

Funding Sources for Small Businesses

In a 2007 study prepared by Rebel A. Cole for the SBA, it was reported that small businesses typically follow a predictable pecking order as they capitalize their business. This stands to reason since the categories of sources of capital, namely debt and equity, have specific requirements as well as pros & cons that determine their respective transaction costs. In general, the pecking order of capital for a small business is of course equity from the owner, loans, and then equity from others.

Debt Funding Sources

You may be hesitant about borrowing money to finance your business, but as long as you will have sufficient cash flow to pay back the debt, debt funding could be a good option. Debt financing is borrowing the money that you need to finance operations and growth. You must enter into a legal obligation to repay the amount of money borrowed.

Advantages

- You will retain full ownership of your business
- You will build your credit

Disadvantages

- Must repay debt
- Principal and interest payments

Three categories of debt funding are personal loans, operations-related financing, and business loans. Below, these categories are discussed in detail.

Personal loans- Personal loans are often the easiest funds for a small business owner to obtain. Types of personal loans are:

Personal Bank Loans- A personal bank loan is obtained from a bank and must be paid back in monthly installments. A personal bank loan can either be secured (collateral is required) or unsecured (no collateral is required).

Loans from Life Insurance- You may be able to borrow against the cash surrender value of your life insurance policy. In many cases, insurance companies allow customers to borrow up to 95 percent of the paid-in value.

Credit Cards- Credit cards are the most common form of short-term credit. Many small businesses use credit cards to buy supplies and other necessities and to pay for everyday purchases. Using a credit card will be a more costly form of credit than other types of personal loans. You should only use this card if your credit limit is high enough to cover your needs, and if you can repay the balance quickly.

Second Mortgage (Home Equity Credit)- If you have enough equity in your home, you may be able to qualify for a home equity loan or a line of credit. Including the first mortgage, you may be able to borrow up to 80 percent for the appraised value of your home. This type of borrowing may offer tax advantages, but make sure you are able to repay the loan because you do not want to be in danger of losing your home.

Friends and Relatives- You may be able to talk to friends and relatives about financial support. If you choose to use this option, treat the transaction in a professional manner. Pay a fair rate of interest, sign a legal promissory note, and repay the money as agreed.

Operations Related Financing- This category of debt financing depends on the day-to-day operations of your business. This category includes options for start-up and established businesses. Types of operations related financing are:

Supplier Credit- The suppliers you do business with can be a source of funds if they extend favorable credit terms to you. The availability of this form of credit will vary depending on the industries you and your vendor are in.

Customer Credit- You may be able to create a form of credit by getting your customers to make a deposit or pay in advance. They may be willing to prepay if you offer a discount as an incentive.

Leasing- Leasing is a rental arrangement that will give you the use of an asset that someone else owns. Also the total cost of leasing will be more than purchasing the item outright, this is a way to reduce the amount of money upfront to get your business running. Little to no down payment is required, and the company can purchase equipment at the end of the lease. Payment terms are usually monthly.

Accounts-Receiveable Financing- If you have receivables (accounts that have been billed but not paid), you may be able to use these as collateral for a small business loan. Lenders that offer accounts-receivable financing will generally offer between 50 and 80 percent of the total invoice amounts outstanding, depending on the type of receivables and collection method.

Factoring- Factoring allows you to sell your receivables to a financing source called a factor. You will be paid a percentage of the total value of these accounts, depending on the type of receivables and collection method. Once you have sold the receivables to the factor, the factor will collect the accounts and absorb any losses. Payment terms are dependent on changes with accounts receivable sold.

Asset-Based Financing- You may be able to borrow money on the assets your business owns. Asset-based financing can be structured as a one-time extension of credit or as a revolving line of credit requiring a periodic review of the assets pledged as collateral. These loans are used for rapidly growing or cash strapped companies. The borrower pledges assets secure a loan that will be used to improve cash flow. Accounts receivable and inventory are common collateral. Additionally, asset-based loans can be used for inventory floor plans. Payments are usually monthly, but payment terms are dependent on changes in inventory and accounts receivable.

Business Loans- This category of debt financing is the most traditional and widely used among small businesses. Types of business loans are:

Term/Installment Loans- These are installment loans that are paid back at regular intervals over a specified period of time. These loans are granted for a specific purpose, such as for working capital or an upgrade in equipment. The term of the loan will depend on the use of the funds, but it can range from short term to long term. The payment terms for these loans are either monthly or quarterly and include principal and interest.

Commercial Mortgages- A commercial mortgage is a business loan that involves business, not residential, real estate. A mortgage is the legal document that insures the payment of the borrower. The payment terms for these loans are either monthly or quarterly and include principal and interest.

Demand Notes- This type of financing is a single-payment loan that is intended for specific short term needs. The contract can call for payment in full within 90 to 180 days, but the lender can call for the repayment of the note at any time. You may also be asked to make periodic interest payments during the life of the note.

Lines of Credit- Like a credit card, a line of credit establishes a credit limit and specific terms for repayment. Lines of credit are easy to access and offer flexibility in managing cash flow needs. Many small business owners establish a line of credit as a precaution. Lines of credit are usually linked to short-term assets (accounts receivable, inventory, etc.). An installment line of credit is when the lender agrees to lend money for a specific time period, usually one year. Lines can be used to facilitate the purchase of inventory and equipment, and cover seasonal business fluctuations. A revolving line of credit is when the borrower has a fixed amount available and when used, the credit line is reduced. When principal is paid, the credit line is restored.

Letter of Credit- A letter of credit is a document issued by the bank to which the bank agrees to accept drafts under set conditions. A letter of credit is used for companies needing to show good faith for a particular purpose. The letter of credit is typically used for exporters and contractors.

Bridge Loans- A bridge loan is a short-term loan, less than one year, between the end of one loan and the beginning of another. It must be paid at the end of the period or consolidated into the next loan.

Permanent Working Capital- Permanent working capital is usually a line of credit that never reaches a zero balance. The loan extends beyond one year. The loan can be revolving. Interest is due on a monthly balance.

Government-assisted loans- There are several loan programs in which the government either directly lends to small business owners or provides a guarantee of loan repayment to small business lenders. Government-assisted small business loans are offered by federal agencies such as the Small Business Administration (SBA), the Economic Development Administration (EDA), the USDA, the Rural Economic and Community Development, as well as by state and local agencies.

Even though there are a couple of disadvantages to SBA guarantees such as guarantee fees, documentation, and in some cases process time, SBA guarantees do have one major advantage: the length of the loan can be spread over a longer period of time. If you feel that an SBA guarantee would help ease your cash flow, you might want to

negotiate this with your lender. Government-assisted loans (such as the SBA 504 or 7a program) usually require that the small business owner have their own money invested in the business in order to share the risk with the lender. Other loans (such as the SBA Community Express) require minimal collateral in order to secure the loan. Because of the variation in the requirements for the different loan programs, please contact your local SBDC Business Consultant for up-to-date information on these loans and their availability.

Equity Funding Sources

Equity financing may seem less intimidating to a small business owner than debt financing because of the lack of concern of qualifying for a loan and paying back debt. Equity financing requires selling a partial interest or ownership in your company. And can involve substantial transaction costs.

Advantages

- No debt payments
- Increases the net worth of the business

Disadvantages

- No longer the full owner of the business because financial contributors expect a share
- Must relinquish some control

The types of equity partners to be considered include informal investors, limited stock offering, venture capital, and initial public offering (IPO). Following, there is a detailed discussion of each type.

Informal Investors- Informal investors can include family, friends, colleagues, suppliers, or private (angel) investors. Private (angel) investors are difficult to find and require a very detailed business plan. You can find investors by contacting the investor directly or by contacting accountants, bankers, stockholders, venture capitalists, or investment clubs.

Limited Stock Offering- Limited stock offering provides an opportunity for your company to raise significant amounts of equity from outside investors without the high cost and burden of a public stock offering. A limited stock offering is still subject to some state and federal regulations. You must make sure your offering complies with all provisions that exempt it from the public offering registration process.

Venture Capital- Venture capitalists are the most risk-oriented investors. Most venture capital firms have specific investment preferences that involve business style, size of investment, rapid growth, and high return. To a venture capitalist, the most important factors are the management team and the ability to recover investment with substantial return in 5-7 years. Venture capital funds are typically available to less than one half of one percent of all new businesses.

Initial Public Offering (IPO)- An IPO involves offering your stock to the public. It is very expensive as it requires extensive registration procedures. Most small businesses will not consider IPO for the afore-mentioned reasons. However, a profitable and well-managed business with great market appeal may consider IPO as an option.

