The Value and Risks of Small Businesses

In the Ninth Federal Reserve District, where there is a need there is a business to fill it. Whether you need your chickens plucked or a lens for the Hubble Space Telescope, there is a small business to provide you with the right equipment or service.

How often have you said to yourself, “If only I had a machine that would align my telescope lens to one ten-thousandth of an inch”? Well, maybe not too often, but that’s just what NASA needed when they ordered the Hubble Space Telescope. Professional Instruments of St. Louis Park, Minnesota, provided a measuring instrument that ensured that the new lens on the Hubble was within that threshold.

Business is up in the Ninth Federal Reserve District for bovine artificial insemination. The dairy industry is growing more and more reliant upon this, umm, accelerated method of fertilization. Several cooperatives and small businesses provide supplies and equipment to dairy farmers and ranchers throughout the country in this most delicate of operations.

Indeed, as you would expect in a district that is as largely rural and agricultural as the Ninth, farm equipment manufacturing and machine shops specializing in farm equipment are some of the most active small business enterprises.

Take, for example, Mike Schweiss with Schweiss Distributors of Fairfax, Minnesota. His 39 employees will supply your farm with bifold barn doors up to 95 feet wide, while his brother, Harold, with Schweiss, Inc., in nearby Sherburn can supply you with nearly every other kind of equipment you could possibly need for the farm, from the aforementioned chicken pluckers (thirty seconds flat) to snow blowers and easy weeders. They do this with about 15 employees. Both of the Schweiss brothers had been farmers but saw the opportunity to start small businesses, and both have flourished.

In the small town of Chassell, Michigan, in the Upper Peninsula (UP), the Einerlei Shop has developed a loyal customer base from within the UP for its wide variety of quality gifts and home furnishings. It offers catalog sales in addition to its retail operation, a

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Which new business is more likely to survive its first ten years: A service business with 4 employees or a wholesaler with 60 employees?

How small is a small business?

What are microenterprises and why should lenders extend credit to them?

In this issue, we present small business development as the third of four cornerstones to strong, vital communities. Affordable housing and downtown revitalization were highlighted in previous issues (see page 7 for ordering back issues), and in a future issue we will focus on nonprofits. We’d like to hear your small business success stories, including successful finance techniques or other elements of innovative lending programs. (See our address on the back cover.)
floral shop, and greenhouse and even has craft classes in the evening. As much as it can, it highlights local artists and artisans.

Small plays a large role

Small businesses and farms come in many sizes and shapes. But what really constitutes a "small" business and what differentiates it from a big business? The Minnesota Department of Trade and Economic Development considers a "very small" business as one with fewer than 20 employees, and "small" as fewer than 100. Within the Ninth Federal Reserve District, over half of all businesses counted in the 1992 County Business Patterns have 1 to 4 employees. Another third have 5 to 19 employees, and less than two percent have 100 or more employees. Similarly, of all employees counted, just under one-third worked in companies of less than 20 employees, and only one-quarter worked in companies with over 100 employees.* This tells us just how significant the small business is in our economy.

But the number of employees doesn’t tell the whole story. An advertising and corporate design business with 100 employees, for example, would rank among the nation’s largest, while a steel fabricating business with that many employees would be only average to small among its competitors.

"To lend or not to lend, that is the question," might have been asked by William Shakespeare had he been a banker rather than a bard. How does the community banker know whether a local entrepreneur with a special component for an emerging computer process has accurately assessed the risks? How does the community banker know whether to extend long-term credit to the local office supply distributor without knowing whether the recent trend toward decentralizing back office operations by insurance companies and financial institutions will continue?

Given the diversity and complexity of small businesses today, it is a daunting task indeed that lenders face when trying to decide

*Employment and business counts in the County Business Patterns exclude most governments, railroads, and self-employed persons. This will of course cause some undercounting of small businesses.
which businesses should get funding.

Starting up on the right foot

Startup businesses pose a particular dilemma for bankers. What makes a successful startup business? Location and linkages, according to Professor Wilbur Maki of the University of Minnesota, Department of Agriculture and Applied Economics. Most small businesses today are starting in or near metropolitan areas and secondary regional centers. This is happening, in part, because of the lack of adequate financing in rural areas, which is due to the higher risk of failure, a lack of essential services, and a lack of other economic activity. As small communities falter, services and business activity are being consolidated into larger regional centers, which in turn are becoming stronger.

Linkages can be provided by proximity to services or related businesses, or by information access such as computer hookups. Professor Maki concludes that small businesses are an essential part of the urban and the rural economy, and that it is possible to judge which ones are more likely to succeed. But he warns that banks need to closely track the economy to determine the industries and regions with growth potential.

Successful small businesses bring benefits to their communities and their owners. They increase employment and economic activity and act as links to more businesses. They are the safest way to establish new markets and new products. A diverse economic base of businesses provides a healthy economy. Furthermore, small businesses grow.

It is, however, unwise to invest in small businesses assuming that they will grow. In a study of business survival rates reported in the July 1994 Business Economics, Joseph W. Duncan and Douglas P. Handler, of Dun and Bradstreet Corporation, found that the overwhelming majority of small businesses that started in 1985 remained small in 1994. However, Professor Maki states that many successful small businesses do their job in establishing a new product line and then are acquired by larger businesses.

Exploding the failure myth

Most conventional lenders will not fund startup business debt because of stories of the persistently high failure rate among startup businesses. But do small startup businesses really have such a huge failure rate? Not according to the Dun and Bradstreet study, which concluded that the smallest startup businesses have the highest survival rates. Almost 75 percent of companies starting in 1985 with less than 5 employees were still there in 1994. The rate gradually decreased with larger startup size, and less than half of businesses that started with over 50 employees survived until 1994.

These numbers are so different from popular belief that it is worth looking more closely at the data source and definitions. Dun and Bradstreet adds a business to its database when it becomes involved in a business activity, such

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**Ninth District small businesses by number of employees**

<table>
<thead>
<tr>
<th>Employees</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>100+</td>
<td>1.9%</td>
</tr>
<tr>
<td>20-99</td>
<td>10.19%</td>
</tr>
<tr>
<td>1-4</td>
<td>54.74%</td>
</tr>
<tr>
<td>5-19</td>
<td>33.17%</td>
</tr>
</tbody>
</table>

(Montana, North Dakota, South Dakota, Minnesota, Upper Peninsula Michigan, northwest 26 counties of Wisconsin)

**Source:** 1992 County Business Patterns
as a purchase requiring use of credit. Types of new businesses not commonly counted by them include subdivisions of existing businesses, casual one-person operations (often moonlighting from their "real" job), "paper" businesses that don't actually contribute to economic activity, and persons selling their own labor, such as lawyers and consultants. Such businesses are often riskier, and if counted would increase the failure rate of very small businesses.

Dun and Bradstreet also counts failures only when the business files chapter 11 or goes out of business with losses to creditors. It therefore avoids counting as failures those small businesses that were added to larger corporations.

The conclusion from the Dun and Bradstreet study is that, with the possible exception of consultants, small businesses that get a solid start are more likely to succeed than comparable large businesses. The key here seems to be the solid start. The wise banker will therefore look at the type, location, and plan for the proposed business, not at its size.

Finding the capital

Even if a lender could overcome the tendency not to fund startup businesses, many very small businesses need far less capital than a conventional banker can justify lending—$100 or $500 or $1,000. A consumer loan may not be the answer if the borrower doesn't have the credit history or income potential to qualify. To compound the problem, as business complexity continues to race ahead, the cost of entry to many small businesses outstrips the traditional nonbank sources of capital for small businesses—personal savings and family gifts or investments.

Where can an entrepreneur turn? The Small Business Administration (SBA) is one likely source. The SBA's 7(a) guarantee program and its new microenterprise demonstration project offer hope to many small businesses by working through conventional lenders. There may be special microenterprise loan funds in your area like The Lakota Fund on the Pine Ridge Indian Reservation, which offers microentrepreneurs hope for capital. (See the accompanying article.) The National Association of Community Development Loan Funds has over 40 member loan funds offering small business loans and assistance throughout the nation. Many larger communities have aggressive government programs that offer specialized technical and financial assistance for small businesses. The Minneapolis Community Development Agency, for example, offers loan guarantees that complement SBA programs, including loans for working capital.

How small is small?
The U.S. Small Business Administration (SBA) measures small businesses in terms of dollars or number of employees, depending on the industry.

Small number of employees
Average number of employees per pay period for the preceding 12 months (includes part-time and temporary employees) must be FEWER THAN:

<table>
<thead>
<tr>
<th>Industry</th>
<th>Number of Employees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale</td>
<td>2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>(hundreds of employees)</td>
</tr>
</tbody>
</table>

Small dollar receipts
Average annual receipts for last three years must be LESS THAN:

<table>
<thead>
<tr>
<th>Industry</th>
<th>Dollar Receipts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail</td>
<td>$5,000,000</td>
</tr>
<tr>
<td>Service*</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Construction**</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Farming</td>
<td>$5,000,000</td>
</tr>
</tbody>
</table>

*Real estate agents must have average annual receipts of less than $1.0 million. **Dredging and surface cleanup activities limited to $13.5 million; special trade construction to $7.0 million.

CONTINUED ON PAGE 5
For their own benefit, banks can no longer turn away small business borrowers without much consideration. Banks recognize that nurturing new business customers is as important as serving their established customer base. Retiring businesses must constantly be replenished by emerging businesses, and conventional lenders must play a major part in assisting them.

Smart market awareness and location analysis will greatly lower the risks and help to ensure profitable investments that will strengthen growing markets. The availability of debt capital can be strengthened by alliances with organizations like The Lakota Fund and by credit enhancements offered through such organizations as the SBA.

Creativity and flexibility are the watchwords, and many lending institutions will look at every possible avenue to make a loan to a new or existing small business, whether it makes chicken plucking equipment or precise measuring devices.

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### Calendar

**February 9-10**
Urban Land Institute, "Shopping Centers: How to Build, Buy, and Redevelop," Washington DC. This seminar will be repeated March 6-7 in Houston and April 3-4 in San Francisco. Contact: (800) 321-5011; in Washington, DC (202) 624-7121.

**February 9-10**
Strategic Research Institute, Bank Lending Compliance in the '90s, Ritz Carlton, San Francisco. Contact: Richard Rodriguez, (800) 599-4950.

**February 15-17**

**March 5-8**

**March 7-8**
Rural America Conference, Memphis, TN. Sponsors: Federal Reserve Banks of Atlanta, Dallas, St. Louis, and Richmond. Contact: (214) 922-5280.

**March 14-16**
Bank Administration Institute, Bank Regulatory & Compliance Conference, New Orleans, LA, Contact: (800) 323-8552.

**March 30-31**
7th Annual Community Economic Development Conference, Kansas Center for Community Economic Development, Hutchinson, KS. Contact: Diane Laughlin, (913) 532-5575.

**April 23-26**
Center for Urban Economic Development Annual Conference, Dallas, TX. Contact: (202) 223-4735.

**June 11-14**
American Bankers Association, National Regulatory Compliance Conference, Sheraton Hotel and Towers, Boston, MA. Contact: (202) 296-5800.
Microenterprise Lending and Economic Development

Tribal members on the Pine Ridge Indian Reservation in South Dakota, with the help of First Nations Financial Project, developed a project that served many of the people who had always been ignored by previous economic development efforts. The Lakota Fund was set up to make loans to members of the tribe who had the lowest incomes, or no incomes, almost no tangible assets to use as collateral, absolutely no business training or expertise, and no credit history or banking experience. It was also the purpose of the fund to provide training as well as access to capital. These goals were different from those of any previous tribal or federal government economic development programs, most of which history shows were unsuccessful.

In the early stages of its development, The Lakota Fund looked at the history of business development on the Pine Ridge Reservation and vowed to not make the same mistakes. Models of development in other low-income areas were examined, and parts of many other projects went into making up The Lakota Fund. Methods were adopted according to their usefulness and adaptability to the unique culture and conditions at Pine Ridge.

The Lakota Fund, alive and well and growing today, is an excellent model of community development directed by the community it serves. It is also an example of what people can do without the help of governments. Although it had the support of the tribal government, the Fund did not solicit or use any government funds. It used a mixture of private loans and grants as well as earned income to fund its operations. As of today, The Lakota Fund has made more than 200 loans totaling over $770,000 through its two separate loan programs.

Why it works

The Lakota Fund uses a peer lending method that makes loans which start at $400 or less and eventually reach $1,000. The peer groups use peer pressure as an alternative to collateral. (The Fund also makes loans up to $25,000 to small businesses on the reservation.) From the beginning, The Lakota Fund recognized these "microenterprises" as viable businesses that added wealth to individual and family households and served to circulate money on the reservation and provide a multiplier effect to the dollars that came through the economy. All previous efforts to improve the economy through business development targeted the more capital and labor-intensive manufacturing businesses which usually came in from outside the reservation. These businesses never lasted.

The approach The Lakota Fund took was similar to many other funds now in existence today throughout the U.S. in low-income communities. These community development loan funds realize that business development doesn’t only have to include the more formal, sophisticated, high-dollar businesses that most state and municipal development corporations target. They target microenterprises to provide access to capital for those on the lower end of the socioeconomic scale. The Small Business Administration has recently begun to recognize these businesses also by providing funds for microenterprise loans of $25,000 or less. President Clinton recently gave credibility to these microenterprises by signing the Community Development Financial Institutions bill which provides funds for financial institutions designed to serve this sector.

What are microenterprises?

Microenterprises are similar to those activities usually referred to as home-based businesses or cottage industries. They differ in this context in that the term microenterprise usually refers to those activities engaged in as a means of subsistence. Income from them is used to supplement other meager income or in some cases to provide sole income. Nonetheless, they are vital contributors to many low-income communities, and with help, many of them can operate more effectively and grow. Although not all microenterprises will grow into small businesses, some will. For many, this is their only entry point into the world of small business.

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Community Dividend, First Quarter 1994. Focus: Cultural and legal considerations for lending in Indian Country. Contains a regional listing of American Indian tribes and reservations, and a profile of two microenterprise loan programs which offer peer lending. Also profiles Joint Policy Statement on Lending Discrimination.

Community Dividend, Second Quarter 1994. Focus: Safe investments in affordable housing. Contains a profile of La Crosse, Wisc., and a newly formed housing-related CDC.

Community Dividend, Third Quarter 1994. Focus: Downtown revitalization. Contains a profile of the downtown council in St. Cloud, Minn.

The Credit Process: A Guide for Small Business Owners. Published by the Federal Reserve Bank of New York. A resource for small businesses, for organizations that assist them, and for lenders that target the small business market. Describes sources and types of financing, business plans, and the compilation of financial data for applications.


Community Development Investments provides guidance to bank holding companies about the formation of CDCs and other uses of equity investments for community development. Federal Reserve Board. 19pp.


Home Mortgages: Understanding the Process and Your Rights to Fair Lending, a brochure that tells where to look, what to look for, and what takes place when applying for a mortgage. Federal Reserve Board. 6pp.


No fax machine? See address on back cover.
On Pine Ridge, many of the smallest of these microenterprises include such things as traditional arts and crafts producers like quilting and bead and quillwork, firewood vendors, food concessions, and tire repair. Some of the larger businesses receiving loans have included construction contractors, beauty salons, restaurants, video rental, hog producers, and several others. Many of these businesses operate in rural areas.

Banks are reluctant to provide financing to these microenterprises because they are riskier and require special handling that would make them unprofitable. Banks, however, can assist these microenterprises indirectly. For example, Norwest Bank South Dakota has been a contributor to The Lakota Fund since its beginning. Also, Norwest Bank in Mission South Dakota, formerly Farmers State Bank, provides a low-interest line of credit to the Sicangu Enterprise Center to make microenterprise loans on the Rosebud Indian Reservation. In some cases banks are able to lend directly to some microentrepreneurs through small, unsecured consumer loans. Those bankers who have helped loan funds such as these find the experience can be rewarding and can strengthen the relationship between the community and the bank. And certainly, from a CRA standpoint it can’t hurt.