Brother, Can You Spare $50,000?

When finding a small business loan becomes a series of closed doors, where does a frustrated borrower turn?

BY CHUCK ZAK

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SGR's case studies, which are composites of real industry companies and situations, present common managerial dilemmas and offer concrete solutions from experts.

Six hundred forty. Not such a bad number if you're filling an order for that many of the artful ceramic mugs that Brady Fitz and his drinkware suppliership routinely produce. But as a credit score, 640 is clearly a glass-half-empty situation.

Having established his company in the midst of the economic turmoil that begat a million small-business horror stories, Brady Fitz feels like he never knew a friendly economic climate. And now that he has begun to search for funding with which to purchase new equipment, he's learning that in the eyes of the banks in his community, he's a risk they're unwilling to take.

But Brady has a clear plan for the money, and after a rough first couple of years in the industry, FitzCo has begun to establish a reputation for itself as a source for unique, creative drinkware. The banks are unimpressed, however, and though the talking heads on the financial news networks continually allege that these banks are "eager to lend," they don't seem particularly eager to lend to Brady Fitz.

Brady hangs up the phone after yet another friendly, but firm, rejection and thinks, "now what?" Does he put his plans for expansion on hold until he can improve his financials and secure better terms from his bank? Or does Brady Fitz investigate alternative sources of capital, immersing himself in this new world of small-business funding with the hope that his sometimes slack grasp on the particulars of capital lending don't get him into trouble? To answer these questions, we've asked professionals with experience on both sides of this dilemma and posed this question: when traditional sources of business funding dry up, where can an imperfect loan candidate find a little cash?

Dan Taylor

We were looking to expand some manufacturing since all of our business is derived from manufacturing elsewhere, and during that process we met with a bank in West Virginia. The reason we did that was that our CPA was located there, and because of low labor, building and land costs. The bank is a regional bank with offices in our area but we looked across the state line because of other incentives, including state and county incentives to bring manufacturing jobs into the state of West Virginia.

We gave the bank all of our financials and the blueprint of what we are looking to do and [so far] everything has been great. But it's been slow in coming, though there's been no negativity. It seems to have been fairly easy since the debt is secured by assets; the bank is willing to loan on that fixed asset, they're agreeable to that, they get the big picture and think it's win/win.

We're still in the investigative process, and we're not necessarily set on that location, but first we had to go through the process of finding out if the bank is willing to work with us and what kind of money are they willing to lend. They looked at our trend lines and I think because our CPA could vouch for our business plan and our success, I think that lent us credibility with our banker.

I've been in business for thirty-plus years and I think since 2008-2009 it's definitely harder to get a bank loan. It has loosened up from my experience, though. With the larger banks there's just so much bureaucracy. Regional banks seem to have more decision-making power at the branch office. So if you're looking for a million or less, I think it's a fairly easy decision if you have the confidence of the local branch VP, at least that's my most recent experience.

Regional banks want a good story attracting a manufacturer looking to move or expand into their local community and investing in the region and driving jobs, they can tout that and it's good PR for them. And if a business has a good track record and good standing in the community, they like to be associated with businesses like that.

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Lisa Ohman

Crowdlending is where small businesses are looking to borrow money directly from investors. So rather than going to a bank to get a loan, or giving up equity in exchange for funds, they're borrowing money from individual investors and then they repay that over time with interest. Similar to Kickstarter or other crowdfunding sites, the borrower creates a listing that explains their business, the funds they're looking for and how those funds will be used, along with financial information about their business, and then they propose the terms.

So say they're looking for $100,000 at 8% over three years. Then the accredited investors can come in and create an offer, they can say "I'm looking to invest for a portion of the amount you're asking for, and based on the information, I'm willing to offer at 6% interest," for example. So it's a dynamic and democratic way for the two parties to negotiate, and the borrower ultimately decides which investment to accept. After that, the borrower pays the funds back to the investor on the scheduled basis.

With InvestNextDoor, businesses can create two types of listings: Private or Marketplace. With a public marketplace listing, borrowers can look for potential investors very similar to crowdfunding campaigns like Kickstarter, but the investors would need to be accredited, so that does streamline some of the individuals who would be engaging. For a private listing, the borrower gets to control who sees that they are out there looking for funds. If you've got a strong network of investors who may have helped at startup, or a strong community network, borrowers can engage them and use some of the SEC exemptions to allow up to 35 non-accredited investors. So maybe they have family or friends who really want to invest but who don't meet the threshold of an accredited investor. That's where the private listing is a great option.

Lisa Ohman is the Chief Operating Officer and co-founder of InvestNextDoor, a community-focused crowdlending marketplace. Prior to InvestNextDoor, Lisa ran the Strategic Initiatives and Mergers & Acquisition integration teams at Active Network, a public software company recently acquired by Vista Equity Partners. She can be reached at (206) 453-0048 or at *lisaohman@investnextdoor.com*

Ty Kiisel

Last October, the Federal Reserve of Cleveland put out a report suggesting that access to capital has eased for all but the smallest business owner. It's still really tight for them. When 2008 happened, there was a knee-jerk reaction and the regulations that applied to all the huge banks also applied to the little banks on Main Street, the community banks that were the traditional source of funding for small business. Money is still tight for them; however, over the last several years, there's been a big industry that's cropped up to fill that void.

Access to capital is such a challenge, and when community banks began to move upstream to bigger and more profitable companies, they left this underserved market that had been traditionally associated with them, so alternative lenders have begun to fill that void. Last year the average SBA loan was about $380,000 and the year before that it was about $337,000. At Lendio, we deal with small businesses all the time and the average per-

son who comes to us is looking for loans of $50,000 or less. So one of the problems isn't that these Main Street businesses are looking for too much, it's that they aren't looking for enough.

Lending to a business that's been around 18 months versus one that has been around 10 or 20 years is a lot more risky. There's just a higher risk profile associated with these smaller businesses. Alternative lenders, however, profile borrowers differently, so they can compensate for the increase in risk. Most bankers want to know what your credit score is, if you have collateral, your character – basically they want to know if whatever you're borrowing for doesn't pan out, how are you going to pay back the loan? It's a pretty straightforward measure, whereas alternative lenders have found that there are dozens of other criteria that are every bit as important.

For example, if you're a merchant cash provider you look at the regular, repeatable credit card transactions as a determinate of whether you will be able to provide a loan and, because you have direct access to the merchant account, you know that you will be able to get paid. So if you have a less-than-perfect credit score, but you have a real strong cash flow in credit card transactions, then a merchant cash lender will be able to work with you when a traditional bank might say no because you have a 620 credit score instead of a 720 credit score.

Ty Kiisel is the author of *Getting a Business Loan: Financing Your Main Street Business* and writes about small-business financing for Lendio, a service matching people looking for business loans with lenders. Mr. Kiisel can be reached via Jeremy Kartchner of Snapp Conner PR at (801) 994-9625 or on Twitter *@tykiisel*

Mel Ellis

When I was at Harvard Business School back in the '70s we used to talk about five-year plans and ten-year plans. Nobody does that anymore. You have to have an idea of what the planning horizon is at least five years out in order to justify capital equipment. We don't have that.

Our bank does enable us to invest in fixed assets on a formulaic basis, but we aren't making as much use of that as we did when the planning horizon was more predictable and not as fraught with risk as it is these days. Last year we relied on internally generated funds; this year we have several high-value projects in mind, and will have to borrow money from the bank. We are doing this because we believe we have some good growth projects. But honestly, we are going on our gut feeling, and our anxiety level is quite high. These days, the risks are greater and the rewards are smaller, so it is hard to justify making significant financial commitments.

You can reach out to private equity, but private equity is going to want a higher probability of success than this industry currently offers. Banks are anxious to lend – they want to lend – but with the complexity and administrative burdens of the Dodd-Frank bill, they are more reluctant to take on new business than in prior periods. Dodd-Frank was intended to return sobriety to the banking industry, but it's more like Prohibition. It's full of rules that haven't been written yet and the cost of compliance is a huge burden to the banks. Banks want to lend, but the new rules make it tougher than ever for firms with marginal credit.

Regulatory burdens are affecting a large number of small businesses. For an example that really brings it down to a granular level: lip balm labels. About a year and a half ago the FDA promulgated a regulation that required 71 words of warning language to be printed on anything that had a sun protection factor in it. These all have the force of Federal law. The cost to HumphreyLine of this one regulation is $100,000 a year. How can a small-business owner see what's coming next? That's the unpredictability of the regulatory environment we live in.

It's what we used to call "contextual uncertainty," and my experience is that most businesses do fine in managing the risks that they can forecast. We can tell you what we're going to spend on labor, how much we're going to spend on rent and a lot of other things – we have a pretty good idea of what our expenses are. We can reasonably predict on a gross level what our revenues are, but no one can predict what is call the "exogenous risk," that event that is not foreseeable. These might include a default on an EU member country's sovereign debt, or the Russian invasion of Ukraine, or even a really harsh winter. Such incidents can have a nasty way of impacting the economy in unpredictable ways, and they can pose a mortal threat to a small business that is unprepared.

Entrepreneurial capitalism is struggling these days, and business conditions are hard. Business risk is higher today than it's ever been in my experience because of the operating environment, and the reward is less because of the intensity of competition in our unique industry, where there is more supply than there is end-buyer demand. The operating environment is really challenging these days, especially for smaller companies – and almost everybody in this industry is a small company. We're mostly little guys who have to live by our wits and have limited resources. But, then again, that's one of the reasons why I love this industry.

Mel Ellis has been at the helm of HumphreyLine since 1991 when he and his wife acquired the business, and has built the company into a recognized leader in American-manufactured promotional products and product safety. Mel was previously Founder and Director of Salomon Brothers Venture Capital from 1985 to 1990. He can be reached at (503) 780-8463 or at *mellis@Humphreyline.com*