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Funding a Business

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You've got your business plan written. You're excited about your business idea, and now it's time to get started. One problem: You don't have the financing to fully realize your idea. What are your options? Aside from using your own funds and borrowing from friends and family, there are numerous routes that you can take, and each has its advantages and disadvantages. Here are some of the major options available for funding your small business, and some of the pitfalls to avoid.

Bank loans

Getting a loan from a local bank is the first option that most people think of when funding a new business. But it's often difficult to obtain a bank loan on the basis of a business plan alone. Banks can't take your idea as collateral for the loan.

If you are thinking of getting a bank loan, you will likely need to secure the loan through other means, such as putting up your home as collateral. A bank loan may be more feasible, though, if you are purchasing an ongoing business outright. In that case, the assets or the business itself can be used to secure the loan.

In any case, the advantage of a bank loan is that you won't have to give away any equity if your business succeeds. You will simply repay the loan and own your business outright. If your business fails, however, you may end up losing more than your business assets, depending on the terms of the loan.

Angel investors

Angel investors are private investors who contribute money to a business in exchange for an ownership interest. The obvious advantage of utilizing angel investors is that you don't have to repay a loan. However, you may have to give up a significant amount of equity (and control, depending on the security issued) to the angel investors. Angel investors typically expect to receive preferred equity security in exchange for their investment.

Perhaps the greatest obstacle is to find the right angels. There are many people out there who want to invest in small businesses, but it's not easy to find the right fit. If you opt for this route, make sure that all parties have the same expectations regarding the prospect of success. You need to agree on how long you expect it will take for the business to be profitable (be aware that most small business plans are overly optimistic as to profit expectations) and whether your angels will hang in there with you if it takes longer than expected.

Venture capital

We've all heard a great deal about venture capital firms over the past few years. The ups and downs of some of these companies have been well documented. But are venture capital firms a potential source of financing for your business?

Venture capital may be a viable financing source for your business but, then again, it may not. Like angel investors, venture capitalists typically take an equity stake in your company, and most expect to receive preferred equity security in exchange for their investment. Most venture capitalists specialize in certain industries, and many provide corporate direction as well as financing (some angel investors may provide such direction, as well).

It is this aspect of specialization that makes venture capital financing difficult for most new businesses to obtain. If your new business doesn't fit into the right niche, your company might not be a candidate for funding.

What fields do venture capital firms focus on? Most venture capital firms specialize in high-tech, computer, and Internet services. Others specialize in scientific projects and inventions that require a lot of cash. So, if you're looking to launch something outside the science and technology field, a venture capital firm probably isn't the right financing alternative for you.

Selling stock

Selling stock in your company can take several different forms. We've all heard and read a lot about initial public offerings (IPOs). IPOs are stock sales in which previously private companies go public. An IPO is a possibility for an ongoing business, but it isn't likely to be a viable alternative for your new company.

A private placement is less complex than an IPO and involves selling shares of stock to a select group of equity investors. The investors typically exercise control over the company in direct proportion to the number of shares that they own.

Selling stock or other securities in your business generally requires compliance with federal and state securities laws. Seek the advice of an attorney experienced in these laws before your business issues any stock or securities.

Factoring

You've been in business for a while and you have customers, but your collections have been bad. You need cash now, but your lack of cash inflow is holding you back. What can you do?

A common solution to this problem is factoring. Basically, you secure a loan (usually at a high interest rate) against your accounts receivable. Factoring companies aren't hard to find, and some offer better deals than others, but they are almost always going to charge you a much higher rate of interest than your bank. Thus, factoring is usually considered as an option only after all others have been exhausted.

Economic development programs

Many federal, state, and local government loan programs are available to small businesses. The Small Business Administration (SBA) is a good place to start.

The SBA offers a variety of loan programs for very specific purposes:

- The 7(a) Loan Program is the SBA's most popular loan program, and it includes financial help for businesses with special requirements. It helps start-ups find funding when they otherwise might not be eligible for traditional financing options. Eligible expenses include equipment, furniture, and supplies, as well as short- and long-term working capital. In addition, , funds are available for loans to businesses that handle exports to foreign countries, businesses that operate in rural areas, and for other very specific purposes. (Source: SBA.gov)

- The Microloan Program provides small, short-term loans to small business concerns and certain types of not-for-profit child-care centers. The SBA makes funds available to specially designated intermediary lenders, which are nonprofit community-based organizations with experience in lending as well as management and technical assistance. These intermediaries make loans to eligible borrowers. The maximum loan amount is $50,000, but the average microloan is about $13,000. (Source: SBA.gov)

- The CDC/504 loan program is a long-term financing tool, designed to encourage economic development within a community. The 504 Program accomplishes this by providing small businesses with long-term, fixed-rate financing to acquire major fixed assets for expansion or modernization. A Certified Development Company (CDC) is a private, nonprofit corporation which is set up to contribute to economic development within its community. CDCs work with SBA and private sector lenders to provide financing to small businesses, which accomplishes the goal of community economic development. (Source: SBA.gov)

Don't overlook your local government loan programs, though. Local governments often offer incentives such as tax breaks or a discounted loan rate if you locate your business in their jurisdiction, often in an area zoned for economic redevelopment.

Customer/supplier financing

This is an option for a business that has a poor credit rating, and a realistic option that many small businesses overlook. In essence, your business bills for part of the services or products that it supplies up front. The rest of the fees are paid as the products are delivered or as the services are completed.

This strategy is aggressive, but many of your customers can appreciate the need that a small business has to keep cash flow current, and won't object to your asking for partial payment up front.

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