The Cost and Availability of Credit and Venture Capital

H. Kent Baker
The American University

September, 1979
ABOUT THE AUTHOR

"Cost and Availability of Credit and Venture Capital in Region III"

H. KENT BAKER Ph.D

is an associate professor of finance at the College of Business Administration at The American University in Washington, D.C. He holds a BSBA in management from Georgetown University, an MBA, MEd, and DBA from the University of Maryland, an MS in quantitative methods from The American University. He is a Chartered Financial Analyst.

He has published more than 60 articles in the areas of finance, accounting and management in such journals as the Journal of Finance, Journal of Financial and Quantitative Analysis, and the Journal of Accountancy. He has served as a consultant to more than 30 public and private sector organizations. Currently, he is a director of the International Instructional Television Cooperative Inc.

He has been actively involved in developing and conducting more than 150 management development programs.

Six publications carry his biography and he is a member of a number of honor societies. He is a Danforth Associate. Among his professional affiliations are the American Finance Association, American Institute for Decision Sciences, and the Washington Society of Investment Analysts.

DR. H. KENT BAKER
CREDIT AND VENTURE CAPITAL

ABSTRACT

It is the final line. No matter how many other factors look favorable. No matter how many potentials are lined up on the plus side. It is the final line that counts. Solid credit lines must be in place and the capital must be ready to tap if a small business is to succeed.

Thus, the availability of credit and venture capital must be assessed and priority must be attached to the removal of obstacles which are found to be creating unfavorable conditions for this aspect of financing small business.

This analysis confirms the presence of obstacles and suggests ways they can be removed. It is not surprising that most of the obstacles to small business expansion are on the doorstep of government. They can be set aside if government somehow could:

-- Revise the tax codes to provide greater incentive for investing in small business;

-- Modify those government regulations which are not designed for the special conditions faced by small business;

-- Reduce the paperwork involved in complying with these regulations, regulations that practically drown small businesses in a sea of paper.

Additional problem areas:

-- The search for the right kind of funding can be a vicious circle process. Fewer sources, better organized, better known (to and including government agencies) would help.

-- Inflation/recession conditions affecting the cost and availability of funds is a serious concern.

-- Difficulty in acquiring equity capital is a special problem in that this also compounds small business access to credit.

The small business operator and the entrepreneur whose records and reputations are on solid footing with the financial world will not suffer too much from the more selective guidelines imposed by money sources. The newcomer or the bearer of a poor track record are finding doors harder to open, and when they do get inside, the high premiums associated with the potential risks are not encouraging.

The cost and availability situation is affecting small business and a strong area of concern is what will happen to growth. The births that are most affected by the rigid selectivity process cannot be aborted if small business is to expand. A healthy atmosphere is vital to small business.
"... subject to a kind of disease, which at that time they called lack of money."
Francois Rabelais, c. 1494-1553, Gargantua and Pantagruel, Book II

SECTION I. DISCUSSION OF THE RESULTS

Both potential entrepreneurs with viable and marketable ideas and operators of existing small businesses frequently suffer from the "disease" noted by Rabelais. That is, they are often unable to obtain appropriate financing to establish, maintain, or expand their businesses. Numerous impediments exist which prevent smaller businesses from attracting capital needed to perform their traditional functions of providing innovation, employment, and competition within the economy. When funds are available, a premium is generally paid to receive financing because of the higher level of risk associated with the investment. Consequently, both the cost and availability of credit and venture capital impact on the growth and development of small business.

This study investigates the cost and availability of credit and venture capital to small businesses primarily from the more common sources of financing. The overwhelming conclusion is that funds are available but on a very selective basis and at a high cost. This does not mean that funds are simply available "for the asking" because the demand for money in the region far exceeds the willingness, if not the ability, of suppliers to provide funds. But it does indicate that both credit and equity financing may be obtained more readily by firms having a good business record, a reasonable equity capital base and sufficient collateral to back up a loan.

The facts of business life suggest that superior firms with proven profit potential and strong management can obtain funds while marginal firms must go begging. The laws of supply and demand are more than theoretical concepts but represent the reality of everyday life faced by small business operators. Thus, some truth exist to the old quip that "A business can't get money unless the firm really doesn't need it."

The results of numerous interviews reveal several major problem areas involving small business financing. First, operators of small businesses
frequently do not know how and where to get financing. By limiting their search for funds to a few sources or by being unprepared when they seek financing, small business people greatly reduce their chances of receiving funds. Second, the potential impact of the impending recession on both the cost and availability of funds to small business is a topic of great concern. Finally, the difficulty of acquiring sufficient equity capital is viewed as a particularly serious problem faced by small firms. The undercapitalization of many, if not most, small businesses further compounds their plight by restricting access to credit. Even mature firms find that financing through the public issue of stock has been effectively eliminated because of the lack of a ready market for stock of smaller companies and the low valuations of stock in the public market.

Numerous suggestions are proposed for increasing the availability and lowering the cost of financing to small businesses. The major thrust of these recommendations centers around revising the tax code to provide a greater incentive for investing in small businesses; modifying government regulations to ease the burden on small businesses; and reducing the paperwork involved in complying with these regulations which has practically drowned small businesses in a sea of paper.

PURPOSE OF THE STUDY

The major purpose of this study is to analyze the cost and availability of short-term, long-term credit and equity capital for small business in Region III. Although many sources of financing are available to small business, emphasis is placed upon the more common sources of credit and venture capital. These sources include a sample of commercial banks, venture capital organizations such as small business investment companies (SBICs) and minority enterprise small business investment companies (MESBICs), and state and local agencies involved in fostering small business. Other individuals having knowledge relating to small business financing are also examined including small business operators, officials in state and local government and trade associations. Telephone interviews are used for obtaining primary data on the cost and availability of credit and venture capital in the region.

The study focuses on obtaining answers to seven major questions.

1. What is the overall availability of credit and venture capital in the region?
2. What is the cost of short-term and long-term credit and venture capital in the region?
3. Is credit more readily available to franchise operations than independent firms?
4. Does the lack of credit limit the growth of small business and increase the probability of failure?
5. Does the shortage of venture capital lead to increased merger activity or the selling out to large business?
6. Do different branch banking laws affect the availability of credit for small business?
7. What steps should be taken to increase the availability of credit and venture capital and reduce financing costs to small business?

AVAILABILITY OF CREDIT AND VENTURE CAPITAL

The results of a survey of suppliers of credit and venture capital and small business people in the region reveal a greater availability of funds to small business than in recent years but at an increased cost. The greater availability of credit and equity capital may partly be attributed to recent changes which encourage the investment in higher risk small scale business enterprises. Some of these changes include the capital gains tax reduction in the fall of 1978 from a top rate of 49 to 28 percent; the liberalization of SEC Rule 144 in September 1978 in which the Securities Exchange Commission doubled the amount of unregistered stock private investors could sell in public markets; the lifting of the public offering ceiling from $.5 to $2.0 million under SEC Regulation A which provides for exemption from registration under the 1933 Securities Act; and a revision of the "prudent man" rule of the Employment Retirement Income Security Act of 1974 (ERISA) which now permits pension funds to buy stocks of small and medium-sized companies on a limited basis. Yet, a growing concern exists among lenders and venture capitalists that the money available to small business will be the first to "dry up" if the U.S. and regional economy move into a lengthy recession.

While funds have generally become more widely available in the region, this does not mean that credit and equity capital are readily available to all types of small business. On the contrary, entrepreneurs and young companies are still having a particularly difficult time obtaining their
financing needs although some greater interest is being shown in start-ups and early stage financing. Minorities are also facing a continuing problem of obtaining funds despite the relatively large number of MESBICs in the region.

On the other hand, companies in the growth and maturity stages of their life cycle generally find funds relatively easier to obtain. This is also true for firms in the high technology field. The availability of financing is affected, however, by such factors as the type and amount of funds sought, the investment policies and industry preferences of suppliers of funds, and the financial position of the firm seeking financing. Hence, money is available in Region III but on a selective basis. Not a single supplier of funds interviewed indicated that funds are unavailable for the "right kind" of small business. For example, TDH Capital Corporation, an SBIC located in Radnor, Pennsylvania, indicated that up to $4 million in funds is potentially available while Norfolk Investment Company, Inc., a MESBIC in Norfolk, Virginia, has only two-thirds of presently available funds invested.

A major difficulty exists in matching the "right kind" of small business with the "right kind" of supplier of funds. Several financing sources expressed the belief that credit and venture capital are available in the region but operators of small businesses often do not know how and where to get financing. This feeling was echoed by small business people who expressed bewilderment in locating appropriate sources of financing and in determining the type of documentation needed to obtain a loan or other financing.

Regarding the issue of how to prepare for obtaining financing, several sources suggested that the following types of information should be prepared prior to the initial meeting with a potential supplier of funds.

1. amount and type of funds desired
2. purpose for which the funds are to be used
3. primary sources of repayment or kind of collateral if a loan
4. history of the business
5. description of the future business
6. background of key individuals involved in the business
7. nature and type of insurance protection
8. current personal financial statements
9. company financial statements for the past three years
10. revenue and cash flow projections
While some sources are fairly apparent such as friends and relatives, commercial banks, SBICs and MESBICs, others are more difficult to identify and locate. For example, in addition to these sources there are also investment bankers, informal investment syndicates, large companies, venture capital arms of family fortunes, publicly held venture capital corporations, private venture capital organizations, and state licensed business development corporations. Additionally some sources located outside of the region will provide credit and venture capital to small business within the region. Thus, determining the potential availability of financing to small business within the region is elusive because of the multitude of sources which are not confined to the geographical boundary of Region III.

Some of the more apparent sources of venture capital located in the region are SBICs and MESBICs. Table 1 lists the number of firms which are licensed by the Small Business Administration (SBA) to provide equity capital and long-term loans to small business. Although the vast majority of these firms has a diversified investment policy, some of them specialize in providing funds to a specific industry group such as real estate, operative builders, grocery stores, communications media and the psychiatric field. The total number represents 6 percent of the nation's SBICs and 12 percent of the MESBICs, which is reasonably consistent with the fact that the region has approximately 10 percent of the total business population and 8 percent of the minority businesses. The larger number of SBICs and MESBICs in Pennsylvania can be easily explained by the fact that this state has more small and minority businesses than any other state in the region.

Some of those interviewed expressed a concern over the inability of small business to raise capital in the public securities markets. Except for the very largest small businesses in the region, the public securities markets are inaccessible. Several factors have contributed to this dilemma, namely, the increasing costs of public issues; the disappearance or consolidation of regional firms involved in underwriting small business issues; depressed stock market prices; and a lack of a ready public market for stock of smaller companies. Thus, even an established and successful small business in the mature stage of its life cycle finds raising funds through a public offering extremely difficult.

In summary, based upon the opinions of those surveyed, funds are
# TABLE 1

NUMBER OF SBICS AND MESBICS BY STATE
IN REGION III AS OF MARCH 1979

<table>
<thead>
<tr>
<th>State</th>
<th>SBIC(^1)</th>
<th>MESBIC(^2)</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>5</td>
<td>3</td>
<td>8</td>
</tr>
<tr>
<td>Maryland</td>
<td>0</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>8</td>
<td>3</td>
<td>11</td>
</tr>
<tr>
<td>Virginia</td>
<td>6</td>
<td>3</td>
<td>9</td>
</tr>
<tr>
<td>West Virginia</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>19</strong></td>
<td><strong>12</strong></td>
<td><strong>31</strong></td>
</tr>
</tbody>
</table>


\(^1\)Small Business Investment Company

\(^2\)Minority Enterprise Small Business Investment Company
available for small businesses which meet the criteria of the lender or venture capitalist. While events of the recent past have improved the potential availability of funds, the prospects of a recession cast an ominous cloud over the availability of funds in the future. Greater attention needs to be placed on assisting small businesses to locate alternative sources of financing and in preparing proposals for financing.

COST OF CREDIT AND VENTURE CAPITAL

Although small business traditionally uses a mixture of internal and external financing to meet its needs, only the cost of external funds is examined. These external funds are divided into short, intermediate, and long-term credit and venture capital. For definitional purposes short-term credit is viewed as credit extended up to 1 year; intermediate credit from 1 to 5 years; and long-term credit for 5 years or more.

The most common sources of short-term credit, exclusive of material suppliers through accounts payable and finance companies on receivables, and intermediate-term credit are commercial banks. Given the nature and sources of their own funds, commercial banks tend to be short and intermediate-term lenders. The funds which they provide generally take the form of lines of credit, notes payable, and other term loans.

The overall costs of short-term credit varied among the bankers interviewed and depended upon such factors as the financial position of the firm, the balance relationships which the small business kept with the bank (i.e., compensating balances), the riskiness of the firm, the location of the bank itself (e.g., rural or city bank), and whether the loan was secured or unsecured. The bankers indicated that no set cost of funds is specified for small business and that each application for credit is reviewed on its own merits with rates set accordingly. Despite the variances which existed in the cost of funds among the commercial banks, credit extended for less than 1 year generally fell in the range of 0.5 to 1.5 percentage points over prime, i.e., 12.0 to 13.5 percent; whereas credit from 1 to 5 years was 1.0 to 3.0 percentage points over prime, i.e., 12.5 to 14.5 percent. The prime rate during July, 1979, was 11.50 to 11.75 percent.

The sources of long-term credit are more varied and consist of commercial banks, venture capital firms such as SBICs and MESBICs, and state-sponsored loan programs. Each of these sources of long-term credit has its
own special characteristics. Other suppliers of long-term credit do exist but they were not investigated.

Although commercial banks prefer to lend short-term or intermediate-term, they do provide funds on a limited basis from 5 to 7 years and sometimes up to 10 years. Long term funds are more difficult for small business to obtain, however. Some bankers indicated a preference to use a floating rate for term loans which is currently prime plus 2.0 percentage points or 13.50 to 13.75 percent. Others indicated a range of 2.0 to 3.5 percentage points over prime or 13.5 to 15.0 percent. Some loans naturally carry a higher or lower rate than specified by this range because of special characteristics of the loan.

Both SBICs and MBICs in the region provide straight debt for a minimum of 60 and 30 months, respectively. The terms associated with debt financing from these sources vary widely. Some debt is secured while other debt is not. Examples exist of subsidized debt with an interest rate as low as 3.0 percent. For some loans the repayment begins immediately and is on a weekly basis while amortization payments on other debt are deferred for several years to assist companies in start-up or early growth situations. Hence, SBICs and MBICs are flexible in meeting the special needs of small business through tailor-made financing packages.

The cost of straight debt naturally differs among the various SBICs and MBICs examined. Although the SBA ceiling is currently 15.0 percent on straight debt, this maximum interest rate is not the norm but the exception used for particularly risky ventures. Based on the firms surveyed, the interest rate charged by SBICs is currently in the 12.0 to 14.0 percent range while MBICs charge 10.5 to 13.0 percent. These rates for Region III are comparable to the average interest rate charged on straight debt instruments in the first quarter of 1979 for all SBICs and MBICs in the U.S. which was 13.15 and 11.16 percent, respectively. It should be noted that the rate is less for MBICs than SBICs.

Long-term debt is also available to selected small businesses through various state and local government agencies and other sources. For example, under the auspices of the Pennsylvania Industrial Development Authority and the Minority Loan Program of the Commonwealth of Pennsylvania, funds are available at 4.0 percent interest for a period up to 20 years. Given the generosity of these terms such loans are almost as good as equity to small
Another example is the RIDC Industrial Development Fund which provides loans to Southwestern Pennsylvania small business enterprises to enable them to survive and expand their business activities. The interest rates are tied to the prime rate in Pittsburg and are dependent upon the risk and valuation of the collateral in relation to the loan.

The cost of equity or venture capital is much more difficult to determine. Although numerous equity-type instruments exist, the three most typical investments are in common stock, loans with warrants and convertible debentures. The problem with calculating the cost of these funds is the expectational rather than explicit nature of the payoff or cost.

In the case of loans with warrants or convertible debentures where an explicit interest rate does exist, this rate is usually lower than prevailing straight debt with similar maturity and risk characteristics because of the equity feature of these issues. In the case of common stock, the cost consists of any dividends paid plus future capital appreciation. Given the uncertainty of these two types of potential return, the cost of equity could only be approximated. Managers of SBICs and MESBICs indicated that they hope to receive an average return on equity type investments in the range of 20.0 to 25.0 percent compounded annually. One SBIC in Virginia even indicated that it sought a 40.0 percent annual return. Experience shows, however, that such a return is rarely achieved despite the high level of risk involved. Consequently, the real cost of equity is probably much lower than the expected rate of return would suggest. One SBIC in Washington, D.C. did indicate that it had achieved a 20.0 annual return on investment for the past decade which indicates that such a high level of return is not impossible.

Table 2 summarizes the cost of short, intermediate, and long-term credit and equity capital by several sources of financing. The ranges represent estimated average returns or costs rather than the full spectrum of cost levied. That is, such costs as advisory fees or compensating balances are excluded from these cost calculations.

### RELATIONSHIP BETWEEN COST AND AVAILABILITY

Given that interest rates, inflation, and the risks associated with small business are all high, the costs of obtaining funds are naturally high. Despite this fact suppliers of funds do not view current costs as
TABLE 2
COST OF CREDIT AND EQUITY CAPITAL BY SOURCE
IN REGION III
(in percent)

<table>
<thead>
<tr>
<th>Source of Financing</th>
<th>Commercial Banks</th>
<th>SBI's(^1)</th>
<th>MESBICs(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 1 year</td>
<td>12.0 to 13.5%</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>1 to 5 years</td>
<td>12.5 to 14.5</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Greater than 5 years</td>
<td>13.5 to 15.0</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Straight Debt</td>
<td>--</td>
<td>12.0 to 14.0%</td>
<td>10.5 to 13.0%</td>
</tr>
<tr>
<td>Equity</td>
<td>--</td>
<td>20.0 to 25.0*</td>
<td>20.0 to 25.0*</td>
</tr>
</tbody>
</table>

\(^1\)Small Business Investment Company
\(^2\)Minority Enterprise Small Business Investment Company

*The cost of equity represents an expected return. The real cost of equity is probably considerably lower based upon past unrealized expectations.
either prohibitive or unreasonable. Of the two factors—cost or availability of funds—providers of financing agree that business is willing to pay the cost to obtain funds provided the funds are available. The high cost of funds does prove to be a major obstacle for new or marginal firms. Small business operators expressed the belief that the unavailability of funds was a more serious concern than cost but agreed that high cost of financing did impact upon their profitability.

Unlike past periods when the cost of funds was high but unavailable, the current period seems to be somewhat of an anomaly. Funds are expensive by historical standards but they are more available. It would be inappropriate and inaccurate to suggest that financing is "there for the asking" in the region. This simply is not the case. Less credit and equity capital exist than are demanded. The chance of receiving the funds needed can be improved if small business seeks out alternative suppliers and improves its documentation procedures for requesting funds.

FRANCHISE OPERATIONS VERSUS INDEPENDENT FIRMS

Given the competitive nature of small business financing, factors exist which give some firms a competitive edge over others. One of these factors is the potential advantage which "name" franchise operations may possess in obtaining funds. Based upon the interviews conducted, however, the question "Is credit more readily available to franchise operations than independent firms?" can be answered with a qualified but not a definitive "no".

While different opinions exist on this issue, the majority opinion suggests that franchise operations as a general rule do not have a competitive edge over independent firms in getting financing based on this factor alone. Requests for funds are viewed on a case-by-case basis as small businesses and not as franchises versus independent firms.

The major exception is a franchise of an established, recognized, and successful larger operation, that is, a "name" franchise. In this instance the individual franchise operation does possess an advantage from the perspective of suppliers of credit and capital. This advantage stems from the belief that the franchisor can provide certain benefits to the franchisee which are not as readily available to the independent firm. Included in these benefits are training, assistance in site selection and promotional activities, consultative services, and expertise and experience in the
specific line of business. Consequently, a franchise of a major regionally or nationally known organization is viewed as positively affecting the availability of credit and capital. An unknown franchise or one with a poor business record has either little or a negative impact on obtaining funds.

LACK OF FINANCING AND BUSINESS FAILURE

Various sources of financing and operators of small businesses in the region were asked "Does the lack of credit limit the growth of small business and increase the probability of failure?" Although almost all responded that the lack of credit does limit growth and does contribute to failure, they were equally adamant in stressing that the unavailability of credit is not the major cause of failure.

Lack of credit is certainly one factor which limits the growth of small business. Given the limited supply of funds available to meet existing demand, funds are necessarily allocated according to some criteria such as the objectives, standards, and preferences of suppliers of credit and capital. Because financing is more readily available to some small businesses than others, the growth prospects of those denied credit or capital naturally are affected. Yet, many other factors affect growth besides credit availability, including the skill of management, nature of the business, and general economic conditions.

While the probability of failure is increased through the unavailability of financing, this reason is also not considered the primary cause of business failure. Business failures are most frequently attributed to a lack of managerial skills or the unsophistication of management. For example, the skills which an entrepreneur needs to establish a business are often inappropriate or inadequate to guide a business through later stages of growth and development. Even if adequate capital may be available, the firm is not likely to grow and prosper unless the entrepreneur has the vision to acquire the managerial talent or to develop the personal skills necessary to operate a more formal and complex organization.

Having sufficient financing does not guarantee success, but a dollar cushion does provide a business with a greater ability to recover from mistakes. For the small business which is undercapitalized, that margin of error is slim.

The president of an SBIC provided the following analogy: If a hunter
has only two shotgun shells, he must make each shot count. If he has a box of shells, he can afford to shoot more and hit less but still bring home the game. For the small business operator with limited funds, fewer mistakes can be made—the probability of failure increases.

Financial people cited another reason for the failure of small business: poor timing. Firms often seek additional financing when it is too late. Several weeks or months are frequently required to acquire certain types of financing even when funds are available. A firm without management experience or skills likely will postpone its search for financing until a crisis arises; then it is unlikely to receive these funds in time to save the business. Although the lack of immediate credit or capital may be the final straw leading to failure, it is only symptomatic or more deeply rooted problems within the firm.

LACK OF FINANCING AND MERGER ACTIVITY

Because financial resources are sometimes unavailable, the operator of a small enterprise may be faced with the dilemma of postponing growth or selling all or part of the firm. To determine the impact of a capital shortage upon merger activity, suppliers of funds to small business were asked, "Does the shortage of venture capital lead to increased merger activity or the selling out to large business?" They responded in a 3-to-1 manner that a lack of financing is not a major cause of merger activity. Several actual cases were cited, however, which indicated that a shortage of venture capital did contribute to the final decision of the owner to sell out or merge. Owners of small businesses often prefer to sell or merge for reasons of liquidity, attractiveness of the offer, need to obtain managerial talent, or other personal reasons rather than because of the unavailability of credit or venture capital.

This finding is contrary to the results presented in the Report of the Task Force on Venture and Equity Capital for Small Business (U.S. Small Business Administration, 1978) in which a nationwide increase in mergers and acquisitions of smaller businesses is noted. Although such a trend appears unabated on a national basis, no strong evidence was obtained from the interviews that the current merger phenomenon is equally prevalent in Region III.
CREDIT AVAILABILITY AND BRANCH BANKING

The commercial bankers contacted regarding the question "Do different branch banking laws affect the availability of credit for small business?" were about equally divided on this issue. Those bankers who believed that branch banking positively impacted upon credit availability to small business felt that branching provided more competition which kept rates down on loans. Furthermore, branch offices were thought to provide a convenience factor which helped small business borrowers in their quest to obtain credit.

On the other hand, several bankers commented that the real issue is not whether different branching laws lead to greater credit availability but whether bank policy encourages lending to small business. That is, branching laws are of little consequence to credit availability if banks harbor a negative attitude toward providing credit to small business.

Table 3 shows the general nature of branching in each state. Statewide branching exists in four areas subject to some restrictions such as in Virginia; limited area branching and unit banking are in one state each. In Pennsylvania branching is limited to contiguous counties.

TABLE 3
TYPE OF BANKING BY STATE IN REGION III

<table>
<thead>
<tr>
<th>State</th>
<th>Type of Banking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>Statewide Branching</td>
</tr>
<tr>
<td>District of Columbia</td>
<td>Statewide Branching</td>
</tr>
<tr>
<td>Maryland</td>
<td>Statewide Branching</td>
</tr>
<tr>
<td>Pennsylvania</td>
<td>Limited Area Branching</td>
</tr>
<tr>
<td>Virginia</td>
<td>Statewide Branching</td>
</tr>
<tr>
<td>West Virginia</td>
<td>Unit Banking</td>
</tr>
</tbody>
</table>
POLICY RECOMMENDATIONS FOR CHANGE

Suppliers of funds and small business people were asked for their recommendations for encouraging the growth of small business. Specifically, they were asked "What steps should be taken to increase the availability of credit and venture capital and reduce financing costs to small business?"

Some of the recommendations focused upon increasing the amount of internally generated funds. That is, if regulatory changes are made which enable small business to reduce the cost of operation and to keep a larger proportion of their earnings, then more funds would be available for growth through internal means. Such changes would not only increase the equity base of small business but also would reduce the dependency upon external sources of financing and increase the creditworthiness of the firm. Hence, small business would be in a better position to acquire outside funds if needed.

Other recommendations focused on creating a climate for external suppliers of credit and capital which would encourage them to supply more funds to small business. These recommendations can generally be grouped into two categories.

The most frequently cited recommendations deal with taxation. These recommendations are:

1. **Reduce corporate and individual income taxes.**
   The surtax on corporate earnings could be increased to $200,000 which would give small business more after tax income. The income tax schedule could be scaled downward which would primarily benefit the sole proprietor and partnerships.

2. **Further reduce the tax on capital gains.**
   A sliding scale could be devised which would reduce the capital gains tax proportionate to the length of time the capital asset is held. This action would encourage equity-type investments in small business by providing a meaningful tax break to investors.

3. **Defer taxes on gains from the sale of equity in a small business which are reinvested in other small businesses.**
   This tax revision would provide venture capitalists with more funds to invest in small business.
4. Reduce the employer's contribution to payroll taxes (FICA). This step would reduce one cost of doing business and provide more internal funds for small business expansion and growth.

5. Provide more incentives to large business to become involved in supplying funds, especially equity capital, to small business. A tax credit could be given for equity-type investments made in small business. This action would provide freer availability of risk capital, promote competition, and reduce the concentration of large business.

6. Permit operating loss carry-backs and carry-forwards for venture capital firms. The carry-back provision of three years and carry-forward for seven years could be enacted. This step would increase the profitability of venture capital firms, provide additional funds for reinvestment, and encourage the formation of venture capital firms.

7. Develop more appropriate procedures for taking inflation into consideration. The depreciation schedules for small business could be liberalized. Such a step would mean faster writeoffs of assets, reduced taxes, and improved cash flow. Current accounting procedures specifically relating to inventory and fixed assets do not provide for appropriate adjustments for inflation which consequently lead to higher amounts of taxes being paid.

Several of these proposed tax revisions would improve the profitability of small business and improve the opportunity for more internally generated funds. At the same time, the increased profitability and improved equity position of these small businesses should also attract more external funds, either in the form of credit or equity capital.

In the short run, the tax changes would result in lost revenues to the government. Over a longer time span, however, the improved position of small business would generate more employment and higher future tax revenues.

A second area of recommendations applies to changes in regulations and the reduction of paperwork. These recommendations are:

1. Provide comprehensive reform to the Occupational Health and Safety Act (OSHA). Changes in OSHA could focus upon reducing the regulations as applied
to small business. Some steps have already been taken in this direction by Senator Richard S. Schweiker in which an amendment was passed on July 20, 1979, by the Senate to severely limit the authority of OSHA to regulate small businesses with good safety records. Specifically, this amendment applies to businesses with 10 or fewer employees, forbids OSHA from conducting random safety inspections of such firms and prohibits the assessment of a penalty against the firm for a safety violation by OSHA without first giving the employer a chance to correct the solution. This amendment could be extended to include even more small business firms.

2. **Change the ERISA "prudent man" provision.**

A revision in ERISA to allow pension funds to invest between 2 to 5 percent of pension fund portfolio assets in smaller, riskier companies would make additional capital available to small business.

3. **Streamline tax returns.**

Both the number and complexity of tax returns could be reduced following a careful review of existing forms.

4. **Reduce the paperwork involved in an SBA loan.**

The paperwork required to apply for an SBA loan involves considerable time and expense for all involved. Some bankers avoided the SBA guaranteed loan program because of the vast amount of paperwork and expertise required to submit an application. The complexity of the process serves as a deterrent to commercial banks and small business people alike.

5. **Permit the SBA to buy preferred stock in SBICs and MESBICs.**

Currently only debt can be obtained from the SBA. The rule change allowing SBA to invest in low yielding preferred stock would help the SBICS and MESBICs provide more equity capital to small business.

6. **Allow SBICs and MESBICs to charge a variable interest rate over prime which could exceed the current ceiling of 15 percent over a period of time.**

This change would help insulate SBICs and MESBICs from changing interest rates over the term of their loans while allowing loan oriented SBIC and MESBICs to take higher levels of risk.

F21
These recommendations are not surprising. In recent years the maze of government regulations, laws, and red tape has created mountains of paperwork hamstringing small business. The costs of compliance have exceeded millions annually and have in some cases restricted the growth and development of small business. Enormous cost savings could be realized by reducing the veritable jungle of regulations and the burdens which these regulations place on small business.

CONCLUSIONS

Although credit and equity capital are available in Region III, this availability is on a highly selective and competitive basis and at a high cost. Financing is especially difficult to obtain for start-ups and more marginal operations. Funds are available for more mature and successful operations if the firm is willing to search for the proper type of financing and supplier of funds. The overall availability of funds in the region has improved over recent years but concern over future availability was expressed in the event of a prolonged economic recession.

Based upon the interviews with suppliers of financing and operators of small business enterprises, the findings suggest the following consensus of opinion.

1. Credit is not more readily available to franchise operations than independent firms except for a very select group of "name" franchises.

2. The lack of credit does limit the growth of small business and increase the probability of failure but credit unavailability is not considered to be the major cause of failure.

3. In some instances a shortage of venture capital has led to increased merger activity and selling out to large business but this is not perceived as a major reason for such activity in the region.

4. Opinion is divided on whether different branch banking laws affect the availability of credit for small business.

5. The primary recommendations for improving credit availability and reducing the cost of financing involve revisions in the tax code, modification of government regulations, and the reduction of paperwork involved with compliance to these regulations.
SECTION II. DISCUSSION OF METHODOLOGY

The methodology for conducting this study consisted of five major steps: (1) review the literature on the cost and availability of credit and venture capital for small business in general; (2) determine the short-term, long-term credit and venture capital sources available for small business; (3) choose the specific suppliers of financing to be investigated; (4) select a sample of small businesses and providers of credit and venture capital in the region; and (5) gather data from the specific business people and suppliers of financing chosen.

The review of the literature revealed that the cost and availability of credit and venture capital are highly dependent upon various stages of the economy. Given the expansionary direction of the economy until recently, small business has been enjoying an improved climate of financing availability but at a high cost. The support of the White House for small business and recent regulatory changes have had a positive impact upon the availability of financing to small business.

The literature review also unveiled a large variety of different sources of financing for small business. These sources consist of the following: (1) friends and relatives, (2) financial institutions such as commercial banks and insurance companies, (3) investment bankers, (4) private investors, (5) large companies, (6) trade creditors, (7) business finance companies, (8) factors, (9) publicly held venture capital operations, (10) private venture capital organization, (11) venture capital arms of wealthy families, (12) informal investment syndicates, (13) SBICs and MESBICs, (14) state-licensed business development corporations and (15) government agencies such as the Small Business Administration, Farmers Home Administration, and Economic Development Agency.

Given the impracticality of investigating all of these sources of financing to small business, only the most common sources were analyzed. These common sources were selected because they represented a major force in providing credit and equity capital in the region and were familiar to small business. These major sources were determined to be commercial banks, venture capital firms primarily represented by SBICs and MESBICs, and state and local agencies involved in fostering small business. Although no single
source of financing clearly dominates in the region, the sources selected represent an important body of financial providers. It is realized, however, that these sources merely scratch the surface of financing availability in the region.

The group of commercial banks and venture capitalists chosen was based on the prominence of these suppliers in the region. The involvement of the commercial banks in SBA-guaranteed loans was only a secondary consideration. The venture capitalists primarily consisted of the SBICs and MEsbics operating in the region. Several small business operators were also contacted to gain their perspective on the subject of cost and availability of credit and venture capital.

Data were gathered for the study by means of a structured telephone interview. The interview largely consisted of the seven questions reported in Section I of this report and background information about the firm and person interviewed. The results of these interviews were tabulated and served as the basis for this report. The vast majority of interviews were conducted during July and August, 1979.
SECTION III. THE DATA BASE

The data base consisted of information obtained from secondary sources and telephone interviews. The major sources of this data base are listed below.

SECONDARY SOURCES


SELECTED INTERVIEWS

**Commercial Banks**

Blumberg, Barry D. Vice President, Maryland National Bank, Baltimore, Maryland. July 1979.


Mountcastle, Frank F., Jr. Vice President and Officer in Charge of Branch Business Group of Richmond, First and Merchants Bank, Richmond, Virginia. July 1979.

Sweeney, Robert M. Assistant Vice President, Consumer Loan Department, Citizens Bank and Trust Company, Riverdale, Maryland. August 1979.


**Minority Enterprise Small Business Investment Companies (MESBICs)**


Small Business Investment Companies (SBICs)—


Other Interviews—


SECTION IV. SELECTED BIBLIOGRAPHY


"SBA Lending Sets Faster Pace." Banking (March 1977): 96+.


