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WHY I CAN'T GET A LOAN...

...AND PROBABLY SHOULDN'T ANYWAY

By C.L. Cheshire

Introduction

At first glance, the topic of this essay may seem unusual, since most of the time such papers explain how to acquire loans to finance a small business start-up. The reason small business workshops often focus on how to get a loan is because the most common complaint among aspiring entrepreneurs is that they cannot obtain a loan to finance their small business start-up. According to these frustrated entrepreneurs, if the banks and the state and national governments were serious about business development, they would "do something to make loans for small businesses easier to obtain!"

In most cases, the aspiring entrepreneur takes the position that if he or she could obtain the financing to start a business, he or she could run out and buy the items needed for the business, put the business together and soon begin to produce a profit. Setting up a business is like buying a water pump for a newly dug well in the entrepreneur's mind. Until the entrepreneur has a pump, the well is relatively worthless. But once the pump has been installed, the well can begin producing water. Some small business start-ups may be this simple, but most of them are not. In fact, most of the small business start-ups in the FSM are far more complicated.

A more accurate analogy for a business start-up in the FSM is a new plant. A healthy new plant needs appropriate soil, the right amount of sunshine and the right amount of water. Like a new plant, a small business start-up needs many things to succeed; financing is only one of them. The amount of financing a business needs varies from business to business just as the amount of water a plant needs varies from plant to plant. A business can fail from too much financing (too much debt), and a business can fail from too little financing. More importantly, a business can fail for many reasons other than financing, just as a plant can die for reasons that have nothing to do with whether or not it received too little or too much water. The seeds might have been bad; the soil may not have been right for that particular plant; there may have been too little or too much sunshine.

developed and maintained a system to supply that market consistently and successfully . If one were to place a dollar value on that network of skills, it would far exceed $3,000. It is this kind of capital that the Grameen Bank and the Yap Small Business Development Center are successfully developing ways to invest in and capitalize on.

Conclusion

It is no help to the Micronesian entrepreneur to make bank financing for business start-ups readily accessible if the end result is a business overwhelmed by debt. The entrepreneur and the goal of developing successful businesses are better served if the entrepreneur is forced to recognize and accept the burden of raising his or her own start-up capital, and if those advising have a variety of strategies to help accomplish this goal. Both boot-strapping and the Grameen Bank model have attractive features that can be built into the small business development program in the FSM. Both recognize and accept that conventional banks are not the solution to the problem of asset-poor small businesses. Boot-strapping puts the burden of financing squarely on the shoulders of the entrepreneur. In doing so, it limits what the entrepreneur can do, but it also keeps the entrepreneur from taking on a debt that the business cannot support. The Grameen Bank makes loans available without requiring collateral, but the loan is made in a very controlled environment where there is constant peer review and peer pressure to pay back the loan. A combination of peer support and peer pressure should work well with Micronesians who are very familiar with collective effort, group support and group pressure.

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Bank of Hawaii

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and ship the handicrafts to Kwajalein. She did not collect any commission for her service, but sold the handicrafts to her buyer on Kwajalein for the same price she returned to her craftswomen. But the craftswomen did not receive payment for their handicrafts until a payment was sent from Kwajalein after the handicrafts had been sold. Sometimes the craftswomen would have to wait as long as a month to a month and to receive payment. Since most of the women made handicrafts in response to an immediate need for cash, this waiting period was a significant disincentive.

The agent concluded that she could better interest handicraft makers if she could pay them at the time they turned in their handicrafts. To do this she would need a loan from the bank or a line of credit up to $3,000. The agent was able to get her handicraft women to accept ten percent less for their handicrafts in return for being paid when they turned in their handicrafts. The agent was also able to negotiate a ten percent increase in the price she charged her buyer on Kwajalein. With this twenty percent margin, the agent would be able to pay the interest on her loan or line of credit (12%) and have enough to pay her expenses ($200 a year for shipping, etc.) and herself ($1,560 per year) for her services.

For a relatively small amount of money and little risk, since the production system and the market demand were well-established, a volunteer operation could have been turned into a stable business providing a steady predictable income for twenty to thirty women. But because the banks were not accustomed to making this kind of loan, this business development opportunity was missed.

What the banks failed to see was the network of human capital that this handicraft operation represented, a network that included the skills of the women who made the handicrafts as well as the skills of their agent who found market for their handicrafts and

An aspiring entrepreneur in the FSM should realize at the outset that starting and growing a successful business is a complicated process. Likewise, a good business assistance program that is trying to help entrepreneurs develop successful businesses should recognize that there are many factors that determine the success of a business. They vary in kind and degree from business to business. Hence, the business assistance needs to be able to adapt to a wide array of business needs and problems. Neither the entrepreneur nor those assisting the entrepreneur can assume that one solution, easy financing, will address all business start-up needs, even if this is what the inexperienced entrepreneur says he or she needs. The following examples, taken from the experiences of several entrepreneurs, help to make the point that a multifaceted, flexible approach to business assistance in general and business financing in particular is essential if entrepreneurs are to receive the help they need in starting and developing their businesses.

Business assistance needs to adapt to a wide array of business needs and problems.

Opening a Gas Station

A gas station start-up is typical of many of the locally owned small business start-ups that are attempted in the FSM. It is usually a simple retail operation: a gas pump and a general store with no garage, no mechanic, and no car repair. The business owner neither possesses nor needs any special expertise, apart from knowing how to manage a small retail store. The only technical assistance required might be help in identifying suppliers and prices for the fuel tanks and pumps, and perhaps the cost to ship them to the FSM. The up-front start-up costs include the cost for the tanks and the pumps, as well as the cost for site preparation, construction of the building and fencing the facility. All of these start-up costs normally require a bank loan since the owner's only equity in the business (what the owner has invested) is the site itself. To the surprise and frustration of the loan applicant and some business development advisors, this kind of loan application is regularly turned down by banks in the FSM.

The banks in the FSM have the money to finance the start-up of the local gas station described above, but it is unrealistic to expect them to do so. To begin with, only the FSM Development Bank can legally accept FSM land, the loan applicant's only asset, as collateral for a loan (other banks in the FSM are prohibited by law from accepting FSM land as collateral to secure a loan), and for a variety of reasons the FSM Development Bank has been reluctant to do this. Moreover, loans for gas stations and other small retail business start-ups are for 80 to 85% of the total value of the business. Banks want the owner's investment in the business to be at least as large as the bank's, and preferably larger, for two reasons. The bank wants the owner, who stands to benefit the most from the success of the business, to be willing to accept the majority of the risk. Also, the bank knows that when 80 to 85% of a small retail business's value is what it owes to the bank, the business is carrying too much debt. For instance, a loan for 80% of the value of the business at 10% interest requires the business to produce an annual profit or net income, after expenses, of at least 8% just to cover the cost of the loan. This is difficult for any small retail start-up business to achieve, but it is particularly difficult for a small retail start-up in the FSM where markets are small, margins are low and payment is slow.

handicrafts and other goods at the YSBDC's monthly flea market. The women used their loans to improve the products they sold. The mutual support and camaraderie the women experienced from selling their goods together carried over in the repayment of their loans. Also, the YSBDC made the payment for the loans fall on the same date as the flea market so that the money would come directly from the sales at the flea market. To date, this system is working well. With their loans, the women were able to make their businesses more profitable. The YSBDC was able to support the growth and development of several businesses and is being repaid in a timely and consistent manner because it instituted a payment schedule that fit the circumstances of its women borrowers.

A general criticism that is directed at the Grameen Bank is that its operating costs are too high. Their costs regularly exceed the bank's income even though the bank charges a high interest rate. In the case of the YSBDC, if the cost of its facility and its staff were set against the income from its micro-loan program, the same criticism could be leveled at it as well. This criticism is shortsighted, though, and fails to take into account the long range benefit of assisting people to become more independent and self-supporting. This same shortsightedness prevented another group of women in Kosrae from getting the financial support they needed to turn their successful handicraft operation into a successful business.

Handicrafts on Kosrae

On Kosrae a group of twenty-four women in Malem came together every quarter and made handicrafts that they boxed and shipped to Kwajalein Island to be sold. Each shipment had an approximate wholesale value of $2,500. The woman who acted as the agent for the group used her own time and money to record, box

tuba on Yap always exceeds supply. Consequently, a bottle of tuba can be sold retail for $4.00 a bottle at any time without any marketing effort or costs. The operator of this tuba business could only produce three bottles a day, but even this small production netted him $10 a day after he paid himself $2 a day in wages. Assuming that production is kept at three bottles a day for 360 days, the business can net its owner $3,600 a year on top of the $720 a year he pays himself in wages. If the owner of this small part-time tuba business were to invest $3,000 of his profits in a juicer and plastic bottles he could expand his operation to include fruit drinks made from local fruits. To do that though, he would probably have to hire one of his brothers or sisters.

Revolving Loans

There are other models for financing asset-poor small business start-ups. The Grameen Bank in Bangladesh, the prototype for micro-loan programs in developing countries, has been very successful in making small loans to individuals without collateral. The Grameen Bank was established because the banks in Bangladesh, much like the banks in the FSM, would not lend money to people without assets. In the place of collateral the Grameen Bank uses peer support and peer pressure to insure that its loans are repaid. To obtain a loan from the Grameen Bank, one must be a member of a five-person group of borrowers. Members of the group cannot borrow from the bank if one of their fellow group members is delinquent or has defaulted on his loan. Consequently, all of the members of the group have an interest in seeing that the loans to group members are repaid. Loan payments are due weekly so no one is allowed to fall very far behind without everyone in the group knowing about it. Furthermore, the members of the group are required to contribute weekly to a group emergency fund that can be drawn upon if one of the members is in difficulty and cannot make a payment.

A variation of the Grameen Bank lending model is being used by the Yap Small Business Development Center (YSBDC). At the YSBDC, micro-loans were given to the women who sold

Betelnut: Low Start-Up, High Income

Still, there are cases where the bank approves loan applications for business with relatively few capital assets that can be used as collateral. In some instances, the loan amount is greater than fifty percent of the company's value. If the loan applicant can show the bank that his or her business will be significantly more profitable with a loan than without one, the bank has a strong, even compelling, reason to make the loan.

For example, there was a loan applicant who owned several acres of land with producing betelnut trees. Apart from the land and the trees, the owner possessed virtually no capital assets: no equipment, buildings, etc. His only costs were from harvesting the betelnut. These costs amounted to approximately $1 per 2 lb. bag of betelnut which normally sold for $3 or $4 per bag wholesale and $5 to $7 a bag retail. However, in the dry season, when only a few of the betelnut trees have access to enough water to be productive, the retail price for a bag of betelnut skyrocketed to $15 to $17 a bag.

The owner of the betelnut trees reasoned that if he could irrigate his trees during the dry season using a nearby well, he would have plenty of productive betelnut trees at a time when the price for betelnut is $10 a bag more than it is normally. Without increasing his costs, he could increase the net income for a 2 lb. bag of betelnut from nothing (since he had no producing trees in the dry season) to as much as $13 a bag.

Even a relatively modest harvest (1,500 lbs. a month) of betelnut during a 2 month dry season could result in an increase of $19,500 in income if the betelnut trees were irrigated. The amount of money needed to irrigate the client's betelnut trees, the amount the client asked for in his loan application, was less than this projected additional income. Knowing the demand and the price for betelnut as well as the productivity of the client's betelnut trees, the bank could be fairly confident that the loan applicant could pay off the loan. Consequently, the bank could afford to make the loan despite the fact that the client could not meet either its collateral or its equity requirements. The key loan factor for the bank was how much more profitable the applicant's betelnut operation would be if he could irrigate his trees in the dry season.

If the loan had produced only a marginal increase in income for the betelnut farmer, applying for a loan would have been a bad idea. A different client recently asked for assistance in applying for a $20,000 loan to start a bakery. Like the betelnut farmer, the client wanted to expand an existing business. He was exporting fish to Guam and clearing almost $1,000 a week after expenses. His fish export business had been so profitable that he had been able to pay for a $16,000 lot in only five months. I pointed out to the client that his bakery operation could be a profitable business, but not profitable enough to justify borrowing $20,000 at 9% to 10% interest. He would be better off saving the $20,000 he needed over the next six months while he built a building to house this bakery. The point is that applying for a bank loan only makes sense when a significant financial opportunity will be missed without it.

Businesses with a Small Profit Margin

The true challenge for potential entrepreneurs in the FSM, however, is not figuring out how to make a successful business out of the sale of betelnut or exporting fish. This is already well known. The challenge is figuring out how to create viable businesses when the profit margin is relatively small, as is the case for FSM gas stations and other small retail operations.

On a recent trip to the FSM, I stopped at a new gas station that had been built within the last year. It was located on a prime site in the middle of town. I went in because I wanted to find out how this particular gas station obtained financing when all of the clients I had worked with had been unable to get a bank loan. When I questioned the clerk at the service station, I was told that the owner of the gas station is a member of one of the prominent families on the island, and that they own several income-producing properties. When I asked how the gas station had been financed, I was told that

can work well in the context of an extended family, but in Micronesia the members of an extended family must be made to understand that the business and the entrepreneur, much like a new plant, need to be fed and supported rather than leaned upon or harvested too early. Boot-strapping also works well when the new business is only a supplemental source of income and is not relied upon as the sole source of support. It ought to work well in a subsistence economy, like that of the FSM, where many of the basic needs are met outside of the cash economy, and the business is relied upon to provide only a small cash income to meet the entrepreneur’s few needs.

An example of such a business is a small coffee shop that was recently started in Chuuk State. The entrepreneur's goal in starting the business was a small cash income of approximately $100 a month or $1,200 a year. He estimated that he could build and furnish a small, open air coffee shop using local materials for only $750. He was able to borrow this amount from a friend at no interest and pay it back in twenty-five monthly payments of $30 per month. By selling both coffee and cigarettes, the owner of the coffee shop estimated he could gross $50 a day in total sales and net after cost of goods sold and operating expenses (which includes an annual payroll of $2,880, $8 per day for 360 days) approximately $9 a day, $270 a month and $3,240 a year.

This $3,240 profit plus the $2,880 payroll adds up to $6,120 which is comparable to two full time jobs at $1.50 an hour, a common entry level wage in the FSM. It is more than a 400% return on the initial investment. More importantly, the $3,240 is money that can be re-invested in the business to expand its goods and services, hire more people and make even more profit.

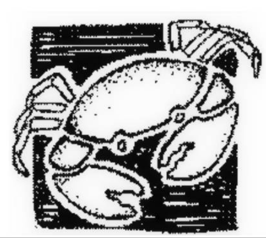
Another example of a similar small business is a "tuba" business on Yap that is operated before and after school by a fourteen-year- old. This business had virtually no start-up costs. The owner lived at home; the coconut trees he tapped for his tuba production were on family property. The bottles were recycled soy sauce bottles (the standard bottle for tuba on Yap). The demand for appropriate budget. In addition, there should have been sufficient follow-up to insure that the marketing plan was successfully implemented. Banks do not normally provide this kind of assistance, but when they are experiencing high default rates, they have little to lose and perhaps a lot to gain by providing it.

Potential entrepreneurs without any assets, however, face a more basic problem than how to market their business to tourists. They must be made to see that their lack of assets is a significant limiting factor. They are not going to receive a loan, especially a large loan, if they do not have any assets. If the proposed business requires more funds than the entrepreneur has, the entrepreneur must either scale down the business to fit the funds or obtain additional funds from family and friends. A bank will not be interested in financing 80% to 85% of his or her small business start-up. Consequently, having the entrepreneur spend weeks writing a business plan as part of a loan application is simply a waste of time. The time would be better spent developing a strategy for raising the necessary funds without a bank loan.

Boot-strapping

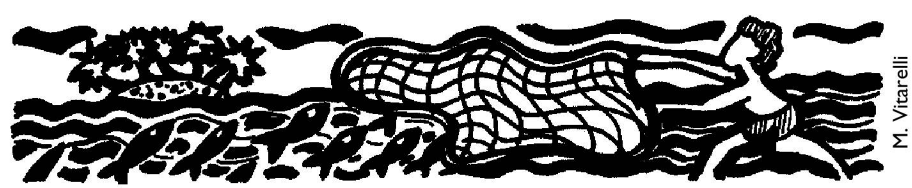
One strategy that is consistently recommended in articles on small business start-ups is boot-strapping. Boot-strapping involves financing the start-up with one's own personal funds in conjunction with loans or investments from family and friends. The amount of funds that can be raised this way severely limits the size and scope of the business–so much so that in most cases the business cannot support the owner, much less his or her family. Almost all of the initial profits from the operation of the business must be re-invested in the business until it grows to a point where it can fully support the owner and his or her dependents.

Boot-strapping works best when someone in the family has a job outside of the business and can bring in a steady income that covers the entrepreneur's living expenses while the business is growing. As such, boot-strapping



the family obtained a loan from the FSM Development Bank. I asked the clerk if a business plan had been prepared as part of the loan application. The clerk, a family member, said that he was not aware of any. The family was assisted in opening the service station by an oil company which probably did a cashflow analysis for the gas station. The oil company also either financed or contributed the new gas station's tanks, pumps and sign. The gas station owners could count these as business assets and part of their equity in the business. As a result, the loan they applied for was only a relatively small percentage, 30% to 40%, of the overall value of the business. It was just enough to pay for the site development and the construction of the store. This is how a loan is typically obtained in the FSM (as well as everywhere else in the world).

The loan applicants were successful not because they were from a prominent family or because they had a well-written business plan, but because they gave serious consideration to the bank's requirements for collateral and owner equity. By meeting these requirements, they made it possible for the bank to lend them the money they needed. This suggests that when a loan applicant cannot meet the bank's equity and collateral requirements, the applicant should change the project or revise the loan application so that he or she can satisfy the bank. Unfortunately, this is not what usually happens. Instead, the loan applicant, with the support of his business advisor and his representative in the legislature, tries to pressure the banks to lower their equity requirements and to accept almost anything as collateral to secure the loan. Banks consistently resist this kind of pressure since they know that such requirements are essential for their survival.



Micro-Loan Programs: The Hope of Small Businesses?

In response to the unwillingness of local FSM banks to lend money to small business start-ups, there was recently a successful effort in the FSM to persuade the legislatures in some of the states to fund a revolving micro-loan program that would make loans for small business start-ups easier to obtain. Making loans easier to obtain, however, does not address the real problem. If a business is asset-poor, a loan will not help them. Even a modest interest rate on a loan to finance 80% of a small retail start-up will leave a business with little margin for error, unless the business is projected to have a very strong cashflow. Yet, most small business start-ups in the FSM cannot project a strong initial cashflow. Consequently, the business collapses under the weight of the loan as soon as it runs into difficulty: a principal in the business gets sick, there is an illness in the family or some shipment is wrong and subsequent shipments take longer than expected to arrive. After several business failures and defaulted loans, an inquisitive legislator might ask: "Where did all of the money for the small business micro-loan fund go and where are all of the new small businesses that were suppose to be created?" And the legislator will discover along with everybody else that the small business micro-loan fund, which is much smaller than it was when the legislature appropriated the funds to establish it, has done very little to create a significant number of new businesses.

How to Stimulate New Business

If more money for easy-to-obtain micro-loans is not the way to create more businesses in the FSM, what is? To begin with, less time needs to be spent teaching everyone how to write a business plan and more attention needs to be given to identifying those people who have the resources to start a business (and separating out, as a different kind of problem, those people who do not). It should be recognized at the outset that people with financial assets and people without financial assets are two distinct groups with different problems that require different solutions, different training and different support.

People with assets, people to whom the bank wants to lend money, do not benefit from the kind of business development assistance that is usually provided: weeks and weeks of classes on how to write a business plan to obtain a loan. A business plan obviously needs to be done, but it should be done expeditiously. The focus of entrepreneur training for these clients should be practical exercises that give the entrepreneur the hands-on experience of actually setting up and operating his or her business. These entrepreneurs can benefit from a wide array of small business training, which can include anything that will help a business operate more efficiently and profitably. For example, a number of hotels in the FSM that have received substantial loans in the last five years are currently struggling. In some cases they need to have their loans renegotiated so that the loan payments are more manageable. But what is needed more than debt relief is assistance in marketing. Even the hotel owners who have been in business for several years need help. In particular, they need help making the transition from being a regional business hotel to becoming a remote destination for an international tourism market. Such a transition requires a far greater marketing budget than many hotel owners are used to, and marketing skills that few local hotel owners possess.

Less time needs to be spent teaching everyone how to write a business plan.

One of the banks in the FSM approved a loan for more than a million dollars for a new hotel in the area. The business plan for the new hotel had virtually no funds budgeted for marketing and a plan that seriously underestimated the cost of marketing the hotel as a remote destination. This should not have happened. Both the bank and the hotel owner would have been better off if the loan amount had been increased by $200,000 and the hotel owner had been assisted in developing a more realistic marketing plan with an