interest rates. While many credit card companies use low introductory rates to lure new customers, once these rates expire in 3 to 6 months, the traditionally high credit card rates of 12 to 20 percent or even more take effect. This is very expensive money because of the high rates and the fact that the interest charges are compounded. Getting behind on credit card payments can put an entrepreneur in a deep financial hole. The worst is when the debt is so far past due that the interest costs are being compounded and late penalties are being added, so that payments never decrease the principal. A situation like this can harm the entrepreneur's personal credit because she is liable, not the business.

Another challenge in using credit cards other than for cash advances is finding suppliers that will accept them. Suppliers that might have credit card payment capabilities have an aversion to accepting credit cards because the suppliers have to pay the issuing institution 1.5 to 3.0 percent. This in effect reduces the price they charge you.

The final negative is that the use of personal credit cards for business purposes is a violation of the customer-cardholder agreement that you sign.

If you are not dissuaded from using a credit card, here are a few suggestions:

- Pay the entire bill before the end of the grace period to eliminate interest charges or late fees. Payment means that the money must actually be received, not simply be "in the mail."
- Not all cards have grace periods. Use only those that do.
- Know how long your grace period is. That is the amount of time a lender allows before charging interest on the balance due. Some grace periods are as few as 20 days. If the bill is paid in full before the end of the grace period, no interest is charged. You should know that federal law says that credit card bills must be received no later than 14 days before the grace period ends.
- Refrain from getting cash advances if interest is charged immediately after the money is given, regardless of whether the account is paid in full during the grace

period. In addition to interest charges, most credit card companies charge a fee of 2 to 5 percent of the total cash advance. Use only cards that treat cash advances like other charges that you make.

- Find out the closing date of your credit card statement. This is the date in every month when billing for that month ends. For example, if your statement closing date is the tenth of every month and you have a 20-day grace period, complete payment must be made and received by the thirtieth of the month in order to avoid interest charges.
- When using the card to pay suppliers, get an agreement with them that no matter when you make the actual purchase, they will bill the credit card on the day following your statement closing date. Using the example in the previous item, that date would be the eleventh of the month. Therefore, that charge will not show up until you receive the bill that closed on the tenth of the next month. With a 20-day grace period added to that, you could get a 50-day interest-free loan.

  Let's use a more detailed example to illustrate this point. The Perkins Company purchases 60 widgets from the Steinharter Company for $1,000 on October 14. The Perkins Company's closing statement date is the twenty-ninth of each month. Therefore, the Steinharter Company submits the charge on October 30. On November 29, the charge is sent to the Perkins Company by the issuer. The 20-day grace period ends December 18. The Perkins Company pays the entire bill at the bank on December 17. The result is that the Perkins Company received an interest-free $1,000 loan for 62 days, from October 14 to December 17.

In closing—*be careful!* Credit card companies are constantly changing things. One such change could be your closing statement date or the number of days in your grace period. Unnoticed changes in either could result in your owing a complete month's worth of interest because your payment was one day late. Finally, just as with any other contract, make sure to read the fine print and know what obligations you and your business must fulfill.

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