LEVEL 2: BUSINESS AND OPERATIONS

To grow, small businesses need to compete with the best-run companies. They need systems that simultaneously achieve efficiency and creativity—and engage their workers.

Financing for Small Business

For most small businesses, access to capital is a major obstacle that makes it difficult for even the most successful small companies to grow. Funding for growth usually begins with "friends, family, and fools," as one small business owner jokes. Some companies on a high-growth trajectory find that early process easy. But most small businesses face significant hurdles to finance real estate and equipment investments, and say that it is even more difficult to secure short-term financing for operations.

Financing operates on two tracks: one for the vast majority of small businesses, and another exclusively for high-growth start-ups. Although New York City has emerged as a global hub for venture-backed start-ups, the financing picture is much less sunny for most small companies looking to grow. Even as money pours in to tech companies, small businesses in many other industries face a dearth of financing opportunities to fuel their own more modest growth.

There are several dimensions to this challenge. Small community banks—traditionally the foundation of small business lending—have been disappearing, and many big banks are uninterested in providing the relatively modest loans that small businesses need, or are unwilling to take the risk. And while financing can be found at the very earliest stages of starting a business and for businesses with significant revenues and strong cash flow, there is a major gap in the market that specifically hurts small businesses seeking to level up.

Once small businesses tap start-up grants, friends and family loans, and community bank loans, they struggle to secure financing for amounts ranging from \$50,000 to \$500,000. Microfinance organizations top out at around \$15,000, and most community banks do not make loans greater than \$50,000 or \$100,000, regardless of the company's revenue stream. At the same time, big banks do not make small business loans for less than \$500,000. "There's a real gap in financing options," says Megan Adams, communications manager for Grameen America, a nonprofit microlender. "Their appetite for bigger and bigger loan products grows, and there [are few] organizations that can meet it."

Investment for high-growth companies is a different story, although the process is by no means easy. Some company founders report that they made pitches to 70 or more investors before finding a partner. The New York investor community, company owners agree, is more pragmatic and "old school" than the investors on the West Coast. "In California, if you say you want to cure cancer, they say. 'Yeah, go ahead,'" says Ravi Sachidanandam of Girihlet. "Here, you need a detailed plan and you have to practically have the cure in the plan. They are very risk averse in New York. California is much better at short-term risk—take six months to a year and allow the company to either succeed or fail."

Jim Grau of Gimlet Media adds, "Access to capital is hard. Lots of businesses in New York want to grow but traditional banks aren't lending to small businesses. Venture capital (VC) money can be tough if you're not looking to expand and expand. Businesses are maxing out credit cards or taking out short term, high-interest loans that can pose a major challenge."

Despite New York companies' success with VC funding, the overall amount of money for start-ups, especially in the tech sector, pales in comparison with competitors like Silicon Valley and greater Boston. Even though New York ranks in the top three regions for VC funding, its per-capita funding is much lower.

For high-growth and tech companies, this kind of investment is essential, says Nicolas Vansnick of BotFactory, a 3D printing firm. “Hardware is extremely expensive so you need a lot of capital to start your company,” he says. “Investors in New York are specialized, but they still need to be educated. Those who invest in hardware don’t really know hardware. One investor didn’t even know what a circuit board was.”

The world of small independent businesses is completely different. The problem, says David S. Rose, CEO of Gust, is that those companies often do not understand that they cannot achieve the same kind of exponential growth as the VC-funded start-ups. “The biggest problem is when founders of small independent businesses—which can grow and make millions in revenues—are mistakenly encouraged to try raising VC and angel money,” says Rose. “It’s just not going to happen.” Investors usually seek returns of 30 times their investment, which is virtually impossible for independent small businesses.

For small businesses, banks are the most important source of financing. But many small companies are forced to reach out to friends and family, take out second mortgages, and use credit cards and other high-interest tools in the absence of small business loans. Small business financing for real estate and equipment, as well as short-term loans to manage cash flow, have been on the decline in recent years. At a time of bank consolidation, small community lenders play an ever more vital role in the life of small businesses, but these institutions face major headwinds, too.

Community banks have always been an essential engine of small business success. Historically, small banks developed specialized knowledge of the

TWO PATHS TO GROWTH

David S. Rose, CEO of the financial technology firm Gust, outlines the two different kinds of small businesses, which offer different potential for growth and require different funding.

Small Independent Business	High-Growth Start-Up
Vast majority of new companies	Makes up 10 to 15 percent of all start-ups
Usually a limited liability company	Usually seeks to go public or get acquired by another company
Incorporated in the home state	Is formed as a C corporation, usually in Delaware
Owned by one or two founders, with no other investors	May have many cofounders
Has few employees	Has few employees and many independent contractors
Does not provide equity to workers	Offers workers equity in the form of stock or options
Operates in a physical location	Often operates with a small office and many virtual or off-site locations
Generates revenue soon after opening	May take years to become profitable
May operate primarily as a cash business, with investments coming from this cash flow or with collateral of hard assets	Gets funding from friends and family, then angels and venture capitalists
Avoids double taxation	Can begin as a corporate tax-through but eventually will pay corporate taxes
Blends ownership and management roles	Separates ownership and management functions
Levels out once profitable, then maintains its size	Aims to achieve continual growth

businesses in their neighborhoods and forged relationships with networks of small businesses in the area. Lenders often spend their entire careers servicing local businesses. Most community banks get clients through word of mouth, underscoring the importance of local networks and knowledge for both lender and borrower.

Community banks and credit unions can make unsecured loans up to $100,000. According to Daniel Gonzalez, director of lending at the Brooklyn Cooperative Federal Credit Union, a nonprofit financial institution based in Bushwick, most borrowers at such banks get $50,000, and young companies are more likely to get loans of $15,000 or less. National banks will not even consider lending to small businesses because the amounts they seek are minimal or their collateral or revenues are inadequate. As a result, small and midsized banks and credit unions make 60 percent of all small business loans even though they account for just 24 percent of all bank assets, according to the Institute for Local Self-Reliance. In areas with a dearth of small banks, financing for small business is scarce.

The transformation of the banking industry has eroded those relationships. Small banks, with assets of less than $10 billion, have been disappearing in New York and across the United States. From 1992 to 2011, according to the state's Department of Financial Services, the number of New York City community banks fell from 299 to 169. The number of banks with less than $100 million in assets declined even more sharply, from 99 to 22 over the same period. The assets of community banks also fell precipitously, from $237 billion to $166 billion. Deposits, which are more important for small banks than big banks because of their more limited activities, declined from $188 billion to $130 billion.

Investment in small businesses is usually a good bet, even when the company owner lacks the revenue streams or collateral that banks seek, says Daniel Gonzalez. In fact, half of the loans Gonzalez oversees would not be possible without the loan guarantee programs of the U.S. Small Business Administration (SBA). "It's a great return on their investment," he says. "The difficulty that people have in getting collateral would prevent them from getting loans. There's all this economic activity that these loans stimulate that wouldn't have been possible without the loan guarantees."

In addition, many small business owners misunderstand credit ratings, which undermines their ability to secure financing for growth. The consumer credit market has used credit scores for decades, but small business credit scores emerged only during the 1990s. Good credit scores give banks the confidence to make risky loans. But nearly half of all small business owners don't even know they have a business credit score. A recent SBA report concludes that small firms are "more likely to be denied credit" than large companies. Banks do not have to explain why they reject small businesses that apply for loans. Business credit scores offer a means to understand the factors that influence lenders' decisions.

Brooklyn Industries offers a case study in the trials and tribulations of small business financing. The

WHERE DID ALL THE COMMUNITY BANKS GO?

Experts debate the causes of the decline in community banks. Some analysts point to the Dodd-Frank banking reform of 2010, a 2,300-page law that attempts to restrict the practices that led to the financial meltdown of 2008. A report by the Federal Reserve Bank of Richmond found that few new community banks—those with less than $10 billion in assets—have been formed since wDodd-Frank. In addition, Federal Reserve economists say, additional regulatory burdens are increasing staff costs at lending institutions, "which can hurt the return on assets of some community banks by as much as 40 basis points," according to the authors of a 2014 Harvard Business School working paper. Along with growing regulatory complexity, Dodd-Frank has encouraged consolidation by providing assistance programs to keep big banks solvent, says Arthur E. Wilmarth of George Washington University. Before 2008, regulators approved more than 150 new small banks a year; since then, they have approved just one. Low interest rates also put the squeeze on small banks, which cannot generate as much revenue in fees as big banks.

A major gap in the financing market specifically hurts small businesses seeking to level up.

company now employs over 120 people in New York City, New Jersey, and upstate. When Lexy Funk started the company, she could not get loans, even from community banks. "I kept being told that I could borrow the money if I put the same amount of money into the bank," she remembers. "I could borrow $7,000 if I had $7,000 in the bank. So I was like, 'If I had $7,000 in the bank, would I be asking you for money?'" She financed her company with savings, investments from family, second and third mortgages on a house in upstate New York, and a unique business arrangement with a Japanese trade group. And, of course, she tapped friends and family. Only when her revenues reached $5 million, she said, would banks consider making loans. Eventually she got financing from Commerce Bank for short-term expenditures. When TD Bank acquired Commerce, the difficulties began anew. TD Bank cut the company's line of credit almost in half, which hampered its ability to place orders for the Christmas season. "We didn't have enough inventory to get back on track," Funk says. "It's almost like when we had lending, [the business] became very precarious."

Durante Rentals, a construction machine rental company that employs 45 workers at its Bronx and Queens facilities, was also rejected by lenders in its early years. "In the beginning, it was impossible," says John Durante, the co-owner. "We got rejected for a loan for a copy machine." The company used credit cards and high-interest lenders—and even borrowed from a competitor, buying $250,000 worth of equipment at a high interest rate. "It took five years to really break," he says. "Now they bend over backwards and [we] get whatever we want—even more." Even after years of success, the company uses equipment finance companies, not banks. "We stopped going to the banks. They say you don't have enough revenue last year to pay for the debt this year." Dodd-Frank, bankers tell him, has caused banks to be more demanding than ever so that "it's now, 'only if you have the money will we give you the money.'"

Investing in the Equipment for Growth

Investment in capital equipment is an imperative for businesses in all sectors. Even non-tech businesses—such as restaurants, travel agencies, business service providers, and manufacturers—require new investment to take advantage of revolutions in computer-aided design, 3D printing, materials, and Internet marketing and sales. Some of these businesses can be started for little up-front capital, but most require some capital to reach healthy levels of scale. Miquela Craytor of the New York City Economic Development Corporation (NYCEDC) estimates that 3,000 firms in New York need to upgrade their equipment.

Especially for low-margin small businesses, investment for growth poses a tricky challenge. New investments are like renovating a home while living in it. "People are not only reluctant because of the cost of the upgrade or the new technology," says Tara St James of Study NY and the Brooklyn Fashion and Design Accelerator. "They're also reluctant to stop what they're doing because it risks losing work all together. So you really kind of have to do the equivalent of starting a new business on the side."

When companies seek loans from banks for investments in machinery and technology, they often struggle to explain their businesses to nonexperts. "My business is too complicated and opaque for most investors to spend the time to try to understand it," says Shant Madjarian of Juniper. "The sources of risk and revenue have to be clear and they're not—we deal with architects, designers; people who make decisions aren't the ones who write the checks, users are different, brand matters at times and other times it doesn't. That complexity makes it very hard for me to present it to someone who doesn't know me personally, to get excited about the businesses."

Crowdfunding is usually associated with start-ups, but has been tapped for a wide variety of small businesses developing new product lines. Crowdfunding offers new options for small businesses, from start-ups to mature companies that need to fund particular projects but cannot get bank loans or other investments. According to the Crowdfunding Center, New York City–based creators raised $46.1 million for 5,062 projects in 2015, an average of $28,311 per project.

Electric Objects, a company that makes electronic displays to bring more than 10,000 works of art into homes and offices, attracted $780,612 from 2,246 backers through a Kickstarter campaign. That campaign had two benefits. First, it demonstrated that there was a significant market for the product. Second, because the company knew exactly how many products to make, it lowered the risks surrounding sourcing.

The federal government's Section 179 program—which allows businesses to deduct the full purchase price of financed or leased equipment and software worth up to $500,000—has given businesses like Durante Rentals the ability to achieve an annual growth rate of 45 percent. Companies that use the benefit can eliminate their federal tax liability, giving them more room to grow. "It's smart because if you got a company that's upping their spend that much every year, clearly they're adding jobs, paying tolls, everything," says the company's co-owner, John Durante.

Cash Flow Woes

For small businesses adding clients and customers—and investing in their own internal operations—cash flow can pose a serious challenge. When payments for goods and services lag, companies struggle to pay their own bills. Only having a reserve of cash or a line of credit can save them from failing. But many small businesses lack this basic capacity. Small companies usually need to generate enough revenue to pay rent, workers, suppliers, and other expenses, and to use those revenues to secure loans for long-term investments. When customers pay late or the company is hit with unanticipated expenses, the company's survival could be on the line.

Cash flow can hurt growing companies even more than stable companies, according to Deborah Alden, managing director of the Brooklyn Fashion and Design Accelerator. "It's difficult when you need to produce before you can sell," she says. "They'll have purchase orders but need to put the money up front in order to have the product made, so it will be 30, 60, 90 days after delivery when they get that money back. We have companies doing exactly what you want to see—hockey stick growth—but it just gets harder and harder." Increasing order sizes creates bigger cash-flow problems. Many companies are unable to develop a reserve to keep bills paid while delivering bigger orders. "It's a catch-22," Alden says.

When they begin operations, most small businesses do not consider the problem of cash flow. But experts say they need to put systems in place before opening for business. Requiring payment up front, getting credit before a cash-flow crisis begins, leasing equipment instead of buying, and using technology or professional services to manage money could prevent companies from getting caught short.

Growth creates a vicious cycle. More growth brings in new revenues, but usually not enough to pay forward for new labor, production equipment and materials, and facilities. High-growth companies that land VC or angel investors can operate for years without turning a profit. But traditional small businesses, from corner kiosks to furniture makers, must rely on revenues and bank credit to fund their operations and fuel growth.

The cash flow problem is more acute for New York City companies than companies in less expensive locales. A company struggling to meet payroll—whether a start-up or a small independent business—will be cut less slack in a high-cost city. "In other cities, I can see really vested team members holding on tight and figuring out ways to cover their $500 a month rent," says Connell McGill of Enertiv. "Here in New York, if you can't hit payroll for a month or two, our employees are racking up thousands of dollars of expenses. Given the market and the availability of other positions for the same pay, it's a lot less compelling [to make a sacrifice for a company]. That's how companies go down. That's always been one of my greatest fears." Jason Chen of Vesper says he considered "going home to Maryland and working virtually from there," even though New York is the ideal market to develop his business.

Outreach and Advice

Small businesses often lack access to advice for product development, operations, hiring, technology, marketing and sales, and more. Businesses often struggle to get off the ground or grow because of a lack of business knowledge and savvy. While they may understand their product or service, they often struggle to use that understanding to create a viable business. An understanding of software or artisanal food does not necessarily translate into an understanding of business and management. Of particular concern, many long-term challenges get neglected because of pressing day-to-day challenges. Many small business owners say they struggle to maintain and update machinery and systems due to everyday business pressures.

Every stage of development requires new knowledge, contacts, data, and capital equipment. But many companies lack the knowledge to navigate these step-ups. Ideally, companies will operate amid a web of peers, suppliers, and consumers from a wide variety of related industries, so that learning can be built into the process of growth and development. Companies also need ongoing feedback and advice. The support of friends and family often suffices at the early stages of a business. But as companies get bigger—and face legal, technical, and sector-specific challenges—they need feedback and advice from experts and accomplished peers.

"A lot of companies are so busy putting out fires, it's hard to focus on strategy," says Gary Hirsch, who advises tech start-ups in the New York area. The problem, he says, is that most small business owners don't know about the full range of services available to them. Referring to a company that fielded hundreds of resumes that produced only one or two acceptable job candidates, he says, "I know a solo practitioner who will screen those resumes for $1,000. But small businesses don't know the resources out there."

Of all the challenges facing small businesses that could benefit from expert advice, managing the supply chain poses the most difficult problems. As small companies grow, their processes become more complex as their demands increase. More customers require greater materials, workers, equipment, production management, staging and storage, marketing, distribution, and so on. When companies begin operations, they often have simple product lines and a small customer base that requires little in the way of customer service and limited management oversight.

Expanding operations need not overburden small businesses if companies know where to go for help. However, keeping more new jobs in New York City poses an additional policy challenge, as companies grow and decide to take advantage of opportunities out of state. The Jam Stand is a case in point. The company, which used to handle all aspects of the business at its Brooklyn site, now outsources its manufacturing to a facility in Pennsylvania. "We submit an order that says, 'I need 3,000 blueberry, I need 4,000,' or whatever, and they schedule dates for production and shipping," says Sabrina Valle. "Operations isn't my strong suit, and the up-front capital that goes into a lot of these things is huge—the equipment, the line, the people you have to staff, the rent you have to pay. So we might be paying a slightly higher price per unit for someone to make it for us, but we are significantly reducing our liability and our overhead costs."

Unfortunately, most small businesses do not know how to take advantage of outside services for office management (e.g., payroll, bookkeeping, and human resources), copacking, marketing, delivery, and more. Retail stores, restaurants, and a number of service businesses are notorious for not developing efficient workflows. Absent those improved systems, companies may never end up in the financial position to push for further growth.

At both the city and state levels, New York companies have access to a number of assistance programs, including a handful aimed at supporting small businesses as they grow. New York City's Department of Small Business Services (SBS) offers a nine-month program, in partnership with NYU and Citi Community Development, focused on helping minority- and women-owned business enterprises (MWBEs) to create a strategic plan for growth. In addition, SBS operates seven Business Solutions Centers, which provide storefront access to myriad capacity-building programs and services, including help navigating the government contracting process and breaking into corporate supply chains.

At the state level, Start-Up New York offers access to top talent and industry experts for small businesses, as well as ten years of tax-free operation in locations on or near eligible university or college campuses. However, the program is targeted at new businesses and firms relocating from out of state, rather than at local small businesses looking to scale up. The state also operates regional economic development councils, including a city council, as well as two dozen New York Small Business Development Centers (SBDC). Eight are located in the city—three in Manhattan (at Columbia, Baruch, and Pace), two in Queens (at LaGuardia and York), and one each in the Bronx (Lehman), Brooklyn, and Staten Island (each with a separate SBDC).

The U.S. Small Business Administration offers consulting services, seminars, and information on the challenges of small business development through its SCORE program. At the center of SCORE's operations are retired executives, who volunteer to offer advice on every stage of business development. New York's SCORE program reaches more than 1,000 business people per year, including start-up founders and experienced owners. When entrepreneurs can demonstrate that they have a viable business plan, they are given priority in the SBA's lending programs.

The problem is that SCORE and related programs have low visibility. Referring to SCORE's location in a building that requires extensive security to enter, Howard Geltzer, a former public relations executive who now volunteers as a SCORE mentor, says, "How do you know about a place in Federal Plaza where you can get free advice about your small business? People don't know about SCORE and other places where you can go for advice or financing."

In 2016, New York's SCORE office launched a new program called the Advisory Board Service to provide free management consulting services to select businesses with more than $25 million in annual revenue. However, the program can serve only a limited number of businesses and is not targeted as the smallest businesses seeking to tackle the first phase of growth.

SCORE reaches only a fraction of small and growing businesses. Other organizations—including the Business Solutions Centers, the Small Business Development Corporation, and the Industrial and Technical Assistance Corporation—also offer guidance and services to small businesses at all stages of development. But many of the small business owners we interviewed expressed frustration at the complexity of this disconnected system of assistance and support, suggesting that these services are not reaching or helping many of the businesses that need it most.

The problem extends to the full range of government consulting and incentive programs. Beth Goldberg, the New York–area administrator for the Small Business Administration, ran a family printing business for 31 years and later owned a travel company. For most of her career, she says, she did not know about government assistance for small businesses. "As a business person, I honestly didn't know SBA existed," she says. "I faced a lot of the same challenges. There's lots I could have benefited from."

Even when small business owners learn about programs for investment and consulting, they have a hard time evaluating them. "It's a crap shoot," says Cheryl Surana, the owner of Brooklyn Cookie Company, which employs five workers, as to whether programs will offer quick and effective assistance. Surana says she waited months for a request from one federal Small Business Development Center without a response. "Crickets," she says. Later, she sought out a different SBDC and got fast and helpful information. Overall, it took her a year to get the information and advice she requested.

Beyond the difficulty figuring out what government services would be helpful and which would not, says Surana, navigating the many offerings of the federal, state, and local governments is bewildering. Noting the similar names of different programs—the federal Small Business Development Centers and the city-run Business Solutions Centers—she said many small business owners get "stressed" trying to understand the range of available programs, let alone make the time to access them.