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Financing Small Business in Nebraska

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FINANCING OF SMALL BUSINESSES IN NEBRASKA

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ABSTRACT

A comparative study was used to analyze the financing of small businesses, less than 3 years old versus firms 3 years and older in Nebraska. Findings indicate that younger firms will give up partial ownership of their company in exchange for equity financing and managerial assistance significantly more than older firms. New firms were also found to be more willing to give up 100% ownership and a local market in exchange for majority ownership and a national market. Moreover, no differences in startup financing were found between younger versus older firms.

FINANCING OF SMALL BUSINESSES IN NEBRASKA

INTRODUCTION

The rapidly changing global economy has recently had a detrimental effect on the workforce in the United States. Daily reports of massive corporate and defense layoffs have caused past employees to search for other means of survival. A current trend for dislocated workers is buying a small business (e.g. franchise) or starting a new venture.

In order to survive in the highly competitive global business environment, a key ingredient for small businesses is adequate financing. Carter & Van Auken (1990); Digman (1990); Jones (1979); Peterson, Kozmetsky, & Ridgway, 1983; Schendel and Hofer (1979), and Wucinich (1979) report that one of the major reasons why small businesses and new ventures fail is a lack of capitalization, high debt loads, or other closely related financial difficulties. In addition, as the U.S. comes slowly out of recession, the capital-raising environment for small companies is highly inefficient (Gupta, 1992).

Given the importance of financing and the current impoverished environment for raising capital to small businesses in the U.S., the purpose of this article is to enhance the business environment in Nebraska by investigating the financing options available to new business startups and small companies. Debt, equity, and other creative forms of financing for small businesses will be investigated in this study.

LITERATURE REVIEW

Small Business Financing

Much has been written on small business and new venture financing (see Apilado and Millington, 1992; Barren, 1989; Bruno & Tyebjee, 1985, 1986; Camp and Sexton, 1992; Fenner, 1991; Freear and Wetzel, 1990; James, 1988; Johnson, 1979; MacMillan, Siegel, & Narasimia, 1985; Maier and Walker, 1987; Norton and Tenenbaum 1992; Owens, 1990; Ruhnka, 1985; Schilit, 1986; Van Auken and Carter, 1989a; 1989b). Traditionally, entrepreneurs and small business owners have used either debt or equity financing. Typically, owners seeking debt capital, retain company ownership, but are usually committed to rigid payback schedules. On the other hand, owners who seek equity capital must be prepared to share company ownership with investors; but they often enjoy flexible payback schedules (Owens, 1990).

The following sections will examine debt, equity, and other creative forms of financing available to new ventures and small businesses.

Debt Financing

The small business owner has a variety of debt financing options to choose from. For instance, small businesses can seek the following debt financing sources: commercial banks, asset-based lenders (ABLs), savings and loans, factors, government programs, suppliers and customers, private foundations, friends and family, personal savings, credit cards, and debt securities. The following is a brief review of a few of these financing options.

Commercial Banks. A popular source of debt financing is through your local neighborhood bank. However, the current tightening of the markets has caused most banks to become extremely stringent on their requirements. Therefore, small business owners should be prepared to submit their past financial statements (e.g. P&L statements, cash flows, balance sheets) and their business plans. It is recommended that individuals develop a trusting relationship with the banker before applying for a loan. Specifically, before applying for a loan, determine the bank's requirements. Furthermore, founders of new ventures have always had trouble getting commercial bank loans (Fenner, 1991).

Asset-Based Lenders (ABLs). One of the most active source of debt capital for small businesses are the asset-based lenders. These include traditional finance companies and ABL departments of commercial banks (Owens, 1990). These companies lend money based on a percentage of an existing company's assets. For example, most asset-based lenders currently give loans based on 80% of a company's receivables.

Government Programs. Federal, state, and local governments have several viable programs designed to assist the financing of new ventures and small businesses (e.g. Small Business Administration (SBA) and local economic development programs).

The most popular federal program is the SBA. The SBA has several loan programs specifically designed to assist small businesses in obtaining financing. For example, the SBA 7(a) loan provides direct and guaranteed loans to businesses that are unable to obtain funding in the private marketplace. In addition, the federal agency's guaranteed loan program helped 16,730 small businesses borrow $3.8 billion in 1990. The program can back as much as 85% of loans up to $750,000, with an average loan of $230,000. Interest rates on SBA loans tend

to be 2 1/4 to 2 3/4 points over prime and about a quarter of such loans go to new ventures (Fenner, 1991).

Equity Financing

Equity capital is virtually nonexistent for the startup and small to medium-sized corporation, unless you have a stellar track record or exceptional opportunity (Owens, 1990). Typically, an equity capital source wants a 50% per annum compounded return based on whatever capitalization standards (i.e. projected earnings, book value, or cash flow) (Barren, 1989).

Small businesses seeking equity capital should seek the following sources: venture capital firms, corporations (e.g. investment banking firms and insurance companies), initial public offerings (IPOs), employee stock ownership plans (ESOPs), small business investment companies (SBICs), minority enterprise small business investment companies (MESBICs), private investors (e.g. angels, accountants, attorneys, friends, and family). A brief examination of several equity financing sources follows.

Venture Capital. Venture capital firms generally include institutional investors as well as traditional partnerships established by wealthy families to aggressively manage a portion of their funds (Schilit, 1986). The ideal candidate for venture capital--equity funds placed by an investment firm that backs unproven young businesses--is a one or two year old company that has the potential to quintuple in value within three to five years (Fenner, 1991). Most venture capitalists look for companies that can grow from startup to about $50 million in sales within five years (Owens, 1990). Generally, venture capital firms focus their attention on high growth firms with a proprietory product, technology, or market niche. They usually require a rate of return of 35% compounded annually.

Initial Public Offerings (IPOs). Small businesses have a slight change of ever having an initial public offering. The following characteristics can be found in most firms which go public: (1) high-growth firms, (2) proven track records, (3) beyond the startup stage, and (4) need at least $5 million in capital.

SBICs and MESBICs. Backed by the SBA, these are privately-owned companies which provide long-term financing for small businesses. SBICs generally fund businesses who have been in operation for a few years and have the following characteristcis: (1) a maximum of $4 million in net worth, (2) a maximum of $9 million in assets, and (3) a maximum average net income of $400,000 (Schilit, 1986). MESBICs provide financing for minority owned businesses and tend to operate similar to other venture capital companies.

Private Investors. These individuals are comprised of almost anyone. For example, previous employees, accountants, attorneys, customers, suppliers, business professionals, family, or friends all fall under potential private investors. Angels are also considered to be private investors. Angels (Fiedler, 1986) are investors, often a businessperson, who wants to put excess cash to work. It is estimated that 720,000 angels invest $32.7 billion of equity in small businesses every year (Fenner, 1991). This makes angels the largest source of equity capital for small businesses. Due to the secretive behavior of angels, it is recommended that small business owners and future entrepreneurs network with their bankers, attorneys, financial advisory firms, suppliers, key customers, and/or accountants to enhance their exposure to these potential investors.

Creative Financing

Several other forms of creative financing are available to small businesses: corporate and R&D partnerships (Evanson, 1986), joint ventures, licensing agreements, mezzanine financing (Stevens, 1989), and venture leasing (Retkwa, 1990). These forms of financing are not as popular with new ventures and small businesses. However, all viable alternatives should be considered when obtaining financing for your business.

Financing in Nebraska

Several sources of financial assistance exist in Nebraska for small businesses. The United Financial Resources Corporation, a subsidiary of United AG Cooperative, is a SBIC located in Omaha. It has capital resources of $1 million and provides loans to grocery stores all over the state (Crawford & Marquardt, 1989). The Nebraska Department of Economic Development provides assistance on identifying financial information and economic development programs. The Nebraska Venture Capital Network stimulates economic development throughout the state by providing a computerized matching service between Nebraska entrepreneurs and potential investors and investment firms.

Other sources of financing in Nebraska include: 1) the Nebraska Investment Finance Authority (NIFA), an independent non-profit, quasi-state agency that provides lower-cost financing for manufacturing facilities, certain farm property, health care, and residential development; 2) Economic Development Finance Program/Community Development Block Grant Program (CDBG) which provides loans and grants to finance job-creation business development throughout the state; 3) Industrial Development Revenue Bonds (IDRB) which provide low cost financing for eligible projects through tax-exempt bonds, and 4) Ethanol Authority and Development Act which provides equity financing for expanded use of Nebraska agricultural products, energy sources, and the development of protein which will be more efficiently stored and marketed.

HYPOTHESES

This study entails a comparative analysis of small businesses in Nebraska differing in age. Comparative studies of small businesses have been virtually extinct in past research. This study will attempt to fill a gap in previous research by testing the following hypotheses relating to small business financing.

H1: New firms, less than 3 years old, will give up partial ownership of their company in exchange for equity financing and assistance in running their business significantly more than firms 3 years or older.

H2: New firms, less than 3 years old, will allow an equity owner of their company a seat on their board of directors in exchange for financing significantly more than firms 3 years or older.

Previous researchers (see Dunkelberg and Cooper, 1984; Van Auken and Carter, 1989a) have found that during the startup stage, the majority of initial capital for small businesses tended to be personal savings. We assume that new firms will have limited capital due to their influx of personal savings. Furthermore, we assume that new firms will be lacking in managerial experience versus older firms. One way these new firms can gain access to additional financing and managerial assistance is through partial ownership of the company.

H3: New firms, less than 3 years old, would rather give up 100% ownership of their company that reaches a local market for a majority ownership (as little as 51%) that reaches a national market significantly more than firms 3 years or older.

Several factors might contribute to the rationale behind why old firms would want to retain 100% ownership that reaches a local market versus a majority ownership that reaches a national market. Established firms might refuse to give up partial ownership of the company because they want to be in total control of the organization. Older firms might also have reached a desired amount of sales and/or not travel or move from well establi

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n.

H4: New firms, less than 3 years old, will rely on debt versus equity during the startup stage significantly more than firms 3 years or older.

As stated previously, research has shown that new firms tend to rely on personal savings during the startup stage. Therefore, since we are examining the startup stage for both new and old firms, we expect there to be no significant difference between debt versus equity financing.

METHODOLOGY

In 1990, data were collected from a mail survey sent to 3,157 small business in Nebraska. Eight-hundred and seventy-three small business owners responded to the survey for a 28% response rate. Responses from the survey were broken into two groups. Group A consisted of small businesses with their first year of operation 1987 or before. Group B consisted of firms with their first year of operation 1988 or after.

The mailing list was obtained from the Department of Labor Unemployment Insurance files. The following qualifications were required for inclusion in the study: (1) firms which became

liable for unemployment insurance within the last two years; (2) firms in the following industries: manufacturing and mining, construction, transportation (excluding railroad), public utilities, wholesale, and services (excluding hotels and other lodging); and (3) firms with 5 employees or more.

The Department of Labor unemployment insurance files were used to generate the list because all firms that pay more wages than $1500 per quarter or have employees on the payroll for more than twenty weeks per year must pay unemployment insurance. These insurance requirements imply that any firm with five or more employees in the manufacturing, mining, construction, transportation, public utilities, wholesale or service businesses located within the state of Nebraska are in the files. The sample of 3157 business firms was selected by computer using a statistical random sampling technique. A response rate of 28% was achieved on the survey so the inferences drawn from this research should be representative of all Nebraska firms in the selected industries.

The responses were broken into two groups -- more established firms (Group A) and newer firms (Group B) which consisted of firms that had been in business for three years or less. This categorization was made because previous communication with venture capitalists and business owners indicated that new small firms which had not been in business for at least three years had a much more difficult time obtaining funds.

The targeted industries were selected because they represent primary industries that could generate significant increases in employment and economic growth. This would stimulate additional economic activity in some other excluded sectors such as railroads, retailing, hotels and lodging.

VARIABLES

Small Business Financing

To understand how small business owners view equity and debt financing the following questions were asked: In exchange for equity financing and assistance in running your business, would you be willing to give up partial ownership of your company in exchange for equity financing and managerial assistance (Yes or No? Would you be willing to allow an equity owner of your company a seat on your board of directors (Yes or No)? Would you rather retain 100% ownership of a small company that reaches a local market, or retain majority ownership (as little as 51%) over a large firm that reaches a national market (Yes or No)?

The businesses were then asked what sources of capital provided the initial financing for their company: (1) equity financing and/or (2) debt financing.

RESULTS

Our Sample

In Group A, 51% of the firms started operation between 1978-1987, while 71% of the firms in Group B started operation in 1988. Groups A and B had the following percentages represented in the representative industries: (1) manufacturing--38.5%, 21.3%; (2) service--28.5%, 35.2%; (3) construction and mining--11.6%, 11.1%; (4) wholesale--5.9%, 4.6%; (5) agriculture--4.5%, 8.3%; (6) transportation, communication, and utilities--4.2%, 5.6%. Approximately 70% of the firms in Group A versus 55% of the firms in Group B has sales above $250,000.

Statistical Analyses

Chi-square analysis was performed to test the four hypotheses. Chi-square analysis was the most appropriate statistical test because all of the variables were collected and coded in a categorical format.

Significant chi-square analysis provides support that two or more variables (in our case two classifications of small businesses) are in fact different from one another. When a chi-square test fails to yield significant results, no statistical evidence can be given to support the hypothesis that the variables are different from one another.

The first hypothesis attempted to determine if there was a difference between new versus older firms who would give up partial ownership of their company in exchange for equity financing and assistance in running their business. Statistical results of hypothesis 1 can be seen in Table 1.

Insert Table 1 here

The chi-square test for the first hypothesis revealed significant results at the .05 level. The results of this test indicate that there is a significant difference between Group B and Group A firms. Group B firms (the younger firms) were more likely to give up partial ownership of their company in exchange for equity financing and management assistance.

The second hypothesis attempted to determine if new firms, less than 3 years old, would allow an equity owner of their company a seat on their board of directors in exchange for financing more than firms 3 years or older.

Results of the second hypothesis were significant at the alpha .10 level. This finding indicates that there was a significant difference between new firms less than 3 years old and firms older than 3 years, with new firms more likely to give an equity owner a seat on their board of directors in exchange for financing. A description of the results is given in Table 2.

Insert Table 2 here

The third hypothesis attempted to determine if younger versus older firms would rather give up 100% ownership of their company that reaches a local market for a majority ownership (as little as 51%) that reaches a national market. Chi-square results for the third hypothesis revealed significant results at the alpha .10 level. Results of this hypothesis indicate that there is a difference between these two groups on this issue, with more firms younger than 3 years opting to give up 100% ownership in exchange for exposure to a national market. Table 3 shows the
results of the chi-square analyis.

Insert Table 3 here

The final hypothesis was found to be not significant at the .10 level. Table 4 shows the results of the statistical analysis.

Insert Table 4 here

Chi-square results from this hypothesis indicate that there is no significant difference

between the reliance on debt versus equity during the startup stage in firms less than 3 years old versus firms older than 3 years. A more in-depth analysis of the results is expanded upon in the next section.

IMPLICATIONS FOR MANAGEMENT

In an attempt to fill a gap in previous research, this comparative study was done on small business financing. An analysis was done on sources of financing and their relationships to small businesses younger than 3 years versus small businesses 3 years or older.

Significant results were found for hypothesis 1. Firms younger than 3 years were significantly more likely to give up partial ownership of their company in exchange for equity financing and assistance in running their business than firms 3 years or older. Explanations for this might be that firms less than 3 years old might lack the financial and managerial expertise during the startup stage of the venture. In addition, older firms might be more financially stable, gained valuable contacts within the financial community, and/or gained the respect and credibility within their communities. Therefore, older firms might not need to seek additional financing or managerial assistance as much as younger firms.

Significant findings were also found for Hypothesis 2. The significant relationship suggests that startups, less than 3 years old, will tend to give an equity owner a seat on their board of directors in exchange for financing more than businesses older than 3 years. Similar to the findings in hypothesis 1, results indicate that new firms are willing to give up a seat on their board in exchange for financing because they have problems raising startup capital. Whereas, older firms are more established and don't need to give up a seat on their board in exchange for

financing.

Previous researchers (Dunkelberg and Cooper, 1984; Van Auken and Carter, 1989a) have found that during the startup stage, the majority of initial capital for small businesses tended to

be personal savings. This reliance on personal funds during the startup stage might limit the small business owner's ability to raise future funds. In addition, allowing an equity owner to sit on the board, might enhance the performance of the business. The equity owner might have access to critical information and/or resources which might assist in the future performance of the firm. Finally, an existing equity owner in the small business might be more interested in the success of the venture due to his or her existing interest in the concern.

Hypothesis 3 was found to be significant. The significant results indicate that firms older than 3 years old will tend to hold onto 100% ownership and their local market versus majority ownership (at least 51%) and a national market. Younger firms were more willing to give up 100% ownership and a local market for exposure to a national market.

Possible explanations for this phenomena could be: (1) Group A firms might not need the broader national market focus because they have already established themselves, are profitable, and/or they're at a mature stage in their market life cycle; (2) Group A firms are growing at a faster rate than Group B firms, therefore, they want to attack the national market; (3) Group A firms don't want to give up ownership to anyone, they want to be in total control of the organization; and/or (4) Group B firms might not have the desired amount of sales yet. These are all areas for future research.

Finally, hypothesis 4 was found to be not significant. New firms, less than 3 years old, did

not rely on debt versus equity financing during the initial startup stage anymore than firms 3 years or older. While there was no significant difference in startup financing between Group A and B, 74% of our entire sample (482) did rely on some sort of debt financing during the initial startup stage of the venture. This is consistent with previous researchers (see Dunkelberg and Cooper, 1984; Van Auken and Carter, 1989) who found a reliance on debt versus equity financing during the startup stage.

Explanations for this phenomena might be: (1) the majority of firms do not have a proprietary product, market, or technology. Therefore, typical equity investors (e.g. venture capitalists) might refuse to invest in these ventures and (2) these firms are new ventures and lack the credentials that financiers look for when providing equity financing (e.g. track record, experience, and collateral).

SUMMARY

The importance of financing to small businesses has been documented by several researchers [(see Carter & Van Auken (1990); Digman (1990); Jones (1979); Peterson, Kozmetsky, & Ridgway, 1983; Schendel and Hofer (1979), Van Auken and Carter (1989a), and Wucinich (1979)]. Despite previous researchers attempts to to investigate small business financing, few studies have attempted to do a comparative analysis between older versus newer firms. This study attempted to fill a gap in previous research by testing four hypotheses relating to small business financing.

The findings of this study indicate that firms less than 3 years old might have a harder time getting financing, therefore they are willing to give up part of their company in exchange for

equity financing and managerial assistance. Furthermore, the significant findings of hypothesis 2 indicate that younger firms would give up a seat on their board to an equity owner in exchange for financing. Hypothesis 3, which was also significant at the alpha .10 level, found that new
firms would rather give up 100% ownership of their company that reaches a local market in exchange for exposure to a national market. Finally, hypothesis 4 found no difference between younger versus older firms and their use debt versus equity during the initial financing stage of the venture.

The findings in this study have important implications for potential investors in small firms, less than 3 years old. Results indicate that investors who want to become a part owner of a new company, should target smaller firms, less than 3 years old. Specifically, it is recommended that future investors, who want to be part owners of these firms, find high growth companies in high growth industries (e.g. computer software and/or biotechnology companies).

Results of hypotheses 1 & 2 could indicate that younger firms have difficulty in obtaining financing. Therefore, they are more willing to give up partial ownership of their firm or a seat on their board of directors versus older firms. Implications to owners of younger firms suggest that they should seek these potential investors, if indeed, they have difficulty in obtaining financing.

Similar to hypothesis 2, the third hypothesis was significant at the alpha .10 level. Implications to practitioners suggest that younger firms might be ready to attack the national market with the help of an equity partner. Also, younger firms may not have the resources (e.g. financial and people) to expand nationally at this period of time without a equity injection.

Finally, results of hypothesis 4 suggest that younger and older firms relied on the same proportion of debt versus equity during the startup stage of financing. These findings are consistent with previous research which states that equity capital is virtually nonexistent for the
startup and small to medium-sized corporation, unless you have a stellar track record or exceptional opportunity (Owens, 1990).

The importance of financing for small businesses has been documented and investigated in this study. However, several research streams still exist for future researchers to examine. First of all, how much ownership will small businesses give up in exchange for financing and managerial assistance? Secondly, what was the ratio of debt versus equity that these firms used during their startup stage? Thirdly, why would a majority of firms rather retain 100% ownership of their company that reaches a local market versus a majority ownership (as little as 51%) that reaches a national market? Fourthly, small firms will allow an equity owner a seat on their board in exchange for financing, but will they allow a non-equity owner (outsider director) on their board? Who are these people who are investing in these small businesses? Private investors, venture capitalists, bankers? and What is the success ratio of these investors?

Only when these and other equally relevant questions are answered will researchers and practitioners fully understand how small business owners use their financial options in the financing of their businesses.

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Table 1. Exchange Partial Ownership For Equity Financing

	Yes	No	Totals
Group A	273 (36%)	484 (64%)	757 (89%)
Group B	46 (48%)	50 (52%)	96 (11%)
Totals	319 (37%)	534 (63%)	853 (100%)

* Significant at $p < .05$

Table 2. Give an Equity Owner A Seat on the Board of Directors in Exchange For Financing

	Yes	No	Totals
Group A	356 (51%)	338 (49%)	694 (89%)
Group B	57 (61%)	36 (39%)	93 (11%)
Totals	413 (52%)	374 (48%)	787 (100%)

$p < .0699$

Table 3. 100% Ownership and Local Market Versus Majority Ownership and A National Market

	Yes	No	Totals
Group A	506 (67%)	244 (33%)	750 (89%)
Group B	57 (59%)	40 (41%)	97 (11%)
Totals	563 (66%)	284 (34%)	847 (100%)

$p < .0875$

Table 4. Debt Versus Equity Financing At Time of Startup

	Equity	Debt	Totals
Group A	110 (14%)	317 (41%)	427 (44%)
Group B	17 (17%)	38 (38%)	55 (56%)
Totals	127 (26%)	355 (74%)	482 (100%)

$p < .21$