



## **Remarks by Governor Mark W. Olson**

**At the Small Business Development Conference, Cleveland, Ohio**

**May 17, 2002**

### **Financing Options for Small Business**

I am pleased to participate in today's small business development conference. These meetings provide excellent opportunities for information-sharing and networking, connecting entrepreneurs with the ideas and the resources that help foster the concepts that generate new business growth.

It is well-known that small business plays a substantial role in our overall economy. In 2000, there were nearly 5.6 million companies with fewer than 500 employees--the U.S. Small Business Administration's (SBA) definition of a small business--and these companies represented 99.7 percent of all businesses. In addition, small businesses employ, collectively, more than half the private-sector workforce and generate about three-fourths of net new jobs each year. These firms also generate more than half the sales revenues of all U.S. firms.

The percentages for Ohio are similar to the national ones, with small businesses representing 98 percent of all businesses and employing more than 49 percent of the state's workforce. Data from the SBA's Office of Advocacy indicate that in 2000 Ohio was ranked twelfth in the country for the increase in the number of self-employed individuals, which is the genesis of employer small businesses.

These data clearly demonstrate the importance of supporting small business development. And, of course, access to capital and credit is one of the most critical elements to the success of these enterprises. Improving the flow of capital to small businesses has been a priority in public policy and private industry for decades, with market forces and technological advances constantly presenting new opportunities for accomplishing this goal. One constant in this quest is the value of good information-- both that which small business owners have and that which they provide. From my experiences as a banker, I would like to share my perspective on small business access to sources of capital that may help entrepreneurs in their decisions regarding capital and credit for their business.

### **What Small Businesses Should Know to Gain Access to Capital and Credit**

As today's conference underscores, small businesses can seek funding from numerous sources. Federal, state and local governments offer various financing vehicles for new and emerging businesses, just as banking, public-private partnerships, and community-based organizations provide capital to firms that qualify for their funding programs. For the entrepreneur seeking financial support for a venture, the most important thing to know is which of these funders is the most appropriate to approach, given the nature of the request, the stage of the business, and most important, the expectations--and appetite for risk--of the capital provider.

*Start-up Funding and Small Companies--Microenterprise Lenders*

Newer and small ventures often require sums that are, relatively speaking, quite modest, but are, nonetheless, critical to getting the business established. At this stage, such an endeavor is characterized as a microenterprise, which the Association for Enterprise Opportunity (AEO) defines as a sole proprietorship, partnership, or family business that has fewer than five employees, that is generally too small to obtain commercial banking services, and that requires \$35,000 or less in start-up capital. Typically, these businesses are funded through the use of the owner's personal assets or credit resources, family, and friends. However, with the growing interest in supporting microenterprise development, increasingly more sources are providing funding for business start-ups. This is particularly the case as microenterprise formation has become associated with creating asset-building opportunities for lower-income families and promoting community economic development in disadvantaged neighborhoods. Financial support for microentrepreneurs can come from a mix of providers. An AEO-sponsored study cites foundations as the most significant source of capital for microentrepreneurs, followed by the federal government--namely the SBA, the Department of Housing and Urban Development (HUD), and the U.S. Treasury's Community Development Financial Institutions Fund. Besides these agencies, many state and local governments have established microenterprise loan programs, often in collaboration with financial institutions, to further support the success of new small businesses. Entrepreneurs at this stage of the business life cycle are more likely to obtain funding to establish their firm from these sources.

Training and technical assistance in business administration are as important as financing to the viability of microenterprises. These companies often need guidance on the principles of operating a business, such as developing a business plan, implementing accounting and financial-reporting systems, and creating marketing strategies. These essential elements of business management are vital to the growth of an enterprise because they demonstrate a firm's organizational capacity and position it for future development and financing opportunities. As a result, microenterprise lenders typically offer extensive training and individual counseling in conjunction with their credit programs. With the mission to serve and promote microenterprises, these organizations have the expertise and the capacity to connect very small businesses with the resources they need. And though the technical assistance that these programs offer is time- intensive and costly, it is consistent with the organization's objectives and tolerance for the level of business and credit risk that is inherent in newer, undercapitalized firms.

### ***Patient Capital--Venture Capitalists and Angel Investors***

Depending on the entrepreneur and the business, another source of funding for new and developing businesses may be equity partners, often known as venture capitalists and angel investors. This type of financing represents the opposite end of the funding spectrum from microlenders and is provided by professionals who invest alongside management in young, rapidly growing companies that show the potential for significant growth. With an ownership interest, these investors have a stake in the success of the business, and with the acceptance of a higher level of risk comes the expectation of a higher return. Not only do they provide capital, they also are generally active in the management of the business, participating in management decisions such as the development of new products or services and business strategies. With extensive experience, these investors bring considerable business acumen to an enterprise; they are valuable resources in managing its expansion and have a long-term orientation when evaluating a firm's potential. However, despite this longer-term focus, these investors also have a definite exit strategy. They expect, at some point, to sell their share of the business.

Equity partners, be they corporations, foundations, pension funds, government, or individuals, are a source of patient capital that can be critical to the growth of a business. Equity provides a buffer during cyclical or periodic downturns in a firm's cash flow and serves as leverage for other types of financing, such as bank credit. Venture capital funds often specialize in providing capital to businesses that fit their investment profile, as defined by a point in the business life cycle, by an industry, or by a mission. Other organizations for equity financing may include government-affiliated investment programs that help start-up companies through state, local, or federal programs, such as the SBA's Small Business Investment Company (SBIC) program. Also, venture capital funds with a social mission support small business and economic development in distressed and disadvantaged communities. Through community-development venture capital funds and the SBA's Small Business New Markets Venture Capital program, equity investment is available to firms that offer the promise of creating jobs and improving the economic prospects of lower-income urban and rural areas.

Entrepreneurs seeking equity funding to support their firms' growth and development should identify investors whose investment objectives are consistent with their businesses' needs, characteristics, and role in the local economy. One resource to aid business owners in conducting this research is the Angel Capital Electronic Network, or ACE-Net, an Internet-based database that matches businesses with investors.

### ***Business Operations Financing--Bank Creditors***

When considering bank financing, it is helpful to first understand how banks as lenders differ from investors. Unlike the venture capital business, banks are lending their depositors money and therefore operate on a much lower risk tolerance. Because bankers have a very low tolerance for error, they conduct careful analyses of a business's financial strength and ability to service the debt from its operations and cash flow. Banks can lend money to either purchase business assets, or to provide ongoing funding for business operations. In either case, banks carefully analyze the capacity of the business to generate the funds to repay the loan. Therefore, typically, banks rely on at least two years of financial statements and the business's track record of meeting its obligations to evaluate credit worthiness and debt-service capability. Bankers also recognize the need to provide financial planning assistance and specific financial management guidance but do not assume the same day-to-day management involvement as would a venture capital investor.

That being said, banks remain an important source of funding for small businesses. The Federal Reserve's 1998 Survey of Small Business Finances indicates that 39 percent of small businesses surveyed used a credit line, loan, or capital lease from a commercial bank. From the perspective of banks, small business lending represents a considerable portion of their assets. As reported in a study by the SBA's Office of Advocacy, loans of less than \$1 million represented 34 percent of commercial banks' total business lending in June 2000. Further, in 2000, 42 percent of all business loan originations made by financial institutions subject to the Community Reinvestment Act were to firms with revenues of less than \$1 million.

### **The Roles of Information and Relationships in Small Business Funding**

Although very different, each of these providers of small business capital faces a similar challenge--how to obtain quality information on the financial and managerial capacity of the enterprise. A problem facing all small business lenders or investors is the difficulty in gathering data that is certified or easily verifiable. Because very little public information on small businesses is typically available, capital providers must collect proprietary data from

the small business owner. As a result, strong relationships between entrepreneurs and their capital providers are critical to ensure access to and continuity in funding. In fact, studies have demonstrated that the quality of these relationships can affect the availability and price of credit to small firms.

Given this situation, entrepreneurs must take great care in managing their relationships with their funders as well as their reputations for honoring commitments. Although obtaining information to assess creditworthiness can be challenging, technology has increased, as in every other aspect of business, the quantity and quality of data that are available. Access to credit history reports and public records provide would-be funders with information about the past performance of small business owners in meeting obligations and expenses and offer insight into other financial and legal issues that the firm may have experienced. In addition, credit-scoring technology utilizes these data as a means for computing and assigning a risk value to a small business, which can serve as a bright line test for whether or not the enterprise qualifies for a loan. These points illustrate the importance to a small business of being mindful of its reputation from the outset.

If there is a single most important ingredient for business success, it is establishing a reputation for integrity and consistency in meeting your business obligations. That's why one of the three C's of credit is character. This point may appear intuitive, but establishing a good character can be more challenging than it seems. Market conditions and economic fluctuations are powerful forces over which an entrepreneur has no control. Sometimes, despite careful planning, a firm may become vulnerable to a financial crisis. At these times, a strong relationship with its funder is most critical. Through an open dialogue, a capital provider can better understand the scope of the situation and respond actively, such as by restructuring repayment terms or providing information resources and referrals to help the business regain financial health.

Another aspect of reputation management and relationship building involves knowing the resources for technical assistance available to small businesses during a time of difficulty or transition. Just as with funding, a wide variety of federal, state, and local organizations exist for the express purpose of advising small businesses. Depending on their focus, these groups offer entrepreneurs a myriad of services, including support in evaluating proposals, developing a business plan, designing marketing strategies, and managing growth. At the federal level, the SBA works with universities and communities to cosponsor Small Business Development Centers (SBDCs) and offers SCORE, the Service Corps of Retired Executives, which shares its expertise with small businesses at no charge. These organizations provide small businesses with valuable resources for obtaining education and information that can foster growth and development. Here in Cleveland, the community-based group Working for Empowerment through Community Organizing (WECO) offers business-planning clinics, technical assistance classes, and one-on-one counseling in partnership with the SBDC at Cuyahoga County Community College. This training complements WECO's recently launched microloan program, which is capitalized by area banks and the state of Ohio.

The Federal Reserve recognizes the importance of creating infrastructures that support information resources and networks. Consistent with its economic growth objectives, the Federal Reserve seeks to promote small business development, particularly in underserved markets, through its Community Affairs Offices (CAOs). The CAOs throughout the country provide technical assistance, host workshops and conferences such as this one, publish newsletters and reports, and sponsor research to help generate knowledge among market players.

I'll just mention a few examples of initiatives that are consistent with this goal as they relate to small business development. Here in Ohio, the Federal Reserve Bank of Cleveland's Community Affairs Office has provided significant leadership in supporting microenterprise development. It has produced an educational curriculum and a video to aid organizations that provide training to microenterprises. Recently, the office has helped create Microenterprise Organizations of Ohio, a statewide resource and referral network for very small businesses, and has supported the strategic objectives of WECO by serving on its microenterprise advisory board.

There are other examples around the country, such as the Georgia Avenue Business Resource Center in Washington, D.C. In Chicago, the Small Enterprise Capital Access Partnership (SECAP) is a partnership that involves a group of players in the small business arena. The Federal Reserve Bank of Boston sponsors regular training workshops for microenterprise support organizations to help these groups obtain the tools they need to assist entrepreneurs in building sustainable businesses.

The Federal Reserve has also helped small businesses through its research efforts. Fed studies have focused on trends in the demand and use of financial services by small businesses, fostering a better understanding of the issues involved with access to credit and capital. Every five years, the Federal Reserve conducts the Survey of Small Business Finances for the express purpose of measuring the use of transaction and credit products by small firms. This comprehensive set of data serves as the basis for additional research. In addition, in 1999 the Federal Reserve System Community Affairs and Research Offices sponsored a research conference dedicated solely to exploring small business access to capital and credit.

By facilitating the delivery of information and development of networks to promote relationships between entrepreneurs and capital providers in these and other ways, the Federal Reserve seeks to help these parties understand each other's needs. In doing so, a small business can better manage its reputation and foster the working relationships that can open the doors to funding now and in the future.

Let me conclude by repeating the fundamental point made in my first paragraph. Small business produces about three-fourths of all new jobs generated in this country. As each of you pursues dreams of business ownership, you also contribute to the economic health of your community and your country. My congratulations to Congresswoman Stephanie Tubbs Jones for recognizing the important role of small business and for sponsoring this conference today.

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