

Chapter 2

SELF-HELP, THE ENTREPRENEUR'S SOURCES

INTRODUCTION

In this chapter we discuss the difficulties entrepreneurs have raising start-up capital. The problem is that banks and most professional investors only want to supply capital to businesses with a track record and start-up businesses have short records, if they have any at all. In this chapter we discuss seven strategies entrepreneurs can use to get start-up capital and build a financial track record that will give them access to other sources of capital.

SELF-RELIANCE

One of the key characteristics of a successful entrepreneur is self reliance. Many people are frustrated from the outset of their venture because they rely upon banks and others for resources. Mark Twain is reported to have said, "A banker is a person who will lend you an umbrella on a sunny day, and take it back when it rains." Most institutional investors are like bankers. Some take back the umbrella at the first cloud, others in the midst of a thunderstorm. When they take back the umbrella that means the investor's perception of risk outweighs the likely reward. When a bank lending officer, angel investor or venture capitalist looks at an entrepreneur's business plan, most see only rain. And in the face of that rain, the entrepreneur's hopes and dreams carry no weight.

Why? Institutional investors look for (i) a revenue stream, from a demonstrable product or service, (ii) satisfied customers - which give them some assurance the revenue stream will continue, (iii) profits which give investors confidence that the enterprise’s costs are under control, and (iv) assets which are a secondary source of repayment if the enterprise fails. In short, institutional investors’ perception of risk, at the beginning of an enterprise, far outweighs any reward they are likely to receive because a start-up enterprise usually lacks some or all to the aforementioned indicia of success. The problems for the entrepreneur are getting started, developing a product, finding the first customers, and establishing a financial track record. So where should the entrepreneur begin? Before we answer that question, let us examine how much is needed to start a company.

HOW MUCH CAPITAL IS NECESSARY?

Inc. magazine focuses on small, emerging companies and the *Inc.* 500 is a list of the fastest growing small companies in the country. Figure 2-1, *Inc.’s Analysis of Start-up Funding* indicates that many of the fastest growing companies started with relatively little capital.¹

Figure 2.1 Analysis of Start-up Funding

Amount	Percent	Cumulative Percentage
Under \$1,000	14%	14%
\$1,000 to \$10,000	27%	41%
\$10,000 to \$20,000	10%	51%
\$20,000 to \$50,000	15%	66%
\$50,000 to \$100,000	12%	78%
Over \$100,000	22%	100%

Two thirds of companies in this survey started with less than \$50,000, which is well within the reach of most individuals who have been working a few years and can employ the seven self-help strategies discussed in this chapter.

SEVEN STRATEGIES TO GET START-UP CAPITAL

Most entrepreneurs know they want to start and run their own businesses long before they launch it. The interval between when a person knows they want their own business and the time they start should be a time of preparation, of carefully laying the foundation for success. One part of that foundation involves setting the stage for raising start-up capital. A number of the strategies discussed below can only be effective if the proper seeds are planted months, or years before capital must be raised. The seven strategies discussed in this chapter include:

- (i) The entrepreneur's own funds from salary, savings and bonuses
- (ii) Investments and loans from friends and family,
- (iii) Credit cards
- (iv) Home equity loans
- (v) Customers
- (vi) Suppliers and Vendors
- (vii) Leases

Savings, Salary & Bonuses

Saving money is the first step on the road to becoming an entrepreneur. A little money saved every payday is important for several reasons. If an entrepreneur can accumulate seed money, he or she has already taken a major step toward financial independence. Saving a regular amount out of each pay requires discipline, and an entrepreneur needs discipline. When the entrepreneur has his or her own money invested in a venture, it builds the confidence of potential investors. A widely used strategy is to save all salary increases and half the amount of after tax bonuses. In addition to that, an entrepreneur needs to live below his or her means. For example, keeping the car an extra two or three years and foregoing the Caribbean vacation are all part of the trade off for future financial independence.

Friends and Family

Capital from friends and family is often the first outside financing for a start-up business. The reason is that if those who know the entrepreneur best, his or her intellect, personality, strengths and weaknesses, do not believe he or she has the drive to build a business, how can strangers be expected to believe? On the other hand, raising money from such close sources has risks.

*“Neither a borrower nor a lender be,
For loan oft loses both self and friend,
And borrowing dulls the edge of husbandry.”*

~ Hamlet, Act I, Scene iii

According to Hamlet, when asking friends and family to invest, the entrepreneur risks losing both their investment and their friendship. But this is only one issue, another one is the form of investment friends and family make.

If the enterprise is successful, investors may believe they are entitled to a share of the profits when you only intended their investment to be a loan. On the other hand, if the business fails, they may demand repayment with interest when you meant for them to share the risk of the enterprise for good or ill. In addition to that, courts may agree with friends and family if litigation ensues. The solution is to these potential problems are document loans with promissory notes and equity investments with stock certificates.

Promissory Notes

A loan can be documented with a promissory note. The elements of a promissory note are:

- Principal - this is usually the amount received. However, sometimes promissory notes are made for a round amount, perhaps \$10,000 or \$100,000 and sold at a discount or premium.
- Interest Rate - this should be the going rate of interest. If the note bears no interest, and does not sell at a discount, the note begins to “look like” an equity investment. Courts often ignore the title of a

document, e.g. "Promissory Note," to find its substance. At a minimum, interest should be equal to the rate on U.S. Treasury Bills. A fairer rate of return to your investors would be the rate banks charge on auto or personal loans, typically 8% to 12%.

- Terms of Repayment – Things to consider in terms of repayment are: Is the loan principal due at a date certain with interest to be accumulated to maturity? Is the loan principal and interest to be paid back in even payments over a term of years? Is the loan to be amortized over a term of 20 years with a balloon payment after five years? Some term of repayment should be specified. If the repayment term is too open ended, it begins to look like an equity investment.
- Maker's Signature - The maker is the person who is responsible for repayment of the loan. Is the loan a personal loan with liability flowing to the borrower personally? Or, is this a corporate loan with liability for payment flowing to a corporation. This is an important distinction and must be explicitly stated in the promissory note. If the loan is an obligation of the corporation, and the corporation fails, the entrepreneur has no obligation to repay the loan. On the other hand, if the entrepreneur signs individually the entrepreneur becomes personally liability for the debt.

Promissory Notes can be purchased in any good stationary store.² Figure 2.2 is a Sample Promissory Note.

Figure 2.2 Sample Promissory Note

Promissory Note	
Amount: \$10,000	
For value received, Blanko Corporation, the borrower, promises to pay the lender, Murray L. Schwartz, \$10,000 with interest at 12% per annum as follows:	
1) Monthly interest only for five years.	
2) At the end of five years the entire loan balance with accumulated interest, shall be due and payable.	
Date: 6/30/2005	<i>Brad Simpson</i> President, Blanko Corporation

Stock

Only corporations can legally issue stock. Corporations are formed by filing Articles of Incorporation with the Secretary of State of the state in which the company intends to incorporate. Articles of Incorporation state the company's name, the number of shares authorized, the names and addresses of officers and organizers, the intended purpose of the corporation, and a number of other requirements that vary from state to state basis.

Corporations can be formed relatively inexpensively, often for under \$500. After the state grants permission to form a corporation, stock can be issued. Stock certificates can be ordered from printers that specialize in printing stock certificates. A stock ledger is usually included with stock certificates. It is used to record issuance, repurchase and cancellation of stock. This ledger will be a critical document in any audit, or due diligence review by a future investor. Before an equity investor invests, he or she will want to know how much stock was authorized in the Articles of Incorporation and how much is outstanding. A sophisticated investor will also want to know whether any options or warrants have been issued, so the company should keep a detailed ledger of options or warrants granted, vesting terms, exercise prices and expiration dates.

Stock issued to investors is subject to securities laws that will be discussed in subsequent chapters. If stock is sold to the public it must be registered with the SEC and it must comply with the state security laws in every state where the stock is sold. If it is not sold to the public, it must still comply with state and federal securities laws. However, regulations covering these "so called" private placements are simpler and less costly to comply with. Securities laws will be discussed in further detail in chapters 11 through 13.

Credit Cards

Entrepreneur can't get bank credit until they demonstrate credit-worthiness, and they can't demonstrate creditworthiness until they have credit. This circular logic can be frustrating, but many entrepreneurs have found a way through it using credit cards. About 50% of small and medium sized businesses used credit cards as part of their financing strategy in 2000, up from 34% in 1997.³

Charlene Connell, CEO of Vital Resources, Inc., a Cleveland computer company used ten credit cards to finance her company for seven

years. Among other things, she used cash advances to meet payroll until client accounts could be collected.⁴ Shoshana Berger, founder of the magazine *ReadyMade*, is boot-strapping her start-up with money from family, friends and 10 credit cards.

Sally Williams and her partners in Hellas International, a Massachusetts importer, borrowed \$150,000 on 18 credit cards to finance their business. She even found credit cards, judiciously used, were more cost effective than a Small Business Administration (SBA) loan. Her SBA fees were \$7,500 on a \$150,000 loan plus 11.5% interest. The average interest on her credit cards was 13.5%. She also noted that time is money and the SBA loan application process was very time consuming.⁵

Credit cards aren't just for travel, office supplies and computers either. People are starting to purchase inventory and raw materials with credit cards. American Express reported that 55,000 wholesalers nationwide now accept credit cards. Broudy Printing, Inc. a Pittsburgh company now buys \$50,000 per month of supplies on credit cards. Champion Lumber purchases materials from Weyerhaeuser Company on credit cards and in April, 1999, monthly purchases reached \$400,000 per month.⁶

Credit Card Advantages, Disadvantages and Strategy

Credit cards have both advantages and disadvantages. Therefore, a well defined strategy should be worked out before the first credit card is used.

Advantages of Credit Cards

The advantages of credit cards include:

- They are easy to get. Most people are solicited for pre-approved credit cards many times each year.
- They provide instant credit with tens of thousands of vendors.
- Most allow cash advances.
- Credit limits can be as high as \$100,000, and
- Introductory rates can be as low as 3.9%.⁷

- It can be one of the first financing sources in the company's name.

Disadvantages of Credit Cards

Balanced against the advantages of credits cards are some significant disadvantages, none of which should be minimized.

- Credit card companies often charge fees for late payment, balance transfers, and annual membership.
- Interest rates can be punishing.
- It would take years to liquidate card balances paying only monthly minimums.
- When card balances reach their limit, credit is cut off.
- Late fees of \$25 or more are often charged when a payment is a day late. Two late fees can cause you to be reclassified as a "risky" client and rates can jump to a punitive 25% - 30%.
- Balances on personal credit cards used for business are not discharged through a corporate bankruptcy.

Credit Card Management Strategies

Credit cards should be used as part of a planned strategy, not on an impromptu basis. The following strategies have been successfully used by a number of companies:

- Search for low cost cards and transfer balances to them on a monthly basis. Beware of cards that charge a transfer fee. A comparison of credit card rates is published monthly at: www.cardweb.com.
- Use some credit cards for business only, and use others for personal purposes only.
- Pay off and discontinue high rate / high fee cards.

- Watch for rate jumps. If a card's rate jumps up, call and ask whether it can be reduced. Card companies often raise rates when they think consumers aren't looking and reduce rates when they get "caught."
- Pay balances monthly, during grace periods, to avoid interest. One survey reports about 60% of small businesses pay off their balances each month.
- One manufacturer works with his vendors to post credit card charges the day after his statement closes. That gives him an extra 15 to 30 days of float.
- One entrepreneur suggests getting as many credit cards as possible before quitting your job to work full time in your business.
- Use the credit history documented through use of credit cards to get a Small Business Administration or conventional bank loan.

Use credit cards cautiously. One out of every three entrepreneurs that uses credit cards choke on the debt, fees and crushing interest.⁸

Home Equity Loans

Home equity loans can provide a significant and cost effective source of capital for a start-up business. The rate on home equity loans rises and falls with a bank's cost of capital and economic conditions. To get a sense of whether the interest rate on a particular home equity loan is reasonable, we can compare it to benchmark rates. Figure 2.3, Analysis of Home Equity and Personal Unsecured Loan Rates compares home equity loan rates to the Federal Funds Rate, the Prime Rate and bank card rates. Home equity loans are about 6.7% less than unsecured personal loans and 7.0% less than bank credit cards. When the Federal Funds Rate and Prime Rate rise Home Equity and Unsecured Personal Loan rates will rise as well. There will always be a differential between these rates and Figure 2.3 provides an estimate of that differential.

Figure 2.3 Analysis of Home Equity and Personal Unsecured Loan Rates

	<u>Rate</u>	<u>Number of Banks</u>	<u>Points Over Federal Funds Rate</u>	<u>Points Over Prime</u>
Benchmark Rates⁹				
Federal Funds Rate	1.24	NA	NA	NA
Prime Rate	4.25	NA	3.01	NA
Loan Rates¹⁰				
Unsecured Personal				
Loan	12.81	8	11.57	8.56
Bank Credit Card	13.19	8	11.95	8.94
Home Equity Loan	6.16	17	4.92	1.91

Advantages of home equity loans include:

- A home equity loan is relatively quick and easy to get if the entrepreneur has equity in his or her home and a steady job.
- They have relatively low interest rates, much lower than conventional or SBA loans.
- Relatively large amounts can be raised through a home equity loan; \$30,000 to \$100,000 is possible.
- The entrepreneur doesn't have to give up equity in his or her business or round up a number of small investors to raise a significant amount of capital.

Disadvantages of home equity loans include:

- If the business fails, the entrepreneur could lose his or home.
- Corporate bankruptcy will not discharge the amount the entrepreneur personally borrowed through a home equity loan.

- If the entrepreneur is married, he or she will have to get the consent of his or her spouse to get the loan. On the other hand, if the entrepreneur obtains a conventional or SBA loan, lenders will require the entrepreneur and spouse to sign personally for the loan.
- Banks are more comfortable lending money for credit card consolidation or a vacation than they are for a start-up business.

If you plan to get a home equity loan, it is much easier while still employed. Once an entrepreneur quits his or her job to start a business, a bank will view him or her as having no verifiable income. However, after two successful years of operations, most banks will accept tax returns in lieu of a W-2 to verify income.

Vendors and Suppliers

When a vendor or supplier sells to a business on credit, it is supplying capital as surely as if it made a loan. Prompt payment of vendor invoices is a way to build a credit history that can be leveraged into a bank loan. Chronic late payments can destroy any hope of getting a bank loan or further vendor credit.

Customers

The transition from having an idea for a company to starting a company frequently comes with the first customer. Customers can be a source of capital if they can be induced to pay some or all of their bill in advance. An example of customer financing occurs in home remodeling. Contractors ask for one-third in advance, one-third half way through the project and one-third on completion. The one-third in advance allows the contractor to purchase supplies and material and meet the first few payrolls. The second third provides another infusion of capital, and the amount of financing that the builder has to provide from other sources to complete the project is only about a third.

Consultants sometimes ask for part payment in advance and negotiate progress payments on large projects. Custom manufacturers require prepayment from new customers and those prepayments help provide start-up funding.

A related customer financing strategy is to get customers to pay before vendors must be paid. One T-shirt manufacturer sells their goods to retailers on ten day terms, but has thirty day terms with its suppliers. So customers and vendors finance the business.

Leases

A lease is another way to get someone else to fund a business. Need a copier and don't have the cash to buy one? Lease one. That way someone else is putting up the purchase money. There are two basic types of leases: operating leases and capital leases.

Operating Leases

Operating leases are like renting. The lessor retains ownership at the end of the lease. Equipment must be returned. Operating leases are accounted for on a pay-as-you-go basis. That is each payment is expensed when due.

Capital Leases

Capital Leases are an alternative to bank financing. At the end of the lease, ownership is transferred to the lessee for a nominal buyout. Because it is like a bank loan, the value of equipment leased is booked as an asset, and the amount financed through the lease is recorded as a liability. The liability recorded is not the sum of all the lease payments. Rather, it is the value of the asset leased less deposits and prepayments.

Since operating leases are not capitalized, that is, they are not recorded as a liability, the decision as to whether to use an operating or capital lease has some importance. Avoidance of liabilities may be a strategic issue if the company is applying for a bank or SBA loan. The more liabilities a company has, the higher it's debt ratio, and the less attractive it is.

Leasing versus Bank Loans

There are both advantages and disadvantages to financing through leasing. Advantages Include:

- Quick turnaround - leasing companies can make a decision in a day or two. It sometimes takes banks weeks or months to make a loan.
- Few strings - banks try to tie clients down with a hundred strings called bank covenants. These include targets on tangible net worth, profitability, and many other restrictions. Leasing companies primarily focus on whether timely payments are made every month.

Disadvantages to leasing include:

- Higher interest rates - the effective interest rate on leases is always higher than on bank loans.
- Effective interest rates are never given. This makes it very difficult to compare leasing to other sources of capital.
- Lease terms can raise the effective interest rate - deposits, prepayment of the first and last lease payment, and origination fees can increase the effective interest rate by 40%.

If leasing is considered, it is strongly recommended that the interest rate be computed. Several books are available to help with this computation. Once implicit interest rates are determined, it is easier to negotiate with lessors and or decide whether other financing sources are more appropriate.¹¹

SUMMARY

Entrepreneurs face significant obstacles in raising start-up capital because a start-up, by definition, has no financial track record that a lender or professional investor can use to evaluate risk. This information asymmetry causes those with capital to err on the side of caution and not provide funds. Entrepreneurs must therefore be self-reliant, and find alternative sources of capital. Many successful, fast growing companies were started with less than \$100,000, an amount well within reach of most working individuals.

An entrepreneur's own savings often provides the seed money for a new enterprise. For this reason, those thinking about starting a company should have a regular savings program.

Friends and family are another source of capital. If those who know the entrepreneur best are not convinced that he or she has the drive and ability

to build a business, it will be difficult to convince others to invest in the entrepreneur's company. Document whether friends and family are lending money to the company, in which case they are only entitled to repayment with interest, or whether they are equity investors in which case they share risks and rewards with the entrepreneur.

Many entrepreneurs use credit cards to start businesses, but high cost can put a company at risk unless credit cards are carefully managed. The strategy most often used to manage credit card debt is to pay off balances each month during the grace period.

Home equity loans can raise relatively large amounts of capital at low cost. However, if the business fails, the entrepreneur could lose his or her home. The entrepreneur should understand that many banks are more comfortable making a home equity loan to fund remodeling or debt consolidation than to fund a start-up business.

Customers and Suppliers represent two additional sources of capital. If the entrepreneur can get a customer to prepay some or all of their bill, the customer is supplying valuable capital. Such prepayments are customary in home remodeling and some consulting work. When a supplier sells to a company on credit, they are lending the company capital as surely as if they gave it a loan in cash.

Leases represent another way to raise capital because a lease shifts the burden of equipment purchase to another party, thus freeing up the entrepreneur's capital for other uses. Operating leases are like renting and at the end of the lease the equipment is returned to the lessor. A capital lease is an alternative to bank financing and at the end of the lease, the entrepreneur can buy the equipment from the lessor at nominal cost. One disadvantage to a capital lease is the value of the equipment is booked as an asset and the principal amount due on the lease booked as a liability.

While it is difficult for first time entrepreneurs to raise start-up capital, there are a number of methods that can be used to raise enough capital to launch a start-up. The keys to success in raising start-up capital are self-reliance and building a financial track record that banks and professional investors can evaluate in providing additional funds.

DISCUSSION QUESTIONS

1. How much capital does it take to start a successful business? What is typical?
2. What are seven sources of capital an entrepreneur can use besides a bank loan?
3. What are the main issues in soliciting funds from friends and family?
4. What are the advantages and disadvantages of using credit cards? What strategies can be used to exploit advantages and avoid the disadvantages?
5. What are the advantages and risks of using a home equity loan? Is there any way to estimate the rate an entrepreneur will pay for a home equity loan?
6. How can vendors and suppliers supply capital?
7. How can customers supply capital?
8. What are the advantages and disadvantages to using a lease to acquire capital assets?
9. What should a company's overarching financial objective be when raising capital through friends and family, credit cards, a home equity loan, or when getting credit from vendors?

ENDNOTES

¹ Ilan Mochari, "The Numbers Game," *Inc.*, October, 2002.

² A question often asked is whether a lawyer is needed to draft a promissory note. On the back of the Bar Association card is a rule that says, whenever anyone asks "Do I need a lawyer for this?" Members of the Bar are obligated to say: "Yes you need a lawyer." Example: Do I need a lawyer to paint my house? "Yes, you need a lawyer."

³ __, "Plastic Was Favorite Financing Medium For Small Businesses," Small Business Banker, Thomsom Financial Media, August 6, 2000; Phaedra Hise, "Don't Start Your Business Without One," Inc., February 1, 1998.

⁴ Hise.

⁵ Greg Lindsay and Sarah Gonser, "The Art Of The Start-up," Folio: The Magazine For Magazine Management, Vol.30, Issue 8, Primedia Intertec, June 15, 2001.

⁶ __ "Credit Cars Charge Into Small Business," Wall Street Journal, Friday, June 4, 1999, p.A2 & A6

⁷ Phaedra Hise, "Don't Start A Business Without One," *Inc.*, February 1, 1998.

⁸ Hise.

⁹ __ Federal Reserve Statistical Release, Selected Interest Rates (Daily) H.15, www.federalreserve.gov/Releases/H15/update as of 4/4/2003, downloaded 4/6/2003.

¹⁰ __ Philadelphia Inquirer, Money Watch, p.E5, 4/6/24

¹¹ David Vance, *Financial Problems & Decision Making*, McGraw Hill, 2002, pp.119-128.



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