Small Business White Paper from NATIONALFUNDING

Where To Go For Financing When The Bank Says 'No'

When entrepreneurs set out on their life's dream to start a small business, many hold the belief they'll be able to finance the whole operation. After all, there is an intrinsic connection between entrepreneur and startup and the less outside assistance needed the better.

However, in reality, many entrepreneurs will need to seek outside avenues of financing, either to help cover startup costs or to secure a loan that would lay the foundation for future growth. Yet when seeking financing, small business owners have to be wary of where they search for funds; even though small businesses are the backbone of the U.S. economy, many financial institutions in the country are not the best bet for small business owners seeking a loan or other means of financing.

A recent study by the Federal Reserve Bank of New York found 90 percent of small businesses have had their loan request rejected by their bank in the past year. It's an extraordinary - and alarming - number given the role small businesses play in the national economy.

So, where does an owner go after the bank says "no"? Many entrepreneurs are left with little idea of where to go and what to do after their bank has denied them financing; but in fact, there are numerous other avenues of loan procurement that small business owners can take advantage of. However, while several loan sources are attractive in some respects, they are less so in others, making it crucial for small business owners to understand and find the financing provider that is right for them.

Small Business Administration

One of the most frequently cited and highly regarded loan providers that owners turn to is the U.S. Small Business Administration (SBA). The government agency offers value resources, advice, and mentoring to U.S. small business owners, in addition to their financing capabilities, and is in good standing among many entrepreneurs.

But the fact remains the SBA is not all it's cracked up to be when it comes to providing small business owners with an easy loan process.

A big part of the challenge owners experience when applying to the SBA for a loan is the amount of paperwork and waiting they must first endure.

According to the *Houston Chronicle*, which writes extensively on small business issues, to begin the process of procuring a loan from the SBA entrepreneurs must first fill out an application, write and submit a full business plan, provide financial statements demonstrating sufficient cash flow, and undergo a credit check [1]. That's all before the paperwork even starts, which requires resumes, business licenses, personal background statements, copies of a business lease, and owner information.

After the extensive amount of paperwork is taken care of, the SBA and its lending partner must then evaluate an owner based on character, management skills, and the amount of collateral they can commit. The agency and lender must then review and examine the entire process. All in all, *The Chronicle* said it takes a minimum of 60 to 90 days to process the loan application.

The newspaper's overview of the process isn't just theory; take for instance the case of Katherine Swanberg, who owns a hair salon franchise in the Seattle area. Speaking with NuWire Investor, an online news source for investing current events, Swanberg said that not only was the process of securing a loan for a startup made harder by the SBA, but the agency elongated the process unnecessarily [2].

"[The SBA is] extremely detail-oriented. Very picky," she told NuWire. "Almost all the documentation I gave them was inappropriate for one reason or another. My tax returns were not signed, or my tax returns were signed but not in blue ink, or my tax returns were signed on all but one page. It was pretty laborious, trying to get them everything that they asked for."

The purported main draw of the SBA for entrepreneurs is that loans awarded through the agency are seemingly faster to obtain than other loans. Again, however, the truth may be farther away, Mike Cafasso, president of a Colorado bank, told a Microsoft small business blog [3].

"An SBA-guaranteed loan will almost certainly be more paper-intensive and take longer than other loans," Mike Cafasso told Microsoft. "If I have all the information on my desk that I require for approving a loan, I could do the loan the next day. With the SBA and its role in reviewing and guaranteeing the deal, that loan is likely to take a month or longer to be approved."

Another hindrance with the SBA is that small business owners must not only deal with the government, but the very same banks that might have turned them down previously. The SBA does not directly hand out loans, owners have to go through a partner bank. And according to recent research, the partner banks of the SBA did little to increase their lending to small business.

The Small Business Lending Fund (SBLF) was introduced to stimulate big bank lending to small businesses, but the results have been less than satisfactory at best. Of the $30 billion in available funds, only $4 billion was disbursed to banks; and of that $4 billion, more than half was used by banks to pay off debt.

"The program was great in theory and policy, but the implementation failed in many areas," Paul Merski, executive vice president of the Independent Community Bankers of America, told The Wall Street Journal [4].

Family and Friends

If entrepreneurs are unimpressed with SBA lending methods, another common source of loans small business owners consider come from family and friends. However, the axiom "never mix business with pleasure" is quite applicable in such situations.

Family and other loved ones are often at the ready to help small business owners in need, but sometimes, such partnerships can end in grudges and family fights. While small business owners understand the nature of the beast, others may not be as knowledgeable to the risks and other idiosyncrasies of small business. As such, if something goes wrong, it won't just put money on the line, but the entire relationship. If it turns out they become personally liable for your business, it can effectively ruin a friendship or severely strain a relationship with relatives.

Seeking loans from friends and family might negatively affect them, but can spell trouble for small business owners. Dun & Bradstreet, a credit reporting agency, warns that such loans can create tax problems because the U.S. Internal Revenue Service (IRS) mandates that loans from loved ones must still carry interest rates in line with the agency's minimum requirements [5].

Home Equity Loans

Yet another way small business owners try to secure funding is through a home equity loan. But owners should know that such avenues of loan procurement are very risky.

A home equity loan is a loan that enables a small business owner to secure funding by putting his or her home's equity up as collateral. Put it this way, if an owner purchased a home for $250,000 five years ago and the listing price for that residence is valued at $350,000 now, that extra $100,000 is the home equity. Homeowners cannot necessarily spend that $100,000, but they can secure a loan of the same sum against the equity.

Several dangers exist for such loans, however, the *San Francisco Gate* said. One such risk concerns interest rates. Home equity loans feature variable interest rates that move in sync with the prime rate, the rate at which banks lend money to each other. The danger lies in the fact that the interest rate is beyond an owner's control: When the rate moves up, they have no choice but to pay more [6].

In addition to possible volatility in interest rates, a recent study from the Office of the Comptroller of the Currency released a report that said pursuing home equity loans can also endanger small business owners to payment shock and refinancing difficulties [7].

Credit Cards

As small business owners continue to look for alternative methods of financing, some have eschewed traditional commercial loans in favor for credit cards. This line of loan procurement happens when small business owners take cash advances from credit cards. However, like home equity loans, such loans are vulnerable to swings in the market and high interest rates. They also carry another risk, that being unstable terms to the loan agreement and very little transparency on the part of the credit card companies, which effectively allows them to do what they like.

Such was the case James and Heather Hills encountered when they opted for credit cards to fund their startup [8].

"Even though we pay quite a bit, they keep raising the interest rates, which makes it even harder to pay off," James Hills told Bloomberg Businessweek. "Virtually tripling the interest rate from the starting rate to now, that's just amazing that they're able to do that."

Investors

When business is on the rise, many owners look to attract investors to try and pump some more cash into the operation in order to sustain growth. While this is often a highly prized opportunity for small business owners to build their business into something even greater, they should still remain cautious of using investors as loan sources.

Of the two most notable kinds of investors - venture capitalists and angel investors - the former presents a potential danger to small business owners. If things don't work out, investors can take owners completely out of the question. As referenced by an Inc.com article, if venture capitalists don't like the direction of the business or the way it's performing, they can make changes as they see fit [9]. Owners have to ask themselves whether the much-needed money is worth ceding aspects of ownership and management to such investors.

"If you open Pandora's Box, you'd better be prepared for a ton of outside pressure, and you certainly won't be your own boss," David Steinberg, partner of a venture firm, told Inc.

Owners should also keep their eyes on angel investors, despite their nice-sounding name. Such investors may offer up big chunks of cash. However, entrepreneurs need to know they don't do so out of the kindness of their hearts, but because they want to increase their wealth. Angel investors expect big returns and when things don't pan out as envisioned, the situation can quickly turn ugly.

Alternative Lenders

When other avenues have been explored and small business owners have not encountered a suitable loan source, they can turn to alternative lenders like National Funding. Big banks have closed their pocketbooks to small business owners and other means of financing like credit cards and home equity present serious risks. Because traditional lenders aren't lending, alternative lenders have picked up the slack and what was once thought of as alternative is becoming the new normal.

While such lenders may sometimes have higher overall costs, small business owners can choose to balance that with the value offered by the proven flexibility and an easy loan approval process.

In comparison with SBA paperwork procedures, alternative lenders require much less documentation, sometimes only asking for a one-page application with supplemental financial statements. They also maintain less-stringent credit standards, meaning those with less than perfect credit scores will be considered for funding. All the factors lead to a faster turnaround time, letting alternative lenders accommodate small business owners who need to get a loan quickly. Less paperwork and simpler policies mean working capital loans can be processed in a week's time while more complicated financing can be resolved in fewer than 30 days.

Seeking financing from alternative lenders also provides the business with more stability than other forms of financing do. Whereas home equity can tumble if the real estate market crashes, alternative lenders offer a consistent and dependable loan that owners don't need to lose sleep over wondering if their interest rates will spike.

Borrowing from family may provide a quick stop-gap measure at first, but involving personal life with business obligations has never been a recipe that benefits small business owners. When owners seek the services of alternative lenders, they'll still feel at home, but without all the added drama.

Nowadays, when small business owners look to procure financing, the most popular options don't always get priority. Banks have sealed their own fate and alternative lenders have picked up the slack, clearly establishing themselves as leading institutions for small business loans.

Sources:

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