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# Types and Sources of Financing for Start-up Businesses

Financing is needed to start a business and ramp it up to profitability. There are several sources to consider when looking for start-up financing. But first you need to consider how much money you need and when you will need it.

The financial needs of a business will vary according to the type and size of the business. For example, processing businesses are usually capital intensive, requiring large amounts of capital. Retail businesses usually require less capital.

Debt and equity are the two major sources of financing. Government grants to finance certain aspects of a business may be an option. Also, incentives may be available to locate in certain communities and/or encourage activities in particular industries.

## Equity Financing

Equity financing means exchanging a portion of the ownership of the business for a financial investment in the business. The ownership stake resulting from an equity investment allows the investor to share in the company's profits. Equity involves a permanent investment in a company and is not repaid by the company at a later date.

The investment should be properly defined in a formally created business entity. An equity stake in a company can be in the form of membership units, as in the case of a limited liability company or in the form of common or preferred stock as in a corporation.

Companies may establish different classes of stock to control voting rights among shareholders. Similarly, companies may use different types of preferred stock. For example, common stockholders can vote while preferred stockholders generally cannot. But common stockholders are last in line for the company's assets in case of default or bankruptcy. Preferred stockholders receive a predetermined dividend before common stockholders receive a dividend.

### *Personal Savings*

The first place to look for money is your own savings or equity. Personal resources can include profit-sharing or early retirement funds, real estate equity loans, or cash value insurance policies.

**Life insurance policies -** A standard feature of many life insurance policies is the owner's ability to borrow against the cash value of the policy. This does not include term insurance because it has no cash value. The money can be used for business needs. It takes about two years for a policy to accumulate sufficient cash value for borrowing. You may borrow most of the cash value of the policy. The loan will reduce the face value of the policy and, in the case of death, the loan has to be repaid before the beneficiaries of the policy receive any payment.

**Home equity loans -** A home equity loan is a loan backed by the value of the equity in your home. If your home is paid for, it can be used to generate funds from the entire value of your home. If your home has an existing mortgage, it can provide funds on the difference between the value of the house and the unpaid mortgage amount. For example, if your house is worth $150,000 with an outstanding mortgage of $60,000, you have $90,000 in equity you can use as collateral for a home equity loan or line of credit. Some home equity loans are set up as a revolving credit line from which you can draw the amount needed at any time. The interest on a home equity loan is tax deductible.

### *Friends and Relatives*

Founders of a start-up business may look to private financing sources such as parents or friends. It may be in the form of equity financing in which the friend or relative receives an ownership interest in the business. However, these investments should be made with the same formality that would be used with outside investors.

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### *Venture Capital*

Venture capital refers to financing that comes from companies or individuals in the business of investing in young, privately held businesses. They provide capital to young businesses in exchange for an ownership share of the business. Venture capital firms usually don't want to participate in the initial financing of a business unless the company has management with a proven track record. Generally, they prefer to invest in companies that have received significant equity investments from the founders and are already profitable.

They also prefer businesses that have a competitive advantage or a strong value proposition in the form of a patent, a proven demand for the product, or a very special (and protectable) idea. Venture capital investors often take a hands-on approach to their investments, requiring representation on the board of directors and sometimes the hiring of managers. Venture capital investors can provide valuable guidance and business advice. However, they are looking for substantial returns on their investments and their objectives may be at cross purposes with those of the founders. They are often focused on short-term gain.

Venture capital firms are usually focused on creating an investment portfolio of businesses with high-growth potential resulting in high rates of returns. These businesses are often high-risk investments. They may look for annual returns of 25 to 30 percent on their overall investment portfolio.

Because these are usually high-risk business investments, they want investments with expected returns of 50 percent or more. Assuming that some business investments will return 50 percent or more while others will fail, it is hoped that the overall portfolio will return 25 to 30 percent.

More specifically, many venture capitalists subscribe to the 2-6-2 rule of thumb. This means that typically two investments will yield high returns, six will yield moderate returns (or just return their original investment), and two will fail.

### *Angel Investors*

Angel investors are individuals and businesses that are interested in helping small businesses survive and grow. So their objective may be more than just focusing on economic returns. Although angel investors often have somewhat of a mission focus, they are still interested in profitability and security for their investment. So they may still make many of the same demands as a venture capitalist.

Angel investors may be interested in the economic development of a specific geographic area in which they are located. Angel investors may focus on earlier stage financing and smaller financing amounts than venture capitalists.

### *Government Grants*

Federal and state governments often have financial assistance in the form of grants and/or tax credits for start-up or expanding businesses.

### *Equity Offerings*

In this situation, the business sells stock directly to the public. Depending on the circumstances, equity offerings can raise substantial amounts of funds. The structure of the offering can take many forms and requires careful oversight by the company's legal representative.

### *Initial Public Offerings*

Initial Public Offerings (IPOs) are used when companies have profitable operations, management stability, and strong demand for their products or services. This generally doesn't happen until companies have been in business for several years. To get to this point, they usually will raise funds privately one or more times.

### *Warrants*

Warrants are a special type of instrument used for long-term financing. They are useful for start-up companies to encourage investment by minimizing downside risk while providing upside potential. For example, warrants can be issued to management in a start-up company as part of the reimbursement package.

A warrant is a security that grants the owner of the warrant the right to buy stock in the issuing company at a pre-determined (exercise) price at a future date (before a specified expiration date). Its value is the relationship of the market price of the stock to the purchase price (warrant price) of the stock. If the market price of the stock rises above the warrant price, the holder can exercise the warrant. This involves purchasing the stock at the warrant price. So, in this situation, the warrant provides the opportunity to purchase the stock at a price below current market price.

If the current market price of the stock is below the warrant price, the warrant is worthless because exercising the warrant would be the same as buying the stock at a price higher than the current market price. So, the warrant is left to expire. Generally warrants contain a specific date at which they expire if not exercised by that date.

## Debt Financing

Debt financing involves borrowing funds from creditors with the stipulation of repaying the borrowed funds plus interest at a specified future time. For the creditors (those lending the funds to the business), the reward for providing the debt financing is the interest on the amount lent to the borrower.

Debt financing may be secured or unsecured. Secured debt has collateral (a valuable asset which the lender can attach to satisfy the loan in case of default by the borrower). Conversely, unsecured debt does not have collateral and places the lender in a less secure position relative to repayment in case of default.

Debt financing (loans) may be short term or long term in their repayment schedules. Generally, short-term debt is used to finance current activities such as operations while long-term debt is used to finance assets such as buildings and equipment.

### *Friends and Relatives*

Founders of start-up businesses may look to private sources such as family and friends when starting a business. This may be in the form of debt capital at a low interest rate. However, if you borrow from relatives or friends, it should be done with the same formality as if it were borrowed from a commercial lender. This means creating and executing a formal loan document that includes the amount borrowed, the interest rate, specific repayment terms (based on the projected cash flow of the start-up business), and collateral in case of default.

### *Banks and Other Commercial Lenders*

Banks and other commercial lenders are popular sources of business financing. Most lenders require a solid business plan, positive track record, and plenty of collateral. These are usually hard to come by for a start-up business. Once the business is underway and profit and loss statements, cash flows budgets, and net worth statements are provided, the company may be able to borrow additional funds.

### *Commercial Finance Companies*

Commercial finance companies may be considered when the business is unable to secure financing from other commercial sources. These companies may be more willing to rely on the quality of the collateral to repay the loan than the track record or profit projections of your business. If the business does not have substantial personal assets or collateral, a commercial finance company may not be the best place to secure financing. Also, the cost of finance company money is usually higher than other commercial lenders.

### *Government Programs*

Federal, state, and local governments have programs designed to assist the financing of new ventures and small businesses. The assistance is often in the form of a government guarantee of the repayment of a loan from a conventional lender. The guarantee provides the lender repayment assurance for a loan to a business that may have limited assets available for collateral. The best known sources are the Small Business Administration and the USDA Rural Development programs.

### *Bonds*

Bonds may be used to raise financing for a specific activity. They are a special type of debt financing because the debt instrument is issued by the company. Bonds are different from other debt financing instruments because the company specifies the interest rate and when the company will pay back the principal (maturity date). Also, the company does not have to make any payments on the principal (and may not make any interest payments) until the specified maturity date. The price paid for the bond at the time it is issued is called its face value.

When a company issues a bond it guarantees to pay back the principal (face value) plus interest. From a financing perspective, issuing a bond offers the company the opportunity to access financing without having to pay it back until it has successfully applied the funds. The risk for the investor is that the company will default or go bankrupt before the maturity date. However, because bonds are a debt instrument, they are ahead of equity holders for company assets.

## Lease

A lease is a method of obtaining the use of assets for the business without using debt or equity financing. It is a legal agreement between two parties that specifies the terms and conditions for the rental use of a tangible resource  such as a building and equipment. Lease payments are often due annually. The agreement is usually between the company and a leasing or financing organization and not directly between the company and the organization providing the assets. When the lease ends, the asset is returned to the owner, the lease is renewed, or the asset is purchased.

A lease may have an advantage because it does not tie up funds from purchasing an asset. It is often compared to purchasing an asset with debt financing where the debt repayment is spread over a period of years. However, lease payments often come at the beginning of the year where debt payments come at the end of the year. So, the business may have more time to generate funds for debt payments, although a down payment is usually required at the beginning of the loan period.



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