The Difficulties for a Small Business in Obtaining Commercial Bank Loans During a Recession

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The Difficulties for a Small Business in
Obtaining Commercial Bank Loans During a Recession

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by
Matthew J. Maruska
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# Table of Contents

I. Introduction ........................................................................................................... 4
II. Research Methods ............................................................................................... 9
III. Pre-Financing Preparation ................................................................................ 11
IV. Financial Position Required of a Small Business ............................................. 16
V. Commercial Bank Financing ............................................................................. 20
VI. A Recession: A Brief Examination ................................................................. 30
VII. Financing a Small Business During a Recession ........................................... 37
VIII. Title Contract Financing ............................................................................... 40
IX. Small Business Survey ..................................................................................... 43
X. Conclusions ....................................................................................................... 49
XI. Appendix .......................................................................................................... 51
XII. Bibliography .................................................................................................... 58
Introduction

It is very difficult for a small business to obtain commercial bank loans during a recession. This thesis attempts to examine the issues surrounding this proposition by first looking inside of small businesses. The significance of a company's financial projections and position will be given, stressing the areas of form and sufficiency. After examining what small businesses must do concerning pre-financing preparation, the option of pursuing commercial bank financing will be explored. Following a description of commercial bank financing, the elements leading to and indicating a recession will be examined. A recession is defined as "the period of declining output, employment, and prices," (Mabry, p.304). Then a section will be presented on the difficulties of financing a small business during a recession. A less known method of financing will be introduced in answer to the logical question of where to go after commercial bank financing. Title contract financing is presented as a solution to this problem. A brief description of each section follows.

Before pursuing financing from a lender, a certain amount of preparation must be done ahead of time by the business. First, a business plan needs to be developed. This tells what the overall strategy of the business will be and how the business will achieve that strategy. After a business plan is prepared, a marketing plan must be created. The marketing plan is a related document to the business plan which describes how a product or service is going to be sold to the public. This is necessary because lenders will want to know exactly how the product or service will be sold.

Financial projections are crucial because they indicate management's expectations for future growth. Similarly, the company's present health is indicated by its current set of financial statements. There are two features of a business' financial projections and position which cannot be emphasized enough. First, all financial statements must be in good form; which means they must be accurate and realistic. For instance, they should be prepared by a
certified public accountant (CPA) and should contain no misleading information. The financial projections should actually be feasible by having extensive analysis done and by coinciding with company goals. Also, the use of new funds should be practical, for example, reducing accounts payable or for funding a new project. The ability to strengthen a firm's financial projections is dependent upon the firm sustaining its financial position.

Maintaining a viable financial position is embodied by preserving cash flow and retaining sufficient equity. Cash flow is the lifeblood for small business to which daily attention must be given. It is emphasized because the business must be able to meet:

* debt payments
* fixed overhead expenses
* unforeseen expenses.

Close attention must also be given to cash flow because it can deteriorate quickly, if not daily. Maintaining positive cash flow is stressed because providers of capital funds will watch cash flow closely. They will unquestionably watch the equity position of the owners of the business.

Creditors prefer to see owners have a large personal stake in the firm. This demonstrates to creditors that the owners will not recklessly manage the firm - the consequences being the owners losing much of their own money. This describes the equity portion of the debt to equity mix, which is termed the capital structure of the business. A point to remember in maintaining a proper debt to equity mix is that increasing debt characterizes augmentation of financial leverage. An expansion in business without the infusion of new funds by the owners is termed leverage. One concern for high debt levels is that additional debt can severely strain cash flow due to the considerable interest expense involved.

As mentioned earlier, a loan from a commercial bank is one of the choices for financing available to the small business. A commercial bank is an optimal choice of financing a business because it may have among the lowest interest rates available, and no direct ownership must be exchanged by the business for the funds. However, there are interest and
principal payments which must be made on time and can represent a substantial amount of a business' cash flow. Yet, there are still difficulties in obtaining financing from commercial banks.

Today, commercial banks are more cautious in loaning money because of the tight financial climate. The economic downturn and the savings and loan debacle have led commercial banks to pursue restrained lending policies. In addition, commercial banks are increasing their reserves and are paying higher insurance premiums to the Federal Deposit Insurance Corporation (FDIC). Consequently, banks are imposing an increasing number of financial constraints upon firms borrowing money. The constraints consist of businesses maintaining acceptable debt and liquidity ratios. Debt ratios compare the amount of debt a firm has to either the assets or the equity of the firm, and liquidity ratios compare the debt payable in less than one year to the assets that can be converted to cash in less than one year.

A recession is often defined as a period of 2 consecutive quarters of decline in a country's gross national product (GNP). GNP simply represents the total output of a country's economy. Along with GNP, there are a number of other economic indicators which can be used to identify when a country is moving in and out of a recession. A combination of economic indicators can reveal the direction in which the economy is moving. As will later be shown, the recession of 1979-1982 and the current recession of 1989 to the present can both be described using different indicators.

Financing is the nourishment of a business. Without it, a business will starve, but with it, the business has the means to survive. In examining the difficulties of a small business' ability to obtain financing during a recession, two points have become readily apparent. First, commercial lending banks become more selective in granting loans. One reason for this is that loanable funds are not as available as before a recession. This occurrence is called "tight money." This could be from a contracted money supply or not enough private savings entering banks. Being more risk averse during a recession represents another reason why banks become more selective during a recession. To clarify, there is a greater probability for small companies, who are in need of operating funds, to fail during a recession. Therefore, banks
are not as willing to make loans to small businesses because of the increased risk of default on loans. Default is the risk that a company will not be able to meet interest payments on time.

The second reason which compounds the difficulties for businesses to obtain financing during an economic slowdown is that the possibility of high interest rates can prevent a firm from being able to afford debt financing, which is a method of financing where one party loans money to another. One of the reasons for high interest rates could be a contracted money supply, possibly resulting from restricted monetary policies of the Federal Reserve. Inflation is another important cause of high interest rates.

Because of the increased difficulty in obtaining loans from commercial banks during a recession, title contract financing is offered as an alternative method for financing a small business. Title contract financing is actually quite similar to a lease with a third party. Title contract financing works best for financing inventory or equipment. For example, a small business may have tried other conventional means of financing, but was unable to arrange an agreement. Now, the business seeks a third party who will purchase the inventory or equipment for the firm. The title for the purchased goods remains with the third party, and the small business will pay back the third party in terms very similar to a lease. While this method is offered as an alternative to commercial bank financing, it still must be emphasized that any party with whom the small business enters into a title contract financing arrangement with will still closely scrutinize the business' financial projections and position.

In order to observe how small businesses actually finance themselves and to find what effect the present recession has had on them, a survey was developed and distributed to 100 small businesses in the central Minnesota area. This survey asked questions concerning what start-up financing was used, what financing was used in the past twelve months, attempted types of financing that have been rejected, and planned financing for the next twelve months. There were also general questions asked concerning the effects the present recession has had on the business and how long the business owner believes those effects will last. The results of the survey are analyzed to come to some conclusions about how small businesses actually
finance themselves.
Research Methods

Three primary processes went into developing this thesis. These processes entailed examining previous research and writings on related topics, interviewing selected sources in business and finance areas, and surveying a number of small businesses for insight into the financing of their companies.

United States Government Documents provided the best source for reading about the past recessions in the United States. Documents coming from the Joint Economic Committee furnished much of the background on the recession of 1979-1982. The information itself was not as important as was understanding the process in which the Joint Economic Committee became informed about the recession. In my opinion, the downfall of the savings and loan industry held a key part in starting the recession that now faces the U.S. The downfall also provides insight into the hard guidelines that the government is now trying to impose to keep banks solvent. Readings for this area were again from U.S. Government Documents and also from a number of books and periodicals.

The Hill Reference Library in St. Paul became an invaluable source. General information was obtained regarding the health of the commercial banking industry, outlines of policies for determining qualifications for prospective customers, and other information regarding how banks are changing and coping with the volatile commercial banking industry. The Venture Capital Handbook by David Gladstone was the primary source used to develop an outline of a good business plan.

The method that worked best for finding articles, was to perform searches on "WilsonDisc" CD-ROM, which is a laser disk that is used as input for a computerized search through a business periodical index.

Personal interviews were held with a number of business banking officers from Twin City commercial banks. Tim Allen of the St. Cloud Small Business Development Center provided the idea for title contract financing through a couple of personal interviews.
A survey was also developed which was sent to 100 small businesses in the central Minnesota area. A small business was defined as a business which had $10 million or less in net sales for the past year. These businesses were chosen at random from the business section of the White Pages in the local phone directory. Others were chosen from a list which contained a random sampling of central Minnesota small businesses.
Pre-Financing Preparation

Before a small business or any business for that matter can approach prospective financiers for funds there are two major items which the small business must attend to before proceeding. These two items are the business plan and the marketing plan. Both represent important plans for the business which are crucial if the owners of the business desire financing from outside sources (Cleveland, personal communication). These plans are so important that they should both exist even if financing is only going to be generated internally (such as more equity from the owners).

The business plan is used as a roadmap to the business. It tells what the overall strategy of the business will be and how the business will achieve that strategy. The marketing plan is a related document which describes how a product or service is going to be sold to the public. The prospective financier finds the marketing plan important because a product may be the greatest thing in the world, but a lender will not give his or her funds to the business if it does not have much of an idea of how it will sell the product.

The ideas presented draw quite heavily upon two sources. The first is David Gladstone's book, Venture Capital Handbook, and the other is Analysis for Marketing Planning, written by Donald R. Lehmann and Russell S. Winer. The former lays out all of the elements that should be included in the business plan, while the latter gives an in-depth, detailed look at how a marketing plan should be formed. Some of the ideas in the two texts overlap and will only be mentioned here once. What is considered the best of both will be combined to give what is contained in a complete business plan plus a sufficient outline for a marketing plan.

According to Gladstone, the business plan has nine sections: summary; business and its future; management; description of the financing; risk factors; return on investment and exit; analysis of operations and projections; financial statements; and projections (Gladstone, p.42). In addition, there should be a complete marketing plan.

The business summary is a short document in itself, in a way the resume of a business.
It should be kept very brief, as details will be added to it later. There should also be a section on the management of the company. This is very important because financiers want to know about the people who will be directing the company. Following the presentation of the managers, it is necessary to give an account of the product/service in which the firm specializes. The prospective financier will want to know what product/service he or she will be financing. Further, the financier will want to know if there is anything unique about the product or service (Gladstone, p.29). The last section of the summary should briefly state the exact amount of funds requested, any collateral that can be offered, and the use to which those funds will go.

The body of the business plan should start with a description of the business and where it is headed. This is important because it is here where a detailed description of the firm is given, including the unique characteristics that will make the business a success. Also to be included in this section will be the purpose and nature of the business, business history, and business future. The purpose and nature of the business basically only need be a few sentences; first stating what the company does, and then a brief description of the products or services offered. It is also wise to keep the history of the business quite succinct, because the prospective investor does not want to read a history book about the past of the business. If the investor desires additional historical information, he or she will ask for it (Gladstone, p.42). Concerning the future of the business, desired goals should be stated including where the firm wants to be in a few years. The investor will be looking here to see what the owners are planning to do to make the company successful.

The other half of this section which figures prominently is that concerning production of the product or service. The first aspect to be mentioned here is the production process. A description of the labor force should be included in the plan. There should also be included information on suppliers and subcontractors. There also needs to be a section describing equipment and facilities. Finally, patents, trademarks, research and development, litigation, and government regulations concerning the firm should also be included (Gladstone, pp. 47-
The next section of the business plan is one describing the management of the firm. This section will include descriptions of some of the achievements of the management, a list of the board of directors and officers, and a description of others involved with the firm (Gladstone, pp.51-53). The section following that on management should be a description of the financing desired by the firm. Once an explanation of the proposed financing is given, it is necessary to incorporate a picture of the firm's current financial situation. The first of these is the capital structure of the firm. Capital structure is the mix between debt and equity used in the firm. Collateral available for financing is another aspect which should be included in the plan if debt financing is pursued. Guarantees and conditions are other elements of the proposed financing that would be included. Finally, there should be included a description of how the firm will report to the financier (Gladstone, p.55).

The next section of the business plan should be comprised of the risk factors involved with investing in the company. This is necessary because the investor will want to know exactly what the risks are in becoming involved with the company (Gladstone, p.57). Two areas to be examined next are the firm's dependence on key management and what would happen if things go wrong. There should also be a section concerning return on investment. An investor will receive cash back from the investment (Gladstone, p.59). Included next should be an analysis of operations and projections. It is in this section where financial statements, including income statements and balance sheet, of the company should be analyzed.

Thus far, a general guide to a business plan for presentation to prospective financiers has been outlined. Practically all of the details that should at least be mentioned have been discussed above. The one section that has so far been left out is that on marketing. Gladstone's purpose was not to give a fine, detailed description of how the business plan should be written. He only gave guideline and advice on what to include. The same goes for the portions of the business plan he devoted to marketing. However, because of the importance a good marketing plan holds for a firm, more attention must be given to the
There are eight main segments to the marketing plan as described by Lehmann and Winer: executive summary, background assessment, marketing objectives, marketing strategy, marketing programs, financial documents, monitors and controls, and contingency plans. Each of these sections, except financial documents, will be discussed only in enough detail to give the reader a general picture of what should be contained in each. Further detail can be found in Lehmann and Winer’s book, *Analysis for Marketing Planning*.

The first section of the marketing plan should be the executive summary, which will be very similar in purpose to the business plan summary. There are three items which should be included in the executive summary: objectives, strategies, and expected financial performance (Lehmann, p.10). These three items will give all that is needed to understand what the marketing plan is all about.

The second part of the marketing plan will be a background assessment. This actually contains three rather important subcategories: a historical appraisal, a situation analysis, and planning assumptions. Further, the situation analysis is composed of a number of parts: the sales analysis, industry attractiveness analysis, competitor analysis, customer analysis, and resource analysis (Lehmann, p.10). These items make up the bulk of the raw data that will be gathered to conduct the marketing analysis.

After gathering the raw data, marketing objectives need to be stated. A marketing strategy also needs to be developed which will provide the answer to how to achieve the objectives set forth. Following the strategy, various marketing programs need to be planned. There should also be financial documents included in the marketing plan (Lehmann, p. 17), even though they are also contained in the business plan.

There are two more sections which should be included at the end of the marketing plan. The first of these is for monitors and controls. In this section data gathered to monitor the marketing operation are described. The final section to be added to the marketing plan is one containing contingency plans and other miscellaneous documents. Contingency plans really
should be made in the event that the future does not perform as expected. There might be alternative strategies laid out in this section, as well as some sort of disaster plan (Lehmann, p.18).

Each section of the marketing plan is tailored to a specific business' needs. The marketing and business plan provide a complete map of the company and represent solid organization and a well thought out business. The ability to produce these documents upon request will demonstrate to prospective financiers that the company is well planned and presents less of a risk than a company which has done none of this planning.
Financial Position Required of a Small Business

The financial projections and position of a small business are of significant importance. These should be in good standing before the owners attempt to obtain outside financing. First, all matters of finance, such as the balance sheet and financial statements, should be in good form, and secondly, the business must maintain good financial position for creditors to extend funds to the business. Good financial position means the business must meet certain criteria for creditors, such as maintaining certain financial ratios. Each of these areas will be examined for what should be expected of the small business.

Many small business owners do not realize the importance of having financial statements in good form. First, these statements need to be accurate. It does not benefit the company at all to develop misleading statements, intentional or not. Statements which are prepared liberally only hide problems from sight until those hidden problems grow into even bigger problems. Sooner or later these problems will become evident.

The small business should hire a certified public accountant (CPA) to prepare the statements. Even if the owner has sufficient knowledge of how to build financial statements, it is well worth the money to get a certified accountant to do the work. There are a couple of reasons to hire a CPA. First, a CPA has been trained in the proper forming of the financial statements. He or she will be able to prepare them correctly according to accepted standards. The CPA is also needed to handle problematic technical accounting details.

There is the further concern that any misleading information can lead to a lawsuit from creditors because they require that accurate information be reported to them. Even if the misleading information was unintentional, the business remains liable for the information it generates. The best course of action for the small business is to have the statements prepared as accurately as possible by a CPA and attack financial problems immediately.

The attainability of the financial projections presents another aspect of preparation for obtaining financing. The forecasts made by the business should actually be attainable. Gross overestimation and underestimation of projections can have undesirable repercussions for the
business. Overestimating the projections can be considered as misleading information and could subject the business to facing disappointed creditors and stockholders for not living up to expectations. Loss of motivation among employees due to the realized unattainability of the forecasts will cause employees not to care how the company performs, further detracting from the performance of the business. Underestimating projections may not subject the business to a lawsuit, but the goals will be so ridiculously low that creditors and employees are going to consider the forecasts a joke and not pay any attention to them. Financial projections should closely reflect the goals of the company, and the goals of the company should be carefully set so they are not too ambitious nor too easily attained.

In obtaining proper goals and projections, detailed analysis should be performed on the entire firm's financial health. This analysis should be completed by an accountant or internal financial manager. Calculating various financial ratios should provide the basis for a financial analysis (An explanation of the more commonly used ratios is provided in the section on commercial bank financing). Once these ratios are calculated, they should be compared to equivalent ratios of the business' competitors and industry averages. Any significant variations from these two comparisons should be analyzed and time spent determining why these variations are present. An analysis should be performed for those ratios which vary significantly above or below the industry average.

The reason for analyzing ratios which are less than desirable is to determine what aspects of the business are functioning poorly and what can be done to rectify the situation. However, ratios that outperform the industry average should also be examined for two reasons. First, the owners should determine what it is the business is doing right and make sure the cause continues in the future. Secondly, developing a keen understanding for all financial interrelations of the business can provide a better understanding of the business as a whole; how each individual part affects the others. The ratios themselves express relationships between certain financial elements of the business. Understanding how changing one financial aspect of the business will affect all other financial aspects of the business will lead to a greater
appreciation of how to generate high performance within the business.

Included in the financial projections should be an explicit outline of how newly acquired funds will be used. Prospective financiers will require that every penny they invest in the business goes to a specific, planned project. This is because the financier wants his or her money going only to projects which will produce a return on their investment. A financier is going to want to know to the dollar how all requested funds will be utilized. Another issue which needs to be discussed is the maintenance of financial position. Specifically, the two critical areas the small business owner should be concerned with are cash flow and sufficient equity in the company.

Cash flow is the life-blood of any business. The balance sheet can be strong and the income statement can show enormous profit, but if there is no cash available to the business, the firm will be forced to liquidate assets in order to obtain the required cash. There are a number of reasons why cash flow is so important to a small business. The business must be able to meet debt payments on time. If this is not the case, then the business has technically defaulted on its loans and can be forced into bankruptcy. There are also a number of daily expenses for which the business must budget which will require a disbursement of cash.

"Projecting, monitoring, and conserving" cash should be very high priorities on the small businessperson's list of concerns (Brandt, p.80). Too often, cash flow becomes a neglected part of the business. In my opinion, many owners focus their entire attention on turning a profit and are not aware of the impact of cash flow on the business. For instance, a business might have attained a profit of $10,000 for the past month. In order to meet forecasted sales for the next month, he purchases $8000 of inventory. However, he or she leaves himself or herself with only $2000 on which to operate for the coming month. This is fine if total cash disbursements for the month will be less than $2000; but for most businesses, this amount can easily be exceeded. If the business had more than $2000 in disbursements for the month, the owner would be forced to try to obtain short-term credit from a bank. Short-term credit would be used rather than long-term debt because short-term credit is used to provide cash for a business for a very short time, whereas long-term debt is used to finance
buildings and equipment which will be used for a number of years. Hopefully the bank will extend the desired amount of short-term credit to the business. If the business cannot obtain the desired credit, the business faces serious difficulty because it will not have the needed cash available to pay expenses. This example illustrates how not monitoring cash flow and not coordinating monthly expenses with cash flow can lead to a cash shortage.

Sufficient equity is the other issue to be considered in the maintenance of financial position. Most importantly, creditors are going to demand a certain amount of equity in the company before extending credit. The reason for this is that the prospective financiers want to see that the owners of the business have a significant personal investment in the business, because this shows that the owners have much of their own at stake. It is thought that people with their own money in a project will work much harder at making a project a success rather than someone who is using someone else’s money.

The other reason for considering the equity position of the company is to monitor the debt and equity mix. If the company becomes too debt laden and prospective financiers turn down the company for financing, it could be possible for the owners to increase the equity in the company by a sufficient amount to a level where financiers would agree to extend financing to the business. The mix between debt and equity is called the leverage of the firm. The higher the amount of debt compared to the amount of equity, the higher the firm’s financial leverage. Creditors will only want to see a certain degree of leverage in the company. Thus, if creditors believe the company to be too highly leveraged, then an infusion of equity in the business will lower that level to where financiers may be able to extend a certain amount of credit to the firm.
Commercial Bank Financing

Debt financing should be the first choice for the small business owner in the decision to seek outside sources to finance a company. A commercial bank is the usual provider of debt financing for small businesses. Despite the many stories that commercial banks are not making any loans to small businesses, or at least have been making it very difficult for small firms to obtain loans, the commercial banks will be willing to make loans to customers who come to the bank prepared. This was revealed in an interview with Patricia Cleveland, business loan officer for First Bank Systems (Cleveland, personal communication). There are many commercial banks who deal with making loans to small businesses.

The lowest interest rates available are the largest incentive for approaching commercial banks. The primary reason for this is that commercial banks are in the business of saving customers funds while providing a modest return. By their very nature, commercial banks do not take great risks. Again, customers place money in these banks to save money, not invest it. So, commercial banks offer low rates for loans because the bank's depositors do not want their funds being invested in a risky venture. The low rate comes from the bank's desire for low risk opportunities.

Timely interest payments are an important trait of debt financing. This is a very crucial factor in developing a debt financing agreement. Payments on debt financing can be arranged in a number of ways. One way is to make only interest payments back to the lending institution on a monthly, quarterly, or semiannual basis. Then, when the term of the loan expires, the entire principal amount is returned to the bank. An advantage to this method is that only the interest needs to be paid on the loan until the term expires. However, there are two disadvantages: one of which is the entire loan amount must be repaid at the end of the loan agreement, while the other has interest being paid on the full amount of principal of the loan. In other words, there is no slow reduction in principal which will reduce the amount of interest that must be paid to the lender.
The ability to slowly reduce the principal of the loan suggests another way to arrange a loan. Paying down the principal would be similar to a house mortgage. For example, when the monthly, quarterly, or semiannual payments come due, not only are there interest expenses being paid, but the principal is paid as well (Erickson, personal communication). The strength of this method is that when the subsequent payment is due, the interest expense will be less because there is less principal remaining. Further advantage is had if the payment is kept at a constant figure throughout the life of the loan. Then, the amount of interest that is being paid slowly decreases over the life of the loan because the total principal is reduced every month. This further suggests that if the percentage of the fixed payment is decreasing with respect to the interest expense, then the percentage of the fixed payment is increasing with regards to the amount of principal being paid off. One effect of arranging a loan this way is that the loan would be paid off earlier than if fixed interest payments were being made and the principal was paid back in one sum at the end of the loan's life.

Since the savings and loan problem became public, the commercial banking industry has also been having a number of problems similar to the savings and loan debacle, but less severe in terms of total dollars lost (Trachtenberg, p.A4). Since deregulation of the banking industry began during the Reagan administration, banks were given the opportunity to invest in other mediums rather than the traditional home mortgages. This means that many commercial banks were able to invest in ventures more risky than those traditionally financed by commercial banks. The long term effects of this practice are just now coming into full view: The commercial banks have been suffering tremendous losses, especially in the Northeast and in the South where real estate values have plummeted. When borrowers defaulted on their loans, the banks were left with real estate that was worth perhaps $1,000,000 at the time the loan was made in the mid 1980's which is now much devalued today (Trachtenberg, p.A4).

In all fairness, it should be pointed out that not all commercial banks and savings institutions fell into this practice. It was the banks who followed very conservative loan practices which are today turning great profits because they never experienced the large real
estate losses or junk bond losses; junk bonds being bonds of very high risk companies called thus because of their apparent worthlessness (in fairness, it should be mentioned that many junk bonds actually thrive with the company having no problem paying it's creditors). As perfect examples, First Federal Savings Bank of Cleveland, Home Savings of America, and Washington Federal Savings all focused on "stay at home" residential loans and mortgages. They steered clear of junk bonds and investments in real estate (Jaben, pp. 10-14). It should also be said that these particular banks also remained out of the market for commercial loans, however the example serves to show that not every banking institution in the U.S. followed the road to disaster.

As in the savings and loan industry, bad management may be another reason that commercial banks are having so many problems. Bad management arose after deregulation of the banking industry (Kane, p.48). Many inexperienced people saw deregulation as a time when it was ripe for entrance into running their own bank (Kane, p.50). Unwise investments were taking place along with a great jump into making construction loans, real estate loans, and investing in new, high risk mediums like junk bonds. The other problem with management, and this is where much of the damage occurred, was that individuals saw the opportunities to reap enormous personal profit from programs that were largely fraudulent (Adams, James, p.125). This practice was made possible largely because of deregulation. Edward Kane's book, The S&L Insurance Mess: How Did It Happen, describes, in depth, what kind of mismanagement occurred in S&L's. While this focuses on the savings and loan scandal, this was also happening in the commercial banking industry. Therefore, it has been pointed out as a warning sign that any bank (specifically thrift, but applies to savings and commercial banks as well) which has seen a management change between 1982 and 1985 might be a bank which is experiencing financial problems (Ring, p. 277).

In my opinion, it is because of these unfortunate happenings in the past decade that banks are becoming more cautious to whom they make loans. Part of the reason for commercial banks' wariness, as previously mentioned, is because of the number of bad loans that they are carrying on their books. These banks have no desire to add any more bad loans
to a loan portfolio that is already riddled with them. Further, the industry and the federal government are trying to weed out all poor managers (and press criminal charges where needed) in an attempt to clean up the industry and make commercial banks profitable once more.

In trying to avoid another savings and loan debacle, the commercial banking industry is taking a number of steps, as a whole, to improve its financial condition. These steps bear indirectly and directly upon small businesses because banks will likely be lending less to these entities. These steps consist of increasing reserves, increased insurance costs, and being more selective in to whom the banks make loans.

Increasing reserves serves a very practical purpose. The industry continues to experience low real estate values and defaults on their loans. Therefore, the increased reserves will provide a cushion against which depositors need not worry about losing their own money. This will indirectly affect the ability of a small business to obtain a loan. By increasing reserves, banks will be taking more of their money out of circulation than if they did not increase reserves. In this sense, the money supply is decreasing. This practice should actually increase interest rates because of less supply. Currently, however, the Federal Reserve Board continues to lower the rate offered at their discount window (Wessel, p.A1). The discount rate offered by the Federal Reserve is the leading influencer on interest rates. By lowering the discount rate, interest rates in general will fall accordingly.

The net effect of less supply, coupled with the continuously lowered discount rate, leads to low interest rates; however, there is still a reduced money supply. To explain, interest rates are very favorable for loans, but banks are being more selective about to whom they make their loans because of the tighter money supply. In fact many commercial banks seem to be phasing out making loans to small businesses. While no single person associated with the commercial banking industry came right out and said so, the messages sent were that overall, loans to large and small businesses were becoming more difficult to obtain, as stated by Cleveland (personal communication). Further, Ken Timboe, Vice-President of Business
Banking at Norwest Banks, stated that lending policies have become more careful all around (personal communication).

Other measures taken to help alleviate the problem facing commercial banks are increased insurance costs by the Federal Deposit Insurance Corporation (FDIC) (United States, Reforming Federal Deposit Insurance). These insurance premiums were increased because of the deterioration of the Bank Insurance Fund (BIF), which is the fund that the FDIC controls to provide insurance to commercial banks.

While these signs show tighter lending practices across the commercial lending arena, the aforementioned tighter restraints can only lead to a slow "squeeze play" of small businesses. As commercial banks pull in the reins to improve their financial health (Daniels, p.A2), the more risky ventures are going to be ruled out. Again, making loans to small businesses is one of those risky areas. As an example of the risk involved, the Federal Small Business Administration (SBA) reports that Small Business Investment Companies (SBIC), SBA-backed venture capital firms, have only had a one third success rate with the small companies with whom they have worked. The remaining two thirds of the small businesses have had to liquidate their assets (Saddler, "SBIC failures soar," p.B2). Speculation by individuals closely related to the commercial banking industry suggests that in the future, many commercial banks will not be making loans to small businesses at all as these institutions move towards safer, conservative prospects. Because of the risk involved in granting loans to small businesses, banks have developed standards as part of the loan agreement to which the businesses must adhere.

In the past, lending institutions have perhaps required certain guidelines that had to be met before they would authorize a loan to a borrower. Two of the main areas commercial banks are concerned with are the maintenance of certain financial ratios and the requirement that firms may not seek financing with any other firm without first consulting the lender. Once the borrower had the loan, it still required that the firm maintain certain financial ratios throughout the life of the loan. This practice is definitely still in effect today.

There are literally hundreds of financial ratios that could be developed which a lender
might choose to examine. Only a few of these ratios will be looked at presently. These financial ratios fall into three general categories: leverage, liquidity, and turnover ratios. Each of these categories has certain ratios which hold great importance for the lender.

The most significant of the leverage ratios is the debt/equity ratio. This ratio divides total debt by owners' equity to arrive at a ratio which tells by what percentage (1 being 100%) debt compares to owners' equity. For example, if the debt/equity ratio is 1.5, then debt measures 150% of owners' equity. In other words, the firm possesses 1.5 times as much debt as it does owners' equity. The benchmark number that banks refer to depends upon the industry in which the small business (or any business for that matter) operates. Overall, for example, First Bank Systems requires 4:1 debt to equity measure on the average of all industries (information courtesy of Patricia Cleveland).

The debt to equity ratio determines if a firm is operating with higher leverage than the industry average. If so, the lender will want to determine why this is the case. Operating too high over the industry average might present a severe strain on the company's cash flow because of large interest obligations. Also, if there has been an increasing leverage position over the past few years, the lender will be interested in finding if this is due to increased debt, or a loss of equity in the firm (Gilliam, p. 75). Both of these conditions can be important. If the debt load on the firm has been increasing, then the lender may deem the financial leverage too high to grant more debt. If the cause was a decreasing equity position, then the lenders may agree to the loan, but only if the owners will first infuse more money into the business. In determining if the business will be able to payback the loan, there is another ratio that becomes very important to the lender.

The current ratio, or it's more stringent cousin the quick ratio, provides insight into how quickly a company is able to obtain cash to be able to meet interest payments and other financial obligations. Again, the specific guidelines for an acceptable current ratio vary from industry to industry, but the meaning of the current and quick ratios can be described.

The current ratio divides current assets by current liabilities. Generally, current assets
and liabilities are defined as those assets and liabilities that expire within one year or less. The resulting ratio is the number of times that current assets can be converted into cash to pay back current liabilities (Block, p.63). For example, a current ratio of 1 means the business has exactly the amount of current assets that would be needed to meet all current liabilities. Generally, a current ratio of 1.5 is desired. The definition of the quick ratio is narrower than that of the current ratio. It takes current assets and then subtracts inventory from this figure, and divides by current liabilities. The reason for subtracting inventory is that it can behave in a seasonal manner, plus the business is generally not certain that it can actually sell all of the inventory in less than a year (because of obsolete stock, for instance). It is generally held that a quick ratio of 1 or higher is safe and acceptable.

The current and quick ratios are important for a good reason. If there are significantly more current liabilities than current assets, it may suggest that short-term debt is being used to finance long-term assets (Gilliam, p.76). This is a very dangerous situation because the inflows and outflows of cash will not be properly matched, plus short-term interest rates are much more volatile than long-term rates. Thus, if interest rates suddenly rose and time came for the firm to refinance its debt, the firm would have to pay very high rates, which probably will not be matched by the flow of cash coming in from the long-term asset it is supposed to be financing. Thus, the lender will be very wary of this situation, and borrower should be made aware of this fact, both for the borrower's own financial good and so that the borrower will be accepted for a loan by the lender.

Another area of ratios in which the lender will be interested is turnover. Inventory and receivables turnover are the two items that the lender will be concerned with. By examining inventory turnover, the lender is trying to determine if the product that the business is selling is being sold at a rate close to the industry average. In looking at receivables turnover, the lender is interested in noting how well the firm's collection policies are working. In other words, the lender wants to see if the business is doing a good job of getting delinquent accounts collected, because this is a vital part of cash flows and the current ratio. If an unusually high percentage of the receivables are not being collected, then the current assets
will not cover all the current liabilities pointed out by the current ratio if all current liabilities came due (Block, p.63). Average collection period is determined by taking accounts receivable and dividing it by the average daily credit sales (Block p.62). The value found represents the average number of days it takes for the receivables to be collected.

Inventory turnover is calculated by sales divided by inventory. This figure yields how many times inventory turns over per year. To make this number clearer, dividing 360 by the figure gives how many days it takes for inventory to turn over. What inventory turnover means is how often it takes for the firm to completely sell its inventory before restocking all inventory. Of course this does not happen in exactly that manner, but inventory turnover provides a good average on which to base turnover.

Another aspect of the small business' financial health the lender will be interested in is cash flows. Maintenance of the cash position has already been discussed, but it is appropriate to say here that the lender will be interested in the cash flow of the company. In an article by Brenda Gilliam, The Bankers Magazine, she states that "if cash flow is insufficient to meet debt service, the lender should determine where the cash drain developed and how the firm's management plans to reinstate a positive cash flow position," (Gilliam, p.79). In doing so, the borrower may be able to make itself presentable once more to the lender. If the lender feels that the borrower will be successful in implementing this correction, then the lender could very well go ahead with the loan covenant (barring any other obstacles).

Another important stipulation that commercial lenders often add to the loan agreement is that the borrower may not seek outside sources for additional financing, unless this is first cleared with the lender (Timboe, personal communication). Seeking outside sources includes going to other commercial banks, but it also may include seeking venture capital or other means of equity. There is very good reason for maintaining this practice. Basically, the lender wants to be sure the borrower will never go to another bank, or elsewhere, to seek additional funds. In doing so, the firm's financial position may be altered enough that the firm
will no longer be conforming to the standards drafted by the firm. It is probably also fair to say that the lender also does not want the borrower taking its financing business elsewhere.

In reality, what commercial lenders actually practice may be quite different from what is suggested in theory. For instance, First Bank Systems relies only on the debt/equity ratio for determining whether or not to grant a loan to a firm (Cleveland, personal communication). They prefer to rely more on other aspects of the business when in the loan deliberation process. The other factors that go into the loan-making process primarily consist of a well-developed business plan, a credit check initiated on the business as well as the owners, and other intangibles that can not be measured quantitatively, but can often make the difference as to whether a firm receives the funds it was looking for.

A well-developed business plan is a must for all small businesses. It cannot be stressed enough, however, that a small business, especially since it really does not have a reputation preceding it, must come to a lender with a full, well prepared, and complete business plan. Numerous people involved in business banking, including those from Norwest Banks, First Bank Systems, and Marquette Banks, have stated that they have many people every year who approach the bank about getting some financing. When asked to present a business plan, about two-thirds of the would-be customers shrug their shoulders and say that they do not have one. The potential loan is immediately "history" for these people as far as the bank is concerned.

A credit check is also required for both the business and the owners of the business. This is necessary to ascertain whether the business or the owner present any credit risk. Even if the business has a good credit rating, if the credit rating of the owner or owners is not very good, then chances are that the lender will turn down the request for a loan. This really is a logical conclusion to make since it was discussed earlier how banks are trying to eliminate undue risks from their loan portfolio, and owners may run the business as they ran their personal finances.

In determining the risk involved with a particular party, the lender wants to know in full detail exactly how the money is going to be used. Patricia Cleveland stated that of the businesses that do have developed business plans, fifty percent of them receive the desired
financing from First Banks or a competing bank offering a better package (personal communication). This would seem to suggest that the small businesses that have spent the time to develop a complete business plan have a better understanding of what their business is doing, and where it will be going in the near future.

Judging the character and competency of prospective borrowers is part of the intangible evaluation process lenders go through. There can be a lot of subjective judgments made on prospective borrowers, but this is part of the job. One individual in the business banking area stated that oftentimes it was just a "gut feeling" that made the final decision on whether or not to make the loan. There is really not much the borrower can do in these circumstances except to present himself/herself in the most professional manner possible, with a complete business plan in hand.

This chapter has outlined a description of debt financing through commercial banks. It emphasized how loans can be constructed, the problems facing the commercial banking industry and how those problems are going to affect small businesses, and the requirements of a small business and loan qualification process that a lender will go through before it will authorize a loan. The chapter has pointed out the advantages and disadvantages of going through a commercial bank for obtaining a firm's desired financing, and it has pointed out some key areas for the small business owner to keep in mind to increase his or her chances for approval by a commercial bank.
A Recession: A Brief Examination

As defined earlier, a recession is "the period of declining output, employment, and prices," (Mabry, p.304). A more exact definition can be found in Barron's Dictionary of Business Terms which states a recession is a "downturn in economic activity defined by many economists as at least two consecutive quarters of decline in a country's GNP," (Dictionary of Business Terms, p.478). In analyzing a recession and its causes, it is first necessary to evaluate the indicators of a recession and how they affect the nation's economy. There are a number of key pieces of information which make up the traditional indicators of economic health. These include inflation, unemployment, interest rates, gross national product (GNP), trade surplus/deficit, housing starts, auto sales, and orders for durables.

Inflation is a great danger for a weak economy. When inflation becomes a factor, as it did in the late 1970's with double-digit inflation, prices rise everywhere. Logically, wages should go up too, but this is not always the case. In a weak economy, businesses will not be able to afford to increase wages to match the increase in inflation, thus households, while still earning the same number of dollars, actually lose purchasing power because their dollars do not spread as far as they used to. Therefore, inflation during a weak economy could easily drive an economy into a recession, because the same value of dollars will chase goods which continue to increase in price.

During the current recession, which began in approximately 1988, inflation has actually been quite low. This is due, in part, to the Federal Reserve not allowing the money supply in circulation to grow. By restraining the money supply, the Federal Reserve has been able to keep inflation in check, whereas releasing more dollars into the money supply often fuels inflation.

Unemployment is another key indicator of economic health. When unemployment figures are low, the economy is generally in a healthy state. This is because businesses employ as many people as possible during healthy times because there is a higher demand for goods. However, once the unemployment rate rises, the threat of a recession should become apparent.
This is because as companies feel a tighter financial squeeze, they begin reducing expenses, and one of the quickest ways to cut expenses is to cut back the number of employees in the firm. Thus, a constant increase in the unemployment rate does not present good news for the economy.

Unemployment rates tend to be higher during a recession and tend to be an excellent indicator of when an economy is heading into a recession. However, unemployment is not the best indicator of when the economy is beginning to come out of a recession. Companies will not be hiring people back to work just to get out of a recession. First, such things as orders for durable goods and housing starts must increase. Once there is an increased demand for production, companies will increase employment in order to match increased business. Monitoring durable orders and unemployment are not the only ways to predict the movement of the economy.

Monitoring interest rates can be a very delicate manner in trying to determine the state of the economy. By examining interest rates alone, one is unable to determine the health of the economy. For instance, in the recession from 1979 - 1982, interest rates were in the double-digits. Compare this with the current recession where interest rates are at their lowest point in years. Both time periods show the economy to be in an economic downturn, however the interest rate levels for the two periods differ radically.

The explanations for the differing interest rates depends upon other factors driving the economy. In continuing the comparison of the last two United States' recessions, the interest rates of the 1979-1982 recession were caused, in part, by double-digit inflation the period was experiencing. In the recession of 1988-present, interest rates have been very low for two reasons. First, inflation has been held quite low. Inflation affects interest rates because it is one of the elements that makes up an interest rate. Second, the Federal Reserve continues to cut the discount rate, which is the rate at which banks are able to borrow from the Federal Reserve. This discount rate has direct impact upon most other interest rates in the economy. Thus, if the discount rate is lowered, so too will all other interest rates.
The Federal Reserve has been pursuing the policy of cutting the discount rate to stimulate the economy. Reducing the discount rate will entice businesses and individuals to borrow money and spend. In my opinion, as of December 1991, this policy appears to have little effect upon the economy. It would seem that businesses and individuals do not want to go out and spend any money for fear of a continuing recession. They are holding on to cash they have for a time of need. It is unfortunate that most do not realize my conjecture that a recession is psychologically driven. In other words, the way people think is what drives the economy. Everyone believes the United States is in a recession, so people hold off spending until they are told the United States is coming out of the recession - regardless of the level of interest rates.

There are other leading economic indicators which are quoted in the press which oftentimes present a better indication of the health of the economy. These indicators consist of gross national product (GNP), gross domestic product (GDP), the trade surplus or deficit, housing starts, auto sales, and orders for durables. Each of these will be examined briefly to point out their value as an economic indicator.

GNP represents the total output of the United States' economy. As a figure, it is only meaningful when examined with past GNP figures. If real GNP is rising on a monthly basis, then the economy is producing more each month. If GNP falls for a couple months, it may be a sign of a weakening economy. A good indicator to watch if GNP is falling is unemployment. If companies believe that the decrease in production is going to last, then they will begin to lay off employees. Then unemployment figures rise in subsequent months. However, if companies do not see the decrease in production as a continuing trend, then unemployment figures will likely remain unchanged. The resulting GNP figure represents goods which may either be purchased domestically or exported for foreign consumption. Gross domestic product is a new measure which is the same as GNP, except that exports are subtracted from the GNP figure to arrive at a figure more meaningful for describing how much the U.S. economy is consuming.

The indicator which is useful for monitoring how well United States' goods fare in
other countries versus how well other country's goods fare in the U.S. is the trade surplus or trade deficit. A trade surplus exists if the dollar value received for U.S. goods in foreign countries exceeds the dollar value of foreign goods purchased in the U.S. Conversely, this figure is called a trade deficit if the total dollar value for foreign goods purchased in the U.S. exceeds the total dollar value received for U.S. goods purchased in foreign countries.

In recent years, the U.S. has been maintaining a trade deficit. The implications of a trade deficit are that U.S. dollars are flowing out of the country into the hands of the Europeans, Japanese, etc. This alone may lead to a decrease in the money supply in the U.S., thus keeping inflation down. However, there is a negative side to this trend. Because of the decreased dollar supply, there is less money available to lend to U.S. businesses, and a credit crunch may emerge. If the country is in a recession, a trade deficit may only lengthen the recession. If the U.S. were not yet in a recession, perhaps just a flat period in the economy, then a trade deficit could drive the economy into a recession. This may happen because inflation would be driving prices of goods in the U.S. higher, but dollars would be flowing out of the U.S., decreasing the money supply. This would produce a credit crunch plus high prices with no real income increases for businesses and households.

Generally, however, the Europeans, Japanese, and others will take much of the money they generate in the U.S. and invest it in the U.S. capital markets. This keeps the money supply from drying up in the U.S, and actually benefits American companies who would possibly otherwise not be able to receive capital. As a final note, it should be mentioned that although some of the money flowing out of the country is returning to the capital markets, much of this money is staying within the foreign countries to support their own economies.

Continuing with certain indicators which could indicate certain economic health, housing starts provide an excellent measure. The main reason why this represents a good indicator is because, as mentioned before, much of the economy is driven by the psychology of consumers. If people believe that solid economic health lies ahead, then more will be willing to build new homes. On the contrary, if consumers believe that the U.S. is not in good
economic condition, they will not be building as many houses because they fear, for example, what might happen if a breadwinner loses a job. If housing starts are believed to be on the rise during a recession for a couple of months in a row, then this represents a favorable sign that the recession might be receding.

Statistics on auto sales represent a similar gauge. Auto sales are driven by the consumer psychology just as housing starts. If people believe that the economy will not be getting any better (if presently in a recession), then they will not risk the purchase of a new car because of the large payments associated with the purchase. However, if people believe that the economy will be recovering soon, then they will be more willing to buy a new car, thinking that their job will be safe and there will perhaps even be a pay increase.

Orders for durable goods can fall into the same category as housing starts and new car sales. The purchase of durable goods can come from both the household sector and the producing sector. Producers oftentimes react in the same manner as households or individuals. The producer sector differs only in that it is made up of businesses.

The next section will examine how different combinations of the indicators described above can combine to form a recession. Two different recession will be looked at. The first will be the recession of 1979-1982, and the other will be the recession from 1988-present (1991).

The recession of 1979-1982 was caused by a number of factors. One of these was the high oil prices experienced in the late 1970's. The Organization of Petroleum Exporting Countries (OPEC) drove up the price of barrels of oil, the increased costs were passed along from producers to consumers, thus causing higher expenses in every sector of the economy. Another contributor to this recession was very high inventory levels maintained by companies. High inventory levels cost money while sitting around. This became an extremely costly problem because interest rates were in the double-digits. Many companies became overburdened by this and were forced to have huge sales of merchandise to rid themselves of inventory. Producers could only try to produce more to lower their inventory levels. However, there was another problem.
Production was very low, resulting in low GNP, again partly because of interest rates. Companies could not afford to run at full capacity because of high energy prices and very high interest rates with which to borrow funds to operate. There was also a high unemployment rate. The combination of high unemployment, high inflation, and low productivity is called stagflation.

The present recession occurred because of a different set of causes. Perhaps the foremost cause for the recession starting in 1988 was the savings and loan debacle. Much of the savings and loan industry collapsed and left U.S. taxpayers with hundreds of millions of dollars to pay back to customers of the S&L’s. One of the causes behind the failure of the S&L’s was the real estate collapse in New England and in the Southwest. Unfortunately, savings and loans institutions had invested heavily in development in these regions. Overbuilding of commercial properties was a big problem in these regions as there were not nearly enough businesses to occupy all of the space. This led to a gigantic decrease in value for this property. Huge buildings were virtually worthless unless one could find lessors for the building. With so much office space available, prices kept dropping and dropping. Because property owners could not get enough revenue from lessors, many defaulted on loans, many of which were from savings and loans institutions. Finally, the financial institutions had to foreclose on the property. Incidentally, because of this savings and loan banks, along with commercial banks, incurred huge losses on their books as this phenomenon began happening all across the U.S.

It is interesting to note that nothing in this recession led to rising inflation or interest rates. It did lead to a huge credit crunch, because banks did not want to make any risky loans at all due to their already poor loan portfolios (Trachtenberg, p.A4). Businesses big and small now had to look elsewhere to find the funds needed to operate. This is oftentimes easier for the larger corporations with a significant reputation. However, obtaining loans is incredibly difficult for a small business that is used to only going to the local savings institution for financing.
As with the recession of 1979-1982, unemployment is high, GNP is not increasing, and housing starts, auto sales, and orders for durables have been suffering for many months. In light of this information, it can be seen that a recession will generally begin with the developing of some significant events in the world which set the recessionary chain in motion. Each recession will have its own characteristics.

In conclusion, there are a number of ways in which the economy can be monitored to forewarn of an up- or down-swing in the economy. These monitors consist of the unemployment rate, inflation, interest rates, GNP, GDP, trade surplus or deficit, housing starts, auto sales, and orders for durables. Certain combinations of these can point to the beginning of a change in the economy. Recessions can be caused by a number of factors within the environment. They may start from certain event in the world, but the indicators outlined will assist in determining the course of the economy.
Financing a Small Business During a Recession

There are a number of difficulties small businesses may have when attempting to finance during a recession. Actually, there has been significant doubt raised as to whether a recession really makes any difference to the difficulties small businesses experience in obtaining funds. It has been repeated by many bankers and outside observers that it is difficult for a small business to arrange financing for itself when the economy is good. While this may be true, it seems that the situation only becomes more ominous and discouraging during a recession.

It is perhaps true that it is very difficult for a small business to obtain this financing form commercial lending institutions when not in a recession, but it does become more difficult when the economy is in a recession. The two reasons presented here for increased difficulty are banks becoming more selective and higher interest rates. In the case of the present recession the argument of higher interest rates does not apply, but should be pointed out nevertheless.

One of the main reasons banks become more selective during a recession is that there may not be money available to loan out to customers. There could be a couple of reasons for. One reason for lack of funds is a contracted money supply which does not allow the banks to have as many funds on hand as they would desire. This is often the case when the Federal Reserve is trying to keep tight control on inflation and they will sell treasury notes to banks so they can collect dollars from the money supply. The other reason for lack of funds in the banks is there may not be enough savings to allow for making more loans. This would happen if people were spending their savings because of unemployment or inflation driving up prices of goods. A lack of funds to loan is not a problem in the present recession. Louis Betanzos, chief financial officer at NBD Bancorp in Detroit states that, "we have lots and lots of money to lend for good loans. We're just not seeing them," (Bacon, p.A1).

Today, it is clear why banks are becoming more selective in making loans to
customers. Commercial banks are not interested in taking on the risks associated with making loans to small businesses. Much of this stems from the S&L problem and with the problem of the "health" of the banking industry as a whole. For instance, many banks across the country are amassing huge losses on defaulted loans (Trachtenberg, p.A4). Thus, the banking industry is trying to strengthen it's health, so it is not as receptive to making loans to small businesses as it used to be.

As if small businesses had a hard enough time staying in business during prosperous times, the situation only deteriorates during a recession. This makes banks even more wary about lending to small businesses during a recession. The commercial banks just are not willing to take the risks anymore associated with lending to small businesses. In the future, it will probably be seen that commercial banks almost totally back out of lending to small businesses, as they will focus their efforts on more stable market segments.

The other reason given for making it difficult for small businesses to obtain loans during a recession was the possibility of high interest rates. This is not the situation in the present recession. However, it did play a significant role in the recession from 1979-1982 where interest rates came close to twenty percent. With rates at this level, tremendous strain was placed on the cash of a business. For businesses tight on cash to begin with, obtaining a loan only meant having to meet monthly payments that were just too much for the company. Because of this, many businesses had to turn away from the loan option or else extensively cut back on expenses elsewhere in the operation.

Interest rates are very complex figures, but there are two items which can greatly affect interest rates. The first is a contracted money supply. This could occur because of the Federal Reserve shrinking the money supply in order to curb inflation, or this could occur if household savings are down. If household savings are down and money is remaining in the hands of the households, then the money supply will not be able to grow as it should through the lending process.

Inflation is another major cause for a rise in interest rates. Most interest rates are adjusted to cover the rate of inflation. One large factor will cause the inflation rate to swell.
This factor is the wage-price spiral. This occurs in a viscous circle of events. It could start with a rise in wages for workers. Costs for these wages are then passed on to the customer, but the workers are the customers, so they demand another raise to compensate for the increased cost of living. One can see how inflation could rapidly increase in this manner.
Title Contract Financing

Many traditional modes of financing for a small business have been explored in this thesis. However, it is becoming the case that small businesses are not able to acquire these modes of financing their operations. Title contract financing is a newer method of financing that may not be known to many small businesspeople, but offers numerous advantages over other ways of financing described earlier. Very little has been written about title contract financing. Now, it may be widespread in its use because of the ever-increasing difficulty for businesses to find funds, especially in a recession. Tim Allen of the St. Cloud Small Business Development Center, described numerous instances of its use. Unfortunately, small businesses implementing title contract financing felt confidentiality was an issue and declined requests for interviews. The details of title contract financing are known, however, and will be presented as faithfully as possible as communicated primarily by Tim Allen.

Title contract financing can be used for whatever financing purpose it can be stretched to - there are no limits to the creativity that can be involved. Primarily, it is used for financing equipment or inventory. A number of items have been mentioned by Allen as having been financed in this manner. Among some of these items were fleet vehicles, machinery for an assembly line, and an inventory of parts for a manufacturing plant. The reason for its use primarily to finance equipment or inventory is because it is quite similar to a lease arrangement.

The way this method of financing works is that a small business approaches a third party to work with, whether it be a bank, a purchaser, or a supplier. Upon agreement, the third party purchases the equipment or inventory for the small business and then leases the equipment or inventory to the small business.

There are a number of advantages to selecting title contract financing. In fact, it is deemed that title contract financing should be a method considered even before some of the more traditional modes of financing. It is interesting to note that as commercial banks slowly get out of lending to small businesses, the small business owner is going to have to turn
elsewhere sooner to search for needed financing. It is suggested that small businesses consider little known alternatives, such as this one, before pursuing banks, venture capital, and the private investor. The business owner will find he or she is left with more control over the company.

One of the advantages is that title contract financing will allow for a lower rate of interest paid out than with commercial bank loans and definitely with venture capital or the private investor. Commercial bank loans are generally the least costly of the traditional alternatives, but the title contract financing arrangement can easily be set up so that the effective rate of interest is lower than the bank.

One reason why this is so is especially apparent if the third party is a vendor for the small business. If this is the case, then the vendor, whether is be supplier or purchaser, gets the benefit of knowing that it is supporting its own business by helping the small business. With the vendor realizing its relationship with the small business, then the vendor could easily be enticed to offer very agreeable terms to the small business. Another reason why the small business would be able to get a lower rate of interest is because the third party receives the added benefit of claiming depreciation expense on the inventory or equipment.

Depreciation is a great source of internal capital for a company. This becomes evident when computing a company's cash flows. First, depreciation is an expense. It is written off as such in the income statement, decreasing net income for the company. However, the crucial realization is that depreciation is a noncash expense. As such, when cash flow is computed for the company, depreciation expense is actually added back to the cash position of the firm using the indirect method of calculating cash flow. The indirect method of calculating cash flow begins with net income and adds and subtracts various income statement entries. With depreciation expense being a noncash expense, the figure which was subtracted as an expense to arrive at net income is now added back to cash because it does not represent a cash outlay for the firm. In this manner, it can be seen how cash is generated internally by the company.
The importance of this explanation of depreciation expense is that the small business owner can use this information to his or her advantage when setting terms with the third party. Depending on the size and type of product being financed, depreciation can represent a substantial amount of internally generated funds for a company. In arriving at a fair agreement with both sides, the small business owner, after pointing out the depreciation aspect, should be able to justify a reasonably low interest rate to be paid back to the third party.

The only disadvantage that seems to be present in this method is that the small business does not possess ownership of the inventory or equipment. Even at that, the small business can arrange the title contract financing so that it would possess ownership after a period of time just as in some leasing arrangements. Unfortunately again, no communication has been established with any firm which has actually used title contract financing. More beneficially, it would be worth more if a firm could be found which has used this financing for quite some time to determine if there are any negative long term effects.
Small Business Survey

Is there a discernible difference in the ability of small businesses to obtain outside financing during a recessionary versus non-recessionary period? To investigate this question, a survey was developed and sent to approximately one hundred small business owners and managers predominantly in the central Minnesota area, asking them a number of questions pertaining to how they financed themselves and how they perceived the present recession was affecting them.

The rationale for the survey was that actually receiving feedback from small businesses would assist in determining the difficulties faced by small businesses when trying to finance themselves in a recession. The structure of the survey consisted of asking a number of questions regarding how the business has been financed in the past, is currently financed, and financing expectations. Next, a couple of general questions are asked regarding how the business owners and managers perceived the present recession affecting them. It should be noted that this survey focused on businesses financing themselves during a recession, and it does not make many conclusions towards the difficulties faced a small business when not in a recession. The survey was mailed to the businesses in mid-December, 1991.

The first question asked was to identify what industry the business represents, whether retail, service, or manufacturing. This is asked to identify if any particular industry is feeling the effects of the recession more than another. The next question simply asks how many years the business has been in existence. This may have bearing on whether the business was able to obtain financing recently.

The next question asks what kind of startup financing the business used. A list of choices is given which includes personal resources, resources from friends or family, resources from other private individual, commercial bank loans, SBA backed loans, venture capital financing, or other (with space to briefly describe). The purpose for asking this question was to determine what kinds of trends exist for financing startup businesses. Further, there may be differences in trends depending upon the age of the business.
The next question asked what type of financing the small business used in the past year. In instances where the business was started in the past year, these answers would be very similar. Otherwise, the question is asked to determine what kind of financing businesses are doing now to support themselves. It was hoped this question would verify if many small businesses were not able to obtain financing from a commercial bank.

The next question sought to determine what types of financing were attempted, but rejected. Again, a list is given and the respondents need only check the ones applicable. Again, this will be interesting to see if there are any trends pointing at the failure of one or more sources of financing for small businesses.

The next question follows the same format as the previous three and asks what type of financing the business plans to attempt in the next twelve months. Again, the purpose of this question is to determine what kinds of trends might be forming in the small business community.

Finally, the last two questions ask about the impact the present recession might be having on the business. The first asked the respondent to describe the effects of the current recession on the business. The second question asks how long the respondent projects the current recession will have an impact on the business. The reason for including these two questions is to find out exactly if small business owners in the central Minnesota area are feeling the effects of the present recession, and if so, how long the owner expects those effects to last.

**Analysis of Survey Data:**

One hundred surveys were sent out to small businesses. Four were returned from the post office with the message "no forwarding address" stamped on the front of the envelope. Five were returned but unanswered because the companies stated that they were large businesses and did not feel they qualified to participate in the survey. 68 were usable for compilation of the survey. This means there were 23 surveys from which no response was
heard. Of those who responded and were usable, 39 responses belonged to companies in the manufacturing industry, 18 responses belonged to companies in the service industry, and 11 responses belonged to firms in the retail industry. An age breakdown was done according to each industry as well as for the results as a whole.

It is interesting to note that 27.9% of all firms were from zero to nine years old, but in the service industry, 44.4% of surveyed firms fell within this group (see Table 1. Accompanying graphs will also be of interest here). This would suggest the rise of the service industries within the economy in the last ten years. Another interesting point is that there were no businesses surveyed which were between 60 and 90 years old. This age would place the birth of those firms somewhere between 1902 and 1932. It is unclear what this means although there is one possible answer.

Firms which began between those two dates would have been relatively young when the Great Depression 1929-1941 took place. It is possible that many firms which started during or before then were unable to remain in business because of the economic times of the 1930's. There were four businesses surveyed who's ages were over ninety years. This might suggest that the older, more established firms were able to survive the Depression, with a few of them continuing business even today.

An interesting trend exists in how owners invested resources into their firm. Across all industries, 51 of the 68 businesses surveyed devoted personal resources in the form of equity to the start-up of the business (see Table 2). Contrast this with the plans for financing in the next 12 months. Only four businesses out of all surveyed claim to be injecting more equity into the business next year (see Table 5). The starkness of this trend can be visualized well by examination of graphs 2 and 5.

This suggests that once the business is functioning, owners may no longer be willing to put up capital for the business. This could be because the owners put everything they had into the business. Also, there may be a lack of desire to inject personal funds into the business due to the present economy. Perhaps small business owners would be more willing to invest more funds in the business if the economy were in a healthier state. In a bad economy, a small
business is at higher risk of failing than in a strong economy. It would make sense then to say that people would generally not want to invest their funds in something that may be likely to fail. Perhaps the reverse of this is true in that owners are more willing to put capital into their businesses only when economic times are good. At the very least, it is only suggested here that owners do not want to invest their own money in their business when the economy is bad.

The rest of Table 5 presents more interesting data. Further, Graph 5 visually shows how lopsided the data is for planned modes of financing. For the upcoming year, 29 firms claimed to be planning commercial bank financing. The "other" box received the next most votes with only 5 people marking it. A couple of conclusions can be drawn from this information. It could be that the businesses have enjoyed success with commercial bank loans before and are planning to pursue that source again. Another possibility is that the firm has not planned for the following year, so commercial loans were checked just because of their popularity. One final possibility is that small business owners are quite well informed and are aware that commercial bank loans are the cheapest way to finance a firm. Any of these answers could be partially correct in explaining why so many businesses are planning on commercial bank loans for the following year.

One other interesting point of information gleaned from the data was that in past year, 53 out of 68 companies surveyed had received loans from commercial banks (Table 3, Graph 3). This is very important because it has been explained how a commercial bank trend is forming to pull out of dealing in small business loans. A possible answer for the strong commercial bank presence in the past year is that the businesses surveyed were all well-established and well-prepared for seeking financing. It could also be that the commercial banks in the St. Cloud area have not really stopped lending to small businesses.

Survey results show that only eight businesses claimed to have been turned down for commercial bank financing in the past year or in the company's first year (Table 4, Graph 4). This is still a very low number. As reported by the respondents, it appears quite impressive that only 8 out of 68 businesses have been turned down for loans in the periods described.
However, firms were also turned down from commercial bank financing more than any other mode of financing (Note: there is the possible concern that the picking for the businesses in the survey was done in a biased manner).

A question remains to what degree were small businesses in central Minnesota affected by the present recession. Breaking down the companies surveyed into the industry groups of service, retail, and manufacturing will help in better answering this question.

Based upon the information provided by survey respondents, the manufacturing industry was hit quite hard by the recession. The companies surveyed were asked to describe the effects of the current recession on their business (see Appendix 1). The comments given by the manufacturing industry were grim. Common replies were that sales were down by 25%, laid off 10 - 45% of the workforce, or profits down by as much as 50%. There were a few bright spots however. One firm claimed growth of 30-40% per year. A number of other businesses replied that they had experience of no effect from the recession. It can be said, though, that approximately 75% of the manufacturing companies experienced negative effects from the recession; effects ranging from only a slight drop in business to laying off 45% of the workforce.

Retail businesses seemed to fare little better than the manufacturing industry. Approximately 66% of the retail firms surveyed claimed to have been negatively affected by the present recession (see Appendix 2). The effect upon these companies does not seem to have been as severe as the manufacturing firms either. The worst specific figure given was that sales had decreased by 7-8%. Most, however, just answered with a general comment as sales were down or only a slight reduction in profits had been experienced.

At the time of the survey, the service industry appeared to be the least affected by the recession. Approximately 77% of the companies surveyed in the service industry had negative results from the recession, however the comments given by some of the firms indicated that times really are not too bad (see Appendix 3). Perhaps the most negative reply given was that a firm's investors were worried because of a significant strain on the cash position of the firm. Beyond that comment, only a slight reduction in the past two months was the worst effect
experienced. On the other end, one firm indicated that they were "busier than ever." Others said that their own firm was doing well, but their customers or vendors were having problems. It can be inferred that this either delayed payments to the businesses or the customers and vendors had reduced their business with the respondents.

A reason for the service industry's relative resilience to the recession industries is that most people or firms who subscribe to services will probably continue those services during a recession. Besides, the manufacturing and retail industries are normally among the hardest hit industries during a recession. If the economy begins to depend more and more upon the service sector, then perhaps a recession will not be as severe in the future. Of course this assumes that the service industry as a whole will not be affected as much as other industries of the economy.

The businesses surveyed were also asked how long they believed the present recession would have an impact upon their business. If the consumers say the U.S. will be out of a recession in a year, then it will probably be so. Replies for each industry can be found in the appendices. Generally, estimations were placed between six months (as of January 1992) to two years. By far, most firms answered within this year and a half time frame. If beliefs of the masses really will pull the U.S. out of a recession and if the opinions of central Minnesota businesspeople are widespread, then the U.S. can look to getting back to prosperous times in six to twenty-four months. In the meantime, small businesses still must cope with the problem of financing themselves during a recession.
## Small Business Survey on Types of Financing

### Total of all Industries

<table>
<thead>
<tr>
<th>age of co.</th>
<th>number of firms</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-9 yrs.</td>
<td>19</td>
<td>27.9%</td>
</tr>
<tr>
<td>10-19</td>
<td>16</td>
<td>23.5%</td>
</tr>
<tr>
<td>20-29</td>
<td>8</td>
<td>11.8%</td>
</tr>
<tr>
<td>30-39</td>
<td>7</td>
<td>10.3%</td>
</tr>
<tr>
<td>40-49</td>
<td>6</td>
<td>8.8%</td>
</tr>
<tr>
<td>50-59</td>
<td>6</td>
<td>8.8%</td>
</tr>
<tr>
<td>60-69</td>
<td>2</td>
<td>2.9%</td>
</tr>
<tr>
<td>70-79</td>
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<td>0.0%</td>
</tr>
<tr>
<td>80-89</td>
<td>0</td>
<td>0.0%</td>
</tr>
<tr>
<td>90+</td>
<td>4</td>
<td>5.9%</td>
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<tr>
<td>total</td>
<td>68</td>
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</table>

### Manufacturing Industry

<table>
<thead>
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<th>age of co.</th>
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<th>% of total</th>
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</thead>
<tbody>
<tr>
<td>0-9 yrs.</td>
<td>10</td>
<td>25.6%</td>
</tr>
<tr>
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<td>25.6%</td>
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<td>10.3%</td>
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<td>30-39</td>
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<td>12.8%</td>
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<td>40-49</td>
<td>4</td>
<td>10.3%</td>
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<tr>
<td>50-59</td>
<td>3</td>
<td>7.7%</td>
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<td>5.1%</td>
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<tr>
<td>90+</td>
<td>1</td>
<td>2.6%</td>
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<tr>
<td>total</td>
<td>39</td>
<td>100.0%</td>
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</table>
### Service Industry

<table>
<thead>
<tr>
<th>age of co.</th>
<th>number of firms</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-9 yrs.</td>
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<td>44.4%</td>
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<td>16.7%</td>
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<td>40-49</td>
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<td>0.0%</td>
</tr>
<tr>
<td>50-59</td>
<td>1</td>
<td>5.6%</td>
</tr>
<tr>
<td>60-69</td>
<td>0</td>
<td>0.0%</td>
</tr>
<tr>
<td>70-79</td>
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<td>0.0%</td>
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<tr>
<td>80-89</td>
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<td>0.0%</td>
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<tr>
<td>90+</td>
<td>1</td>
<td>5.6%</td>
</tr>
<tr>
<td><strong>total</strong></td>
<td><strong>18</strong></td>
<td><strong>100.0%</strong></td>
</tr>
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### Retail Industry

<table>
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<tr>
<th>age of co.</th>
<th>number of firms</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-9 yrs.</td>
<td>1</td>
<td>9.1%</td>
</tr>
<tr>
<td>10-19</td>
<td>2</td>
<td>18.2%</td>
</tr>
<tr>
<td>20-29</td>
<td>1</td>
<td>9.1%</td>
</tr>
<tr>
<td>30-39</td>
<td>1</td>
<td>9.1%</td>
</tr>
<tr>
<td>40-49</td>
<td>2</td>
<td>18.2%</td>
</tr>
<tr>
<td>50-59</td>
<td>2</td>
<td>18.2%</td>
</tr>
<tr>
<td>60-69</td>
<td>0</td>
<td>0.0%</td>
</tr>
<tr>
<td>70-79</td>
<td>0</td>
<td>0.0%</td>
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<tr>
<td>80-89</td>
<td>0</td>
<td>0.0%</td>
</tr>
<tr>
<td>90+</td>
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<td>18.2%</td>
</tr>
<tr>
<td><strong>total</strong></td>
<td><strong>11</strong></td>
<td><strong>100.0%</strong></td>
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</table>
## START-UP FINANCING

### Table 2

#### Total of All Industries

<table>
<thead>
<tr>
<th>Referral Number</th>
<th>Mode of Financing</th>
<th>number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Personal resources</td>
<td>51</td>
</tr>
<tr>
<td>2.</td>
<td>Resources from friends or family</td>
<td>12</td>
</tr>
<tr>
<td>3.</td>
<td>Resources from other private individual</td>
<td>17</td>
</tr>
<tr>
<td>4.</td>
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<td>41</td>
</tr>
<tr>
<td>5.</td>
<td>SBA back loans</td>
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</tr>
<tr>
<td>6.</td>
<td>Venture capital financing</td>
<td>6</td>
</tr>
<tr>
<td>7.</td>
<td>Other</td>
<td>9</td>
</tr>
</tbody>
</table>

#### Manufacturing Industry

<table>
<thead>
<tr>
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<th>Mode of Financing</th>
<th>number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Personal resources</td>
<td>33</td>
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<tr>
<td>2.</td>
<td>Resources from friends or family</td>
<td>9</td>
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<tr>
<td>3.</td>
<td>Resources from other private individual</td>
<td>10</td>
</tr>
<tr>
<td>4.</td>
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<td>26</td>
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<tr>
<td>5.</td>
<td>SBA back loans</td>
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</tr>
<tr>
<td>6.</td>
<td>Venture capital financing</td>
<td>5</td>
</tr>
<tr>
<td>7.</td>
<td>Other</td>
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</tr>
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</table>

#### Service Industry

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>1.</td>
<td>Personal resources</td>
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</tr>
<tr>
<td>2.</td>
<td>Resources from friends or family</td>
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<td>3.</td>
<td>Resources from other private individual</td>
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</tr>
<tr>
<td>4.</td>
<td>Commercial bank loans</td>
<td>8</td>
</tr>
<tr>
<td>5.</td>
<td>SBA back loans</td>
<td>0</td>
</tr>
<tr>
<td>6.</td>
<td>Venture capital financing</td>
<td>1</td>
</tr>
<tr>
<td>7.</td>
<td>Other</td>
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</table>
Retail Industry

<table>
<thead>
<tr>
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<th>Number of firms</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Personal resources</td>
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</tr>
<tr>
<td>2.</td>
<td>Resources from friends or family</td>
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<tr>
<td>3.</td>
<td>Resources from other private individual</td>
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</tr>
<tr>
<td>4.</td>
<td>Commercial bank loans</td>
<td>7</td>
</tr>
<tr>
<td>5.</td>
<td>SBA back loans</td>
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</tr>
<tr>
<td>6.</td>
<td>Venture capital financing</td>
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</tr>
<tr>
<td>7.</td>
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FINANCING IN PAST YEAR

Total of All Industries

<table>
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<th>Mode of Financing</th>
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<tbody>
<tr>
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<td>3.</td>
<td>Resources from other private individual</td>
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<td>4.</td>
<td>Commercial bank loans</td>
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<td>5.</td>
<td>SBA back loans</td>
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Manufacturing Industry

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<td>Personal resources</td>
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<td>Resources from friends or family</td>
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<td>3.</td>
<td>Resources from other private individual</td>
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<td>4.</td>
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<td>SBA back loans</td>
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<td>6.</td>
<td>Venture capital financing</td>
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</tr>
<tr>
<td>7.</td>
<td>Other</td>
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### Service Industry

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</thead>
<tbody>
<tr>
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<tr>
<td>2.</td>
<td>Resources from friends or family</td>
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<tr>
<td>3.</td>
<td>Resources from other private individual</td>
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</tr>
<tr>
<td>4.</td>
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<td>5.</td>
<td>SBA back loans</td>
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<td>6.</td>
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<tr>
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<td>Other</td>
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### Retail Industry

<table>
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<tbody>
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<td>Resources from other private individual</td>
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<td>4.</td>
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<td>5.</td>
<td>SBA back loans</td>
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### REJECTED FINANCING FROM START-UP OR PAST YEAR

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<th>number of firms</th>
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<tr>
<td>2.</td>
<td>Resources from other private individual</td>
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<td>Venture capital financing</td>
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Table 4

### Total of All Industries

<table>
<thead>
<tr>
<th>Number</th>
<th>Mode of Financing</th>
<th>number of firms</th>
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</thead>
<tbody>
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<td>1.</td>
<td>Resources from friends or family</td>
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</tr>
<tr>
<td>2.</td>
<td>Resources from other private individual</td>
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</tr>
<tr>
<td>3.</td>
<td>Commercial bank loans</td>
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</tr>
<tr>
<td>4.</td>
<td>SBA back loans</td>
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<tr>
<td>5.</td>
<td>Venture capital financing</td>
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<tr>
<td>6.</td>
<td>Other</td>
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</table>
### Manufacturing Industry

<table>
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<th>Referral</th>
<th>Mode of Financing</th>
<th>Number of firms</th>
</tr>
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<tr>
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<td>3.</td>
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<td>4.</td>
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### Service Industry

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### Retail Industry

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### FINANCING PLANNED FOR NEXT 12 MONTHS

#### Total of All Industries

<table>
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#### Service Industry

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Graph 1

Total Businesses Surveyed:
By Age and Industry

Total Business Surveyed:
By Age Group
Graph 2

Startup Financing:
By Industry

1. Personal resources
2. Friend/Family resources
3. Other private resources
4. Commercial bank loans
5. SBA backed loans
6. Venture capital
7. Other

Number of Times Used

1. 2. 3. 4. 5. 6. 7.

Mode of Financing: By Referral Number
- Manufacturing
- Service
- Retail

Startup Financing:
All Industries

1. Personal resources
2. Friend/Family resources
3. Other private resources
4. Commercial bank loans
5. SBA backed loans
6. Venture capital
7. Other

Number of Firms

1. 2. 3. 4. 5. 6. 7.

Mode of Financing: By Referral Number
Graph 4

Rejected Financing From Startup
or Past Year: By Industry

Number of Times Used

1. Friend/Family resources
2. Other private resources
3. Commercial bank loans
4. SBA backed loans
5. Venture capital
6. Other

Mode of Financing: By Referral Number

Manufacturing
Service
Retail

Rejected Financing From Startup
or Past Year: All Industries

Number of Firms

1. Friend/Family resources
2. Other private resources
3. Commercial bank loans
4. SBA backed loans
5. Venture capital
6. Other

Mode of Financing: By Referral Number
Graph 5

Planned Financing for 1992:
By Industry

1. Personal resources
2. Friend/Family resources
3. Other private resources
4. Commercial bank loans
5. SBA backed loans
6. Venture capital
7. Other

Mode of Financing: By Referral Number

Manufacturing
Service
Retail

Planned Financing for 1992:
All Industries

1. Personal resources
2. Friend/Family resources
3. Other private resources
4. Commercial bank loans
5. SBA backed loans
6. Venture capital
7. Other

Mode of Financing: By Referral Number

Number of Firms

0 2 4 6 8 10 12 14 16 18 20 22 24 26 28 30

1. 2. 3. 4. 5. 6. 7.
Conclusion

It has been the goal of this study to show that small businesses have great difficulty in securing commercial bank loans during a recession. This study focused on what a small business had to do to prepare itself for obtaining financing, conditions which exist during a recession, and how a small business could finance itself during a recession. A survey of central Minnesota businesses was also completed in order to gain information directly from small businesses as to how they financed themselves.

A combination of research and the survey suggests that there is no difference in the methods small businesses must go through to finance themselves with commercial bank loans. Also, commercial banks do not use a different set of standards with which to evaluate loan requests during a recession. However, it does become more difficult for small businesses to obtain commercial bank loans during a recession, largely because of increased caution among commercial lenders. It is my opinion that small businesses have a difficult time obtaining financing whether the economy is in recession or not - a tough situation only becomes worse in the recession. It has been shown in the analysis of the survey that commercial banks, which are the most common form of lender behind personal investment, are turning down many businesses compared to the other options.

It is also a conclusion of this thesis that commercial banks are slowly getting out of the small business lending segment of banking. Recent statistics show that in 1992, "thirteen percent fewer Minnesota banks are lending about 21 percent fewer dollars, after adjusting for inflation, to business borrowers than in 1987," (Oslund, p.1D). In recession or not, commercial banks are trying to get out of business lending. The survey seemed to indicate that many small businesses were being granted loans from commercial banks. However, this may not be the case so often in the future with commercial banks getting out of granting loans to small businesses. Norwest Bank is able to decrease loans to businesses because of the full line of financial services it offers to its customers. Enough revenue is generated from those services to compensate for the decreased number of loans granted (Oslund, p.1D). This is
likely to be the case with many large lenders. They will be relying more upon revenues generated from financial services rather than from traditional lending.

Pressure exists in the community, however, to get banks to lend more to businesses. In response to this pressure, First Bank established a new unit which is devoted to handling loans to businesses ("New First Bank unit," p.1D). This does not necessarily mean that more loans will actually be granted to businesses. This doubt is raised because even in Minneapolis-sponsored business loans, loan totals dropped from $3.9 million in 1990 to a mere $390,000 in 1991 ("New First Bank unit," p.1D).

Once the U.S. economy pulls out of the present recession, small businesses are still going to find it quite difficult to obtain financing for their businesses. In the past, commercial banks have provided much of the sources of funds for small businesses. Now that it appears they are pulling out of the business loan segment, small businesses will have to turn to other means of financing. Experts conclude that presently, there have been no alternatives to fill the financing void left by the commercial banks (Oslund, p.1D). It was actually difficult for a small business to obtain financing from a commercial bank during good economic times. After going through a recession and after having commercial banks pull in the reins, small businesses will only find it more difficult to obtain the financing they need.

This difficulty is the reason why small businesses need to turn to other methods for financing such as title contract financing. This and other little known methods can offer small businesses greater flexibility in how they finance themselves. The businesses will not have to rely as heavily on commercial bank lending as they do now. When in a recession, the need for these lesser known methods becomes even greater because of the increased difficulty of obtaining financing.
Appendix 1

These notes are arranged so that the exact words used by every response are recorded. Observed will be some duplication in responses, however all were left in their original form for ease of analyzing data.

Manufacturing:

Description of effects current recession has had on business:

- Laid off 20% of work force in April 1991, workers returned in November 1991
- Sales down
- Customers are not keeping parts in inventory, thus giving us no lead time
- Noticeable
- Very little
- Distributors are being effected by the increasing reluctance of banks to lend money
- None
- Sales down 25%
- New orders down 20% from 1990 level
- Customers have reduced orders
- Sales down 6.6% from plan, up 0.7% from 1990: taxable income up 4% from plan, up 90% from 1990
- Sales strong and recruitment efforts are easier
- First year have not seen increase in sales, but feel fortunate that last year's level is maintained
- Orders being pushed back, banks slow in responding, cash flow poor
- Sales down but expect 1992 to be good year
- Business effected 35 - 40%
- Growth of 30 - 40% per year
- None
- none
- laid off 45% of workforce
- profits down by 50%
- no effect
- none until last quarter of 1991
- reduced sales growth, lower earnings
- none
- sales down 10% in 1991, competition is fierce
- Slow down of present customers and new business
- Business dropped 45%, receivables and payables are out past 60 days
- none, medical technology company
- It has caused an aggressive sales effort to remove commodity and semi-commodity grades from the structure and replace with additional market share of core business. Thus far it has been successful although decreased margins have affected pretax; the effect is less than experiencing downtime from lack of orders.
- sales down 30% from 1988, which was when downturn began
- busy, but profit margins reduced
- has caused us to reduce profit margin to make sure we keep business level high so we do not have to reduce our number of employees
- There is an extremely competitive atmosphere which tends to make it more difficult to break ground with a new customer. We also watch our operating expenses very closely. At times we have had to cut production workers from 40 to 36 hours per week.
- Current business down 20%
- slowdown in incoming orders
- No noticeable impact other than credit terms are extremely tight with vendors
- Sales down slightly, but earnings above budget
- must be more competitive on our quotes
- Sales down, receivables very slow
- Have not felt recession because of diversification efforts. There are several parts of our business we do not expect to return for several years.

*Time current recession will have an impact on business:*

- 2nd quarter 1992
- Not much impact, the so-called recession is affecting the bloated retail and real estate areas nearly exclusively
  - as long as it lasts
  - through 1992
  - 18 months [from January 1992]
  - 2nd quarter 1992... expect economy to turn by then
  - until its over
  - who knows?
  - April or May 1992
  - 2 years [from January 1992]
  - 1 year [from Jan. 1992]
  - during 1992
  - things look strong again already
  - 6 to 12 months [from Jan. 1992]
  - 1992 for sure - possibly 1993
  - three to six months [from Jan. 1992]
  - for about a year after recession ends
  - third quarter 1993
  - first half of 1992
  - 9 to 12 months [from Jan. 1992]
  - January 1993
- We see 1992 with cautious optimism, but do not look for strong, sudden economic surge.

- January 1993
- January 1993
- difficult to determine
- July 1992
- 6 months to a year [from Jan. 1992]
Appendix 2

Retail:

*Description of effects current recession has had on business:*

- overhead keeps going up but not able to adjust prices to cover the increases. Expect business to decrease in 1992

- downswing on sales and profits. We have reduced labor and advertising costs

- not much

- 7 to 8% decrease in sales, cash flow weak

- sales down some, pulled in a little last summer and have budgeted accordingly.

- business down 3%

- horse shit: never had a loss except for last 2 years

- only slight reduction last 2 months

- not much

- none

- smaller contracts being written, unit volume steady, smaller gross profits and net profits, sales to remain same or slight decline, keep employees but overtime cut

*Time current recession will have an impact on business:*

- through 1992

- six months [from Jan. 1992]

- six to eighteen months [from Jan. 1992]

- 6 to 12 months [from Jan. 1992]

- do not know

- mid 1992

- 2 more years [from Jan. 1992]

- spring 1992

- spring 1992
Appendix 3

Service:

Description of effects current recession has had on business:

- receivables extended
- sales down last 2 months, sales for 1991 up 4%
- busier than ever
- slightly depressed
- prices for services are dropping, items purchased are going up, profit down
- none
- drastic, slow work availability, layoffs, limited hours
- not much
- This is the first year we have not seen an increase in sales, however we feel fortunate to maintain with last year's sales
- It's been worse than normal years because more people fall behind in paying bills.

otherwise, fairly recession proof [food industry]

- sales down some, pulled in a little last summer and have budgeted accordingly
- sales up
- slight reduction past 2 months
- slowed the growth of revenue but also providing opportunity to obtain a larger share of our market place because we anticipated it and were better prepared than some of our competitors

- enhanced the emphasis on our lower price points and therefore increased sales due to a larger market share
- not hiring but expect our growth to continue due to expansion in other areas
- some people having difficulty paying deductibles and copayments. some companies are cutting back health insurance benefits so their employees have larger balances or reduced coverage
- decreased demand causing a tremendous strain on our cash which has our investors worried

*Time current recession will have an impact on business:*

- another year [from Jan. 1992]
- April 1992
- 1 to 2 years [from Jan. 1992]
- no great impact
- 1993
- who knows?
- Jan. 1994
- 6 to 18 months [from Jan. 1992]
- 2nd or 3rd quarter of 1992
- sometime within 12 months [from Jan. 1992]
- do not know
- early spring 1992
- three to four years, because will have lost the growth of 1 to 2 years and some of our customers' effect of the recession will pass through to us but will be partially offset by new business of some of our competitor's customers.
- 6 to 12 months [from Jan. 1992]
- 6 to 12 months [from Jan. 1992]
- indefinitely
- 1993-1994
Bibliography


"New First Bank unit to focus on loans for small businesses." *Minneapolis Star Tribune.* Friday, April 3, 1992. 1D.


