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Introduction

This chapter helps your writing process because it gives you an idea of what lenders and investors want to see in a finished plan. Your ability to understand your financiers’ motives can mean the difference between getting a loan or an investment and coming up empty-handed. If you already have financial backing, you can skip this chapter.

Many people and institutions are looking for sound loans and investments. From their side of the fence, it can often seem extremely difficult to find a good one. Many potential financiers have been frightened by news stories about small business financial problems, con artists selling phony tax shelters, business bankruptcies, and so on.

What does this mean to you? Simply that you must both create a sound business plan and present it, and yourself, in a way that appeals to lenders’ and investors’ needs for security and profit.

If you have a good business idea and are patient and persevering, you should be able to find financing. It was Calvin Coolidge who, sometime in the 1920s, said, “The business of America is business.” It’s no less true today.

Ways to Raise Money

Before you can sensibly plan to raise money, you need to know how it’s commonly done.

Loans

A loan is a simple concept: Someone gives you money in exchange for your promise to pay it back. The lender could be a bank, friend, family member, or anyone else willing to lend you money. The lender will almost always charge interest, which compensates the lender for the risk that you won’t pay back the loan. Usually, the lender has you sign some papers (called a note and loan agreement) spelling out the details of your loan agreement. (See Chapter 10 for examples.)
While these basic concepts are simple, not everyone seems to clearly understand them. For example, some people put a great deal of energy into arranging to borrow money, but think little about the hard work that goes into repaying it. The important thing to understand is that the lender expects you to pay the money back. It’s only fair that you honor your promise if you possibly can.

Your business may be so successful that you can pay back the loan sooner than the original note calls for and save some interest expense in the process. Some state laws allow repayment of the entire principal at any time with no penalty. However, laws in some states allow the lender to charge a penalty of lost interest if the borrower pays the loan back sooner than called for. Make sure you read the loan documents and ask about prepayment penalties. Your lender may be willing to cross a prepayment penalty clause out of the agreement if you ask.

As for the manner in which loans are repaid, there are about as many variations as there are loans. Here are the most typical:

- **Fully amortized loan.** This type of loan repayment provides for principal and interest to be paid off in equal monthly payments for a certain number of months. When you’ve made all the payments, you don’t owe anything else. The amount of the interest rate and the number of years or months you agree to make payments can change your monthly payments a great deal; pay close attention to these details. For example, if you borrow $10,000 for five years at 10% interest, you will agree to make 60 monthly payments of $212.48, for a total repayment of $12,748.80. That means you will pay $2,748.80 in interest. Now let’s say you borrow $10,000 for five years at 20% interest. Your monthly payments will be $264.92 and you will end up paying $15,895, including $5,895 in interest.

- **Balloon payment loan.** This loan (sometimes called an interest-only loan) calls for repayment of relatively small amounts for a preestablished period of time. You then pay the entire remaining amount off at once. This last large payment is called a “balloon payment,” because it’s so much larger than the others. Most balloon payment loans require interest-only payments for a number of years until the entire principal amount becomes due.
and payable. Although this type of repayment schedule sounds unwieldy, it can be very useful if you can’t make large payments now, but expect that to change in the near future.

### Problems With Cosigned Loans

Bankers sometimes request that you find a cosigner for your loan. This is likely if you have insufficient collateral or a poor or nonexistent credit history. Perhaps someone who likes your idea and has a lot of property, but little cash, will cosign for a bank loan.

A cosigner agrees to make all payments you can’t make. It doesn’t matter if the cosigner gets anything from the loan—she’ll still be responsible. And if you can’t pay, the lender can sue both you and the cosigner. The exception is that you’re off the hook if you declare Chapter 7 bankruptcy, but the cosigner isn’t. Cosigning a loan is a big obligation, and it can strain even the best of friendships. If someone cosigns your loan, you might want to consider rewarding your angel for taking this risk.

From my own experience, I cosigned a car loan for an employee once, and I’ll think twice before I do it again. I didn’t lose any money, but the bank called me every time a payment was 24 hours late, and a couple of times I thought I might have to pay. I didn’t like being financially responsible for a car that I had never driven and might never see again.

### Secured Loans

Lenders often protect themselves by taking a security interest in something valuable that you own, called “collateral.” If you pledge collateral, the lender will hold title to your house, your inventory, accounts receivable, or other valuable property until the loan is paid off. Loans with collateral are called “secured” loans.

If you don’t repay a secured loan, the lender sells your collateral and pockets the unpaid balance of your loan, plus any costs of sale. Not surprisingly, if you have valuable property to secure a loan, a lender will
be much more willing to advance you money. But you also risk losing your house or other collateral if you can’t pay back the loan.

A lender will expect you to maintain some ownership stake in the asset. This will normally be 10% to 30%, depending on the type of asset and the type of lender. That means you can’t expect to get a loan for the same amount as your collateral is worth.

If you default on a loan and proceeds from the sale of the collateral are not enough to pay off the loan, the lender can sue you for the remaining amount. The best advice is this: Be very cautious when considering a secured loan. Make sure you know your obligations if the business fails and the loan can’t be repaid.

Lenders like collateral, but it never substitutes for a sound business plan. They don’t want to be selling houses or cars to recoup their money. In fact, lenders often only accept real property, stocks and bonds, and vehicles as collateral. Items of personal property, such as jewelry, furniture, artwork, or collections usually don’t qualify. All lenders really want is for you to pay back the loan, plus interest. If they have to foreclose on your house, it makes them look, and probably feel, bad. Here’s an example of a loan secured by real estate and used to open a business.

**Example:** Mary needs to borrow $50,000 to open a take-out bagel shop. She owns a house worth $200,000 and has a first mortgage with a remaining balance of $100,000. Uncle Albert has offered to lend Mary the amount she needs at a favorable interest rate, taking a second mortgage on Mary’s house as collateral for the loan. Mary agrees and borrows $50,000, obligating herself to repay in five years with interest at 10%, by making 60 payments of $1,062.50. If Mary can’t make all the payments, the second mortgage gives Uncle Albert the right to foreclose on Mary’s home and sell it to recover the money he loaned her. Uncle Albert feels secure, since he is confident the house will sell for at least $150,000, and the only other lien against the house is the $100,000 first mortgage. If a foreclosure did occur, Mary would, of course collect any difference between the selling price and the balance of the two mortgages.
Unsecured Loans

Loans without collateral are called “unsecured” loans. The lender has nothing to take if you don’t pay. However, the lender is still entitled to sue you if you fail to repay an unsecured loan. If he wins, he can go after your bank account, property, and business.

Lenders typically don’t make unsecured loans for a new business, although a sound business plan may sway them. Remember, the lender’s maximum profit from the loan will be the interest he charges you. Since he won’t participate in the profits, naturally he is going to be more concerned with security.

Equity Investments

An equity investor buys a portion of your business and becomes part owner. The equity investor shares in your profits when you succeed. Depending on the legal form of ownership, she only shares in your losses up to the amount of her initial investment. Put another way, most equity investors’ risk is limited to the money they put up, which can be lost if the business fails.

Investors expect you to think of their money as a tool; you will use their tool for a while, and then you will give it back. Your business plan should include a forecast of when and how that will happen. Failing to discuss a repayment strategy in your plan can cause a potential investor to wonder about your motives.

To understand a little more about your potential backers, let’s look at the dilemma they face when they consider investing in a small business like yours. On one extreme are the very safe investments that produce a low profit. At the other extreme lie investments that promise a very high profit but that also carry a high risk of losing the entire investment.

Your new business proposal will be far less safe than an insured bank deposit. This means that to attract money, you must offer investors the possibility of fairly high returns. While investors will not find your proposal as risky as casino gambling, the smart ones will know that, statistically, putting money into a new small business isn’t a whole lot safer. In addition to the possibility of a big gain, investors will want
to minimize their risks by looking for any security-enhancing feature your investment proposal offers, such as your skill at making businesses succeed or your business’s profitable track record.

You will want to offer investors the possibility of a good financial return, a sense of security, and, if possible, a little more. Often, this is a vision of engaging in a business designed to enhance some particularly worthwhile objective such as health, education, or environmental concerns. Or it can be simply an opportunity to help someone with enthusiasm and drive. One of the best ways to convince a potential lender or investor that his money is secure is to convince him that you are an honest, sincere person. At least as many businesses fail to get financed because potential investors don’t like the person making the sales pitch as those that fail because investors don’t like the pitch itself.

In fact, when they like you and your idea, some investors and banks want to make sure that you have something to lose other than just your pride if the business fails. They will want to see that you are backing your ideas with your hard-earned dollars. Be prepared to put up most of your own money to get the business open. This lets them know that you will do everything in your power to make the business work; sometimes, your dollar commitment can take the place of any other guarantees.

Return on Equity Investments: What’s Fair

Every investor has her personal requirements and every deal is different. The important thing is that both parties understand the risks and think it is a good deal. Here are some suggestions that have worked well for others in situations where the potential investors weren’t well acquainted with the entrepreneur. Obviously, if your investors are family members, close friends, or people who wish to support your business for political or personal reasons, they may be willing to accept a lower rate of return.

If you are starting a new business and do not plan to guarantee the return of the investment, you’ll almost always need to offer investors a high possible return. If you don’t put up any money, investors may expect as much as 75% of the profits. You, the promoter, may get as little as 25% of the profits plus a reasonable salary for your work to make the project go. Of course, it is rare that a person who starts a business doesn’t
invest at least some of his own money, so the investors’ percentage would normally be adjusted downward.

### Should You Guarantee a Return?

Very few investment proposals offer the investor any guarantees. Nevertheless, some equity investors want a guaranteed return in addition to a share of the profits. If you guarantee a return, you will pay back the original investment plus a profit on the investment, even if the deal goes sour. Doing this is great if the project makes the profit you think it will. But it’s a risk for you since you’ll have to get the money to pay off the investor from some other source if your business fails.

If you are willing to guarantee the repayment and the profits, you may be able to get an investor to accept the return of her investment plus a reasonable profit of 20% or 30% on her investment, within a year or two time frame.

Guaranteed investments are rare, and I suggest you avoid the temptation to offer a guarantee. Most entrepreneurs with the ability and assets to offer a guarantee can secure financing at a lower cost from more conventional sources. Perhaps they can pledge their assets for a straight bank loan or sell their assets and obtain money that way.

Another alternative for a start-up business where investors bear the entire risk of loss is for the founder to work in the business on a daily basis and receive a small wage as a project expense. The first profits are used to pay back all the money advanced. Profits are split on an agreed percentage. If the investor puts up all the money, this might be 50/50; if the investor puts up less, his share should also be less. Sometimes these profit splits terminate after a specific number of years, and sometimes they continue indefinitely. Occasionally, the parties agree on a formula to establish a price for which one party may buy out the other party in the future.

If you’re expanding an established business, the returns can be adjusted toward normal bank loan rates if the expansion appears
conservative. Investment profits will have to be considerably higher than bank rates if the project appears risky. The main thing that increases risk for an established business is changing its normal course of business. For example, an established employee leasing company that plans to expand its receivables in the face of increasing demand is more conservative than the same company that plans to open a new office in another state. It’s a higher risk if the same company plans to enter a completely new line of business, such as management consulting.

Legal Forms of Owning Equity Investments

An equity investor chooses among three options in sharing ownership in your small business. These are the only options available, even if the consideration for the ownership share is something other than cash, such as labor, materials, and so forth:

- **General partnerships.** A general partner joins you in owning the business. He shares in your profits and losses in proportion to his partnership share. General partnerships work best when all partners work full-time in the business. Equity investors normally prefer not to become general partners, because they don’t want day-to-day involvement in your business. Also, by law, if the partnership loses money, the investing general partner must pay back part or all of the losses. Everybody has heard stories of partnerships that went sour, with dire consequences. These were usually general partnerships. If you are interested in forming a partnership, limited or general, or learning more about them, see *Form a Partnership*, by Denis Clifford and Ralph Warner (Nolo).

- **Limited liability companies (LLCs).** LLCs are becoming more popular for small business owners. They offer the liability protection of a corporation, but are cheaper and easier to create and maintain. The relationship of you (as the entrepreneur) to your investors is similar in many ways to the relationship in the corporate form (discussed below). Limited liability partnerships (LLPs) offer similar benefits but are usually reserved for professionals like doctors and dentists. If you are considering either an LLC or LLP, consult with your accountant or attorney before proceeding.
• **Corporations.** One of the most popular methods of selling equity investments is to form a corporation and sell shares of stock. The shareholders’ potential losses are typically limited to the purchase price of their shares. A corporation is a legal entity that is separate from you. You form a corporation by paying fees and filing forms at a state office. A corporation lets you keep management control of the business; as long as you retain 51% of the shares of stock, you can call the shots.

How much people are willing to pay for your stock depends mostly on what they think of your prospects. If you have a firm, exclusive contract to sell a popular, new type of computer peripheral and only need money to build a showroom, potential buyers will probably find you. However, if you’re trying to build a factory to mass produce a new and relatively untried type of pooper-scooper, you will almost certainly have more difficulty.

If you conduct business in a legal and ethical manner, the corporation can shield you and your shareholders from personal liability for business losses. However, officers and directors of a corporation can be held personally liable for any corporate acts that break the law or breach their duty to the shareholders to act responsibly.

If you are interested in forming a corporation, I recommend *Incorporate Your Business: A Legal Guide to Forming a Corporation in Your State*, or *How to Form Your Own California Corporation*, both by Anthony Mancuso (Nolo). These books show you how to set up your own small profit corporation and also go into considerable detail on limited liability, electing Subchapter S tax status, issuing shares, holding your first Board of Directors meeting, and so on.

By the way, Nolo (www.nolo.com), the publisher of this book, provides many ways to assist you when it comes to corporations and LLCs—including assistance with state filings, helpful books, and lots of free information. Visit the site and click “Business Formation” under “Get Informed.”
Corporations bring several complications—but most entrepreneurs consider the costs and inconvenience a small price to pay for the ability to raise the capital they need. I only summarize a few issues here:

- **Record keeping in corporations.** Keeping your shareholders informed and your corporation in good standing means that you have to perform certain legal acts and pay various taxes and fees. It’s more complicated and expensive than doing business as a sole proprietor.

- **Taxes and corporations.** You can take money out of your corporation in only two ways: salaries and dividends. Both payments have to be approved by your board of directors and entered into the minutes of the company. Salaries become your personal income and are taxed at your personal rates. Dividends are payments to shareholders made only after corporate taxes have been paid. Dividends then become personal income to the shareholders and are taxed at personal rates.

- **Selling shares in your corporation.** Both federal and state regulatory authorities have many rules and regulations governing sales of corporate shares or limited partnership interests. The bottom line of all these regulations is this: You can’t take any money into your venture until you comply with the appropriate rules. These rules try to protect investors from crooks and con artists and also try to make it relatively easy to raise money for legitimate ventures. Before selling any security, or soliciting for the sale of any security, make sure you have complied with the appropriate regulations.

CAUTION

Lenders and landlords normally require that corporate officers personally guarantee any loans or leases that the corporation enters into until it has a several-year track record and a strong financial position. So, you can expect to be held personally responsible for company debts even though you form a corporation and are protected from routine business losses.
Loans and Equity Investments Compared

To raise money for your new business, you must decide whether you prefer to borrow money or sell part of your project to an equity investor. Often, you may not have many options. The person with money to lend or invest will obviously have a lot to say about it. But you should know the trade-offs you normally make by preferring one to the other:

- **Loan advantages.** The lender has no profit participation or management say in your business. Your only obligation is to repay the loan on time. Interest payments (not principal payments) are a deductible business expense. Loans from close friends or relatives can have flexible repayment terms.

- **Loan disadvantages.** You may have to make loan repayments when your need for cash is greatest, such as during your business’s start-up or expansion. Also, you may have to assign a security interest in your property to obtain a loan, thereby placing personal assets at risk. Under most circumstances, you can be sued personally for any unpaid balance of the loan, even if it’s unsecured.

- **Equity investment advantages.** You can be flexible about repayment requirements. Investors sometimes are partners and often offer valuable advice and assistance. If your business loses money or goes broke, you probably won’t have to repay your investors.

- **Equity investment disadvantages.** Equity investors require a larger share of the profits. Your shareholders and partners have a legal right to be informed about all significant business events and a right to ethical management; they can sue you if they feel their rights are compromised.

Loans are better for businesses if the cash flow allows for realistic repayment schedules and the loans can be obtained without jeopardizing personal assets. Equity investments are often the best way to finance start-up ventures because of the flexible repayment schedules.

If you don’t already know an accountant specializing in small business affairs, you will be wise to find one. Your personal tax situation, the tax situation of the people who may invest, and the tax status of the type of business you plan to open are all likely to influence your choice.
Common Money Sources to Start or Expand a Business

Most small businesses are started or expanded with money from one of seven readily available sources. They are in order of frequency:

1. the savings of the person starting the business
2. money from close friends and relatives
3. scaling back cash requirements and substituting creative cost-cutting for financial equity
4. selling or borrowing against equity in other property
5. money from supporters or others interested in what you are doing
6. bank loans, and
7. venture capital.

I recommend never financing a business with only borrowed money, even if it’s possible. If you’re starting a new business and use your own money or sell equity, you can make your inevitable start-up mistakes cheaply and survive to borrow money later, when you know how better to use it.

My general rule is that you should borrow less than half of the money you need, especially if you’re starting a new business. If you’re expanding an existing business, make sure that you can handle the cash payments necessary to repay the loan even if business isn’t as good as you hope. In other words, it’s usually more dangerous to borrow too much than too little. If you have to raise nearly all the money from others, I recommend selling equity instead of borrowing.

Now let’s look at each of the most likely funding sources for new and expanding businesses in more depth.

Money From Your Personal Savings

Most businesses are financed, at least in part, with personal savings. Sure, it’s hard to save money, but this form of financing has so many advantages, it’s worth some effort. Incidentally, savings don’t necessarily come from a bank account or piggy bank. Lots of entrepreneurs sell or refinance a house or some other valuable property to come up with cash.
Starting a business with your savings is the quintessence of the capitalist idea. As the entrepreneur with capital, you hire people, purchase equipment, and ideally create profits. It’s a long and honored tradition. Henry Ford, John D. Rockefeller, and, more recently, Steve Jobs of Apple Computer all started with at least some money from their own pockets and ended up creating industrial empires. While chances are your goals are more modest, the idea is pretty much the same.

If you finance a business with your own money, you won’t have to worry about making loan payments or keeping investors happy. Think of it this way: The more you borrow, the more you increase your fixed operating costs—making it more difficult to survive the slow periods and mistakes almost every business faces.

Another reason to start a business with savings is that you enhance your borrowing capacity for the future. The inventory, fixtures, and equipment you purchase with your cash investment are treated as assets should you later apply for a business expansion loan.

Of course, not everybody is lucky enough to be able to start or expand a business entirely from savings. But there are at least two ways you may be able to increase the amount of money you can put into your business.

**Living Expense Deferral**

People who need just a little more cash than they have sometimes take a risky—but not unheard of—step. This might more appropriately be called “borrowing from the future,” as it involves deliberately falling behind in monthly living expenses or taking cash advances from credit cards. This way of getting extra money involves risk, and it’s not for everybody.

You may have a credit card or two that has more credit available; by running your credit line to the maximum, sometimes you can obtain some cash from an unexpected source or buy material for the business. Of course, the interest rates are high, and you flirt with bankruptcy if you can’t make payments. Still, several people I know have used this method to help start a business.

If you have a good payment record with the telephone company, gas and electric company, landlord, bank, and so forth, you should be able
to skip several months’ payments without seriously damaging your credit rating. Of course, you’ll have to catch up again fast. In the meantime, you can use the money to help get your business going.

You may be able to fall behind a month or two on your mortgage payments and generate some quick cash that way. However, the mortgage holder will take the property back from you after a few months. Don’t use this method unless you’re very sure that you can become current again quickly.

**CAUTION**

This scheme should be tried only if you’re sure you’ll be able to come up with the money when you need it. As with everything else, common sense should be applied to living expense deferral plans. Otherwise, you may find yourself trying to read a foreclosure notice in a dark room.

**Trade Credit**

Arranging for trade credit involves borrowing from the companies from whom you will buy your merchandise or raw materials. This form of borrowing rarely works for service businesses, because salaries are the biggest expense and employees are usually not interested in lending you their salaries. However, I do know of a number of new businesses where friends and family members pitched in for free in the early days; it never hurts to ask.

If you’re in a retail, wholesale, or manufacturing business, arranging for trade credit can help considerably. In most businesses, you typically order supplies and pay for them 30 to 60 days after you receive them. The problem for new businesses is that it’s also standard practice for suppliers to demand cash up front from start-ups. This policy isn’t immutable, however. Often, if you present your business plan to potential suppliers, you can arrange to order at least some supplies and merchandise on credit. After all, your supplier has an interest in helping you succeed so that you will buy his merchandise for many years to come.
The key to maintaining good relations with suppliers while borrowing from them is to keep them informed of what you’re doing and why. This communication rule is particularly important for new businesses. If you arrange credit and can only pay a part of your first bill in 30 days, pay that amount and ask the supplier for a short extension.

Some suppliers may offer extended payment terms to get your business. Occasionally a supplier will ship merchandise in a slow part of the season and let you pay for it several months later, in the busy season. Before you try any of this, check with your suppliers’ sales reps about company policies. Your suppliers are invaluable to your business, and you want to keep them on your side.

**Friends, Relatives, and Business Acquaintances**

The type of financing provided by close friends and relatives does not normally vary much from that provided by strangers. The help may be in the form of a gift, a loan, or an equity investment. The big differences are usually the availability of money in the first place and the interest rate or investment return.

With friend- or relative-provided financing, however, the commercial model isn’t the only one. A common alternative is the loan-gift hybrid. Here a relative or friend lends you money at either a low interest rate, or with no interest at all, telling you to pay it back when you can and to treat it as a gift if you can’t. Obviously, this type of help is invaluable if it’s available. It gives you time to get your business established with a minimum of pressure. If you’ve any doubt about your angels’ financial position, make sure they consult their bankers, attorneys, or financial advisors before advancing you the money. Also, check with a tax advisor if you receive a substantial gift in one year from any individual, since there may be tax implications. Generally, property you receive as a gift, a bequest, or an inheritance is not included in your income. However, if property you receive this way later produces income such as interest, dividends, or rentals, that income is taxable to you. For additional information, refer to IRS Publication 17, *Your Federal Income Tax*. You can find this publication online at the IRS website www.irs.gov.
Finally, write down the terms of the loan or transaction and make sure everyone thoroughly understands them. After all, you want to feel like you can go to family reunions even if your business fails.

CAUTION

**Think twice before you accept.** Think about what a business reversal could do to your personal relationship, even if your relative or friend says they don’t need the money. I know families that have been torn apart because a borrower didn’t meet the agreements she made with a lender. Besides, a loan from a relative or close friend that comes with emotional strings probably isn’t worth the cost.

Your Money Machine

Here is a task you can start right now that will save you time and frustration. Begin writing a list of all your relatives, friends, business acquaintances, supporters, professional advisors, and so on. This list will be one of the primary sources of money for your new or growing venture, since people who know you already are most likely to be interested in your business.

One advantage of dealing with your relatives and friends is that they already know your strengths and weaknesses. They are likely to be more understanding than a banker if you have start-up problems and make a few late loan payments. Nevertheless, you’ll be wise to treat people close to you in a businesslike manner.

Don’t make the money a test of whether they love you or not. If your close relatives feel they can decline the investment opportunity without hurting your feelings, both of you will be happier in the long run. Pay attention to criticism and suggestions, especially if they come from people with business experience. If they don’t wish to invest or lend
you money, accept their reasons at face value—you might not like their hidden reasons.

Some people looking for business financing will write a business plan and loan package and then show it only to the bank, assuming relatives or friends don’t need to see it. This is a mistake. Make sure those people close to you get the benefit of all your hard work. A good business plan may even help them see you in a new light and encourage them to make a financial commitment.

**Creative Cost Cutting**

Although not really a funding source, one of the most effective ways to finance a small business is to make do with less. If your initial business proposal calls for $50,000, think about how you can reduce spending on nonessential items. Perhaps you can begin your consulting business in your home or share expensive equipment with an established business rather than buying it.

Of course, there will be many situations where you will need a fair amount of money to get started—it’s hard to cook without a stove, paint without a ladder, or program without a computer. The important principle is not that you should avoid raising outside money, but that you should borrow or raise equity capital only if you absolutely can’t do without it. For more on this concept, I recommend *Honest Business*, by Michael Phillips and Salli Rasberry (Shambala).

**Equity in Other Assets**

You may choose to raise money by selling existing assets or by pledging your equity in them as collateral for a loan. Remember, collateral is something you own that you give your lender title to until you pay back all the money you borrowed, plus interest. If you fail to repay the loan, the lender keeps the collateral. Basically, equity is the difference between the market value of property you own and what you owe against it, plus any costs necessary to turn the asset into cash.
EXAMPLE: Eric owns a car worth $9,000, but owes the bank $4,000. His equity in the car is $5,000. To convert the equity to cash, he could try to sell the car for $9,000 cash and pay off the bank loan, leaving him $5,000. If he borrows against the car, he’d probably be lent less than $5,000, since banks don’t like to finance 100% of an asset’s value.

Supporters

Many types of businesses tend to have loyal and devoted followers—in many ways, their customers care about the business as much as the owners do. Examples are as myriad and varied as the likes, loves, and desires of the human community. A health food restaurant, an exercise club, a motorcycle shop, a family counseling facility, a solar heating business, a religious bookstore, or a kayak manufacturing shop all could work, assuming you can find your audience.

As with the discussion about family members, people who care about what you do may well be willing to support you on better terms than would a commercial investor. No matter what your business or business idea, think about who you know or can get to know and who really cares about what you plan to do. Share your idea with these people and be ready to listen to them. You’ll surely get lots of good ideas, and you may be surprised at how easy it is to raise money for what people perceive as an honest and needed endeavor.

Crowd Funding Online

The Internet offers new ways of raising money for new ventures. This field is undergoing rapid development with daily changes.

For example, at this writing, President Obama has signed a new law permitting start-up companies to raise money over the Internet. But, be aware that any funding has to go through a funding portal—read, “new company that will take a fee.” And, the SEC has up to 270 days to
write the rules and regulations for this new process. You can track their progress at www.sec.gov.

In the meantime, there are other funding portals which are already up and running. The portals listed below are basically introduction services, and the hard work to convert a potential interest into a viable investment is up to you.

- **Gobig Network** (www.gobignetwork.com) offers funding for start-ups and claims that 300,000 companies have used their services.
- **Kickstarter** (www.kickstarter.com) and **Indiegogo** (www.indiegogo.com) offer people with creative projects the ability to raise money from small investors while retaining complete ownership. “Creative project” refers to innovative artistic projects as opposed to profit-making companies. Donors may receive trinkets but cannot receive ownership shares.
- **Prosper** (www.prosper.com) is a lending portal that facilitates person-to-person loans, but no equity is allowed.

As with any supplier, do your homework to be sure that the company has a positive track record and that they offer what you want, on terms you can afford.

One potential disadvantage is that selling small numbers of shares to several early investors may interfere with your ability to ramp up to bigger investors if your venture is very successful.

**Banks**

When asked why he robbed banks, Willie Sutton said, “Because that’s where the money is.” For the same reason, banks are high on the list of potential sources people ask about for business funding. Unfortunately, as far as a small business is concerned, banks act cautiously when lending out money. This makes sense when you remember that it isn’t their money.

This discussion applies to financial institutions that lend to businesses and individuals. Recent banking deregulation has made it more difficult to locate which of the various departments of institutions such as the
Bank of America, Wells Fargo, and others actually make loans, but the same fundamentals apply when you finally locate the right department and person.

Banks always want to see a written business plan along with your loan application. Banks are financial intermediaries. They pay interest to account holders to attract deposits, which they lend out to people like you. When lending, they charge enough interest to pay for their cost of funds and produce a profit. Any transaction you have with a bank will be a loan and will come with a repayment schedule. Banks try to minimize risks by making sure you have enough assets to pay them back, even if your business does badly. They don’t make equity investments in businesses.

Some commercial banks work closely with the Small Business Administration (SBA) (www.sba.gov) in offering loan guarantee programs. If you want a loan but don’t qualify under the bank’s normal guidelines, the banker may suggest that you apply for an SBA guaranteed loan. If you’re approved, the SBA guarantees the bank that you will repay the loan and the bank lends you the money. While this program can work for start-ups, it is most used by business owners wanting to expand a successful business. Ask your banker if he knows about the SBA guarantee program. (See below for background on the SBA.)

Commercial banks sometimes lend to a start-up business, but they almost always ask for collateral to secure the loan. The most banks will usually lend a start-up is half the cash needed. In addition, they usually require that you do not borrow all or most of your cash from someone else; they want you to have as much to lose as they do.

The good news about banks is that money generally costs less from banks than from other professional lenders, such as mortgage loan brokers. If the bank lending officer likes your business plan and loan application, and you have sufficient collateral, she may give you an interest-only loan for a short time, with the option of converting it to an amortized loan later. That means you can delay larger principal payments until your business has a chance to generate a positive cash flow.
EXAMPLE 1: Katherine O’Malley Pertz-Walter has saved $20,000 to start the Rack-a-Frax Fastener Company, but she needs an additional $10,000. After a careful study of her business plan, a banker grants her an interest-only loan with payments to be made quarterly for one year and takes a second mortgage on her home as collateral. At the end of the year, she must repay the entire principal. Her interest rate will probably be something like the prime rate (the interest rate charged the bank’s favored customers) plus 3%. If the prime rate is 12%, she’ll be paying about 15% interest, and her quarterly interest payment will be $375. At the end of the year, she will be obligated to repay the $10,000 in one lump sum.

EXAMPLE 2: To continue this story, let’s assume that at the end of the first year, Ms. Pertz-Walter asks the bank to convert the loan to a three-year payment schedule, including principal and interest. Based on her favorable first-year results, the bank agrees to amortize the loan rather than demand immediate repayment. She now has to make 36 equal monthly payments of $341.75. After she makes those 36 payments, the loan will be paid off completely.

EXAMPLE 3: Now let’s forget about Rack-a-Frax and switch to the story of a friend of mine. Peter Wong wanted to start a garage specializing in Italian cars in Santa Fe, New Mexico. He estimated that he needed a total of $50,000 to get his business started. He had $25,000 cash saved from his job as chief mechanic at an independent Ferrari garage and $30,000 equity in a house. He thought he was home free and confidently walked into a local bank to ask for a $25,000 loan.

An hour later he walked back out with his head spinning. The banker asked him a number of questions about monthly sales projections, cash flow, and cash for a parts inventory. Peter hemmed and hawed. It came down to this: The banker didn’t want to talk to Peter seriously until he produced a written business plan demonstrating that he understood how his business would
work. After the initial shock of his bank interview wore off, Peter went to work. Putting his plan down on paper and doing a budget encouraged him to deal with a number of details he had never thought about before. When he did, he changed his plan considerably.

Finally, Peter presented his plan to the bank loan committee. This time they offered to lend him $25,000, provided he put up the other $25,000 and give the bank a second trust deed on his house and title to all equipment purchased for the shop. The bank also asked that Peter buy a life insurance policy for $25,000, naming the bank as beneficiary. He negotiated the second trust deed on his house out of the requirements and then agreed to take the package. The terms were 36 monthly payments at a floating interest rate that was calculated at the prime rate plus 3%.

By this time, Peter and the banker, whose name was Fred, had established a good relationship. When the business got off to a slow start, Peter kept Fred informed of the problems and his plans to deal with them. Fred let Peter delay three payments in a row with no penalty. Eventually, when the business began to do well and Peter wanted to expand, Fred worked out a financing package, this time taking as collateral Peter’s accounts receivable and inventory.

**Angels and Venture Capitalists**

Angels and venture capitalists can be anyone who invests equity money in a business in the hope of future profits. While this can include any business investor, from your Aunt Rose to the largest investment banker in New York, the term often connotes a group of businesses that look for hot companies in which they can make large profits. Typically, this group won’t consider any investment smaller than $500,000 and prefers companies specializing in the emerging technological fields, where a lot of money is needed to get started and where it’s possible to
achieve enormous returns. Computers, genetic engineering, and medical technology are familiar examples.

Most readers of this book will be interested in starting or expanding small or medium-sized service, retail, wholesale, or low-technology manufacturing businesses. Large-scale venture capitalists traditionally do not invest in these areas. Fortunately, relatives, friends, business acquaintances, and local businesspeople with a little money to invest can all be pint-sized venture capitalists. Many do very well at it.

EXAMPLE: Jack Boots loved to ride dirt motor bikes on the weekends. He was frustrated that no retailer in his county carried either a good selection of off-road bikes or the right accessories. He and his friends sometimes had to drive 200 miles to buy supplies.

Eventually, it occurred to Jack to quit his job and open a local motorcycle store. He talked to several manufacturers and was encouraged. The only problem was, he would need $50,000 to swing it. As he only had $20,000, he was about to give up the idea when some of his biker buddies offered to help raise the cash. Jack found six people willing to invest $5,000 each in a limited partnership. Each of these friends was, in reality, a small-scale venture capitalist, betting a portion of his savings on the notion that Jack would succeed and they would participate in his financial success.

Jack’s Cycles opened for business and is doing well. All the limited partners were paid back their initial investments plus the agreed-upon return set out in their limited partnership agreement, and Jack is now the sole owner. The only sad part of it is that Jack is too busy to ride much anymore.

Many cities have venture capital clubs, comprising groups of individual investors interested in helping businesses start and grow. These clubs often serve as an introductory service—you receive a few minutes to discuss your business at a club meeting. If any investors want to pursue the discussion further, they make an appointment with you privately. You can use these groups to expand the list you are making of investment prospects.
You may also be able to obtain computerized lists of venture capitalists and investor magazines in which you can advertise your proposition. Often, these clubs are formed and disbanded rapidly; ask the local Chamber of Commerce or your local bankers if there is an active club in your area.

When thinking about raising money by selling a share in your business, it’s important that you have a hard-headed picture of what you’re getting into. Amateur venture capitalists or equity investors gamble on your idea for your expansion or new venture. They invest money hoping that you’ll make them rich, or at least richer. If you intend to look for equity investors, your business plan needs enough economic and marketing research to show investors that your idea has the potential of making a substantial profit. You’ll also need to show potential investors exactly how they’ll profit by investing in your business.

EXAMPLE: Jack Boots spelled out his profit distribution plans in his limited partnership document: Investors received 50% of the profits paid monthly according to their relative share of investment after he paid himself a nominal, agreed-upon salary for running the store. In addition, they qualified to buy merchandise at a substantial discount. They also owned a share of the assets of the business. Jack estimated that a $10,000 investor would receive a monthly cash flow of $200 for an annual return of 24%. When added to the partner’s investment share in the inventory of the shop, this would make a $10,000 investment worth $20,000 in three years.

Now That You’ve Proven Yourself, How About Expanding?

If you’ve been in business for at least three or four years and can show a history of profitable operations, a whole new world of financing options opens up to you. The major advantage you have over a start-up is that
you can prove what you say, whereas a start-up can’t. Be careful if you’ve been in business for less than three years or can’t show a profitable history—financing sources may consider you a start-up and put you in a higher risk category.

Take your latest two or three years’ financial statements with you as part of your business plan when you talk to any financing source. That way, the lender or investor can see where you’ve been and where you’re planning to go.

Discussed below are readily available financing sources for expanding your small business. Consider each potential source of money carefully—each has unique advantages and disadvantages as they apply to your business. Approach whatever source makes the most sense for your business first; you can try others if the first one doesn’t work.

**Trade Credit**

After you establish a reliable record of prompt payment with your suppliers, normally they will consider extending additional credit for your expansion plans. Let them know of your plans well in advance; if you begin delaying your payments to finance your expansion without notifying them, they may get annoyed. They have an interest in seeing you grow; after all, you’ll be buying more from them in the future. Sometimes they will even introduce you to their bankers and investors if you approach them with a well-thought-out business plan.

**Commercial Banks**

Remember those banks that were so hard to get money from when you started your business? Well, once you can show a profitable history, they become a lot more friendly. As an established businessperson you can often secure flexibility from banks that you might not expect. For example, they may lend you money and take a security interest in your accounts receivable. Or they may take a security interest in your inventory, equipment, or other business assets.
Equipment Leasing Companies

Leasing companies own equipment that they rent to businesses and individuals. Some leasing companies are similar to rental yards in that they have a supply of equipment on hand that they rent out. Sometimes these companies offer repair and trade-in privileges in addition to short-term rentals.

Other leasing companies—called full-finance leasing companies—do not take physical possession of any equipment. You find the equipment you want, and they buy it for you. Full-finance leasing companies have no equipment inventory and offer no return or repair services. They borrow money from a bank, so you’ll have to pay back the equipment cost plus interest and a leasing company service fee over a fixed time. Normally, you have the option of buying the equipment for an additional price at the end of the lease term. Full-finance leasing companies base their credit decisions on your company’s financial condition. They will want to see lots of financial records from your company and may request that you pledge some of your personal assets to guarantee the lease. Of course, make sure you understand what you agree to before you sign anything.

Accounts Receivable Factoring Companies

Factoring companies—also called factors—buy your accounts receivable at a discount. Then, they collect your accounts at full face value. This can be a very expensive way to raise cash—I only recommend it as a last resort. Some factors require that your accounts pay them directly instead of paying you. This can cause problems with customers, who’ll assume that you are having serious cash flow problems. Approach a factor with caution and make sure you understand the implications of the agreement before you sign it.

Factors can buy your receivables with or without recourse—that is, your guarantee of payment to the factor. Factoring with recourse means that the factor pays you a higher percentage of the receivable in cash and makes raising cash less expensive. But you can be seriously damaged if
a big account fails to pay its bill and you have to make good on your guarantee.

**Venture Capitalists**

Some venture capitalists specialize in funding businesses after they have a track record and are willing to take a smaller return as a result. The industry is changing, and more venture capitalists are looking at a wider range of possibilities and client companies. Often a venture capitalist will specialize in a market area and company size or stage of growth. The possibilities have increased, and so has the work involved in finding just the right backers.

**Money Brokers and Finders**

Money brokers and finders develop and maintain lists of investors and lenders interested in businesses. For a fee, they will circulate your financing proposal to potential money sources. A legitimate broker or finder can look at your business plan and know if he has a good chance of finding money for you.

Finders simply introduce you to possible backers; they cannot negotiate on your behalf, and they are not licensed. Money brokers are licensed and can negotiate on your behalf. Fees for both finders and brokers are comparable. I recommend that you work with people who work on a contingency fee basis only and do not require up-front fees. While some worthwhile finders and brokers require an up-front fee, there are some nonlegitimate people who take the up-front fees and disappear. Also, I recommend that you obtain references from any broker or finder and that you verify the references.

Total fees, including both up-front and contingency, can range up to 10% or 15% of the money raised, so be cautious and remember that everything is negotiable. You can contact finders and brokers in the financial section of your newspaper’s classified advertising section.
If No One Will Finance Your Business, Try Again

Let’s say that you’ve been unsuccessful in your attempts to raise money for your business from the primary sources listed above, or you have raised some money, but still need more. What do you do next? The first step is to go back to the people who initially seemed interested but ultimately turned you down and find out why. This is not a waste of time. If you get the same answer from several people, you will know what you have to work on. And then there is the possibility that someone’s circumstances have changed and they have more funds now. Remember, it took the man who invented dry paper copying 21 years to raise the money to get the first photocopier made.

If a bank lending officer, or even two or three, turned you down but you still think borrowing is a good way to fund your business, try other lending officers at other banks. A friend of mine got a $15,000 unsecured loan to improve some agricultural property just by going to five different banks. The first banker laughed him out of the office, the second banker listened to his story for five minutes and the third for ten minutes. By the time he got to the fifth bank, he knew what questions the banker was going to ask and was ready with some solid answers. The banker was impressed and he got the loan. In fact, for this very reason, it’s not a bad idea to try a longshot bank first and the most likely one last. (See Chapter 10 for ideas on how to present your business plan to bankers.)

**EXAMPLE:** Sue Lester tried all the usual sources to get the $20,000 she needed to open a piano school. One person she talked to was her Aunt Hillary, who had loaned her money to go to school several years before. This time Aunt Hillary said, “Sorry, but no.” One afternoon a few months later Sue ran into Hillary at her niece’s birthday party. Hillary asked how she was doing with plans for the school. Sue told her she was still short $10,000 and was going to try the Small Business Administration as soon as
she made one or two changes in her business plan. Aunt Hillary asked about the changes. Sue told her that an experienced teacher had suggested she charge slightly more per hour, start with a good second-hand piano instead of a new one, and try to work out a referral arrangement with a local piano store. This way she could pay herself more salary and wouldn’t need to take another job to make ends meet. Hillary asked to see the changes when they were complete.

After Sue showed the revised plan to her Aunt Hillary, she offered to lend her the money. Sue was both delighted and curious. When she asked, Aunt Hillary said there were two reasons for her change of heart. First, she was pleased that the more realistic sales projections left Sue enough money to live on so she would be able to keep her enthusiasm for the hard job of creating a new business. Second, she had sold a small piece of land for more than expected and now had the money to lend.

Secondary Sources of Financing  
for Start-Ups or Expansions

Let’s assume you have tried all of the primary sources of financing small businesses at least twice, and have been turned down each time. Is it time to head for the showers? Not if you really want to start your business. If everyone turns you down, you have no choice but to get creative. Remember Knute Rockne’s exhortation, “Winners never quit and quitters never win.” Here are some suggestions.

Small Business Administration

Many years ago, Congress recognized both that small businesses provide most of the employment and growth in the country and that they have a great deal of trouble borrowing money because large corporations tend to hog too much of the loan money from banks. As a result, Congress
created the Small Business Administration (SBA) and several other
government organizations specifically to help small businesses compete
with larger corporations for loans.

While the SBA can make direct loans to small businesses, it usually
guarantees loans from commercial banks. The SBA will guarantee
85% of a bank loan up to $750,000 if the loan meets SBA criteria.
These criteria are not as difficult as some readers may think. Typical
requirements include that the borrower show profits for at least two
years, that the borrower work in the business full-time, and that the
borrower have some real or personal property available to offer as
collateral.

Some bankers are strongly interested in working with loans guaranteed
by the SBA since the bank can make a fee by processing the loans and
later selling them to other financial institutions. Since the bank’s fee is
based on the size of the loan, such banks are typically only interested in
processing loan requests for more than $50,000.

Many banks treat SBA loan origination as a profit center and
aggressively seek out borrowers. Some of these banks offer assistance
in completing the SBA forms for a fee and offer quick turnaround
on decisions. If any banks in your area offer this service, make an
appointment with a loan officer specializing in SBA loans. Chances are,
he will be able to estimate your chances of success based on reading your
business plan. Loan approvals sometimes take place as soon as a week
or so after you complete all the paperwork. The SBA’s past reputation of
being hard to deal with and not very cooperative seems to be changing!
That’s true for the guarantee program, at least.

Your chances of receiving a direct loan in a reasonable time from the
SBA will be greatly enhanced if you qualify for a preference category.
For example, if you are disabled or a veteran, requirements are slightly
less restrictive. Ask your local SBA bank or SBA office about some of the
direct loan programs.

There are also small private business lending companies that perform
a function similar to a bank’s function in assisting small businesses
obtain SBA financing. To get names and addresses of organizations in
Small Business Investment Companies (SBICs)

A Small Business Investment Company (SBIC) is a corporation established with the assistance of the SBA to lend money to small businesses. Some SBICs serve minority enterprises, and are called Minority Small Business Investment Companies (MSBICs). An SBIC can borrow up to four times its invested capital from the SBA. It then lends out these funds to other businesses, aiming to make a profit on each loan transaction. There are some 400 of these across the country, each with different investment goals and objectives. For more information on business financing, click “Loans & Grants” on the SBA home page (www.sba.gov). The SBA site also offers a list of SBIC addresses and areas of investment specialty. And, you can call their helpline at 800-827-5722 or email them at answerdesk@sba.gov.

USDA Rural Development

This loan program is aimed at businesses that provide jobs in rural America. Business loans through the U.S. Department of Agriculture’s Rural Development program (formerly the Farmers’ Home Administration or FmHA) are guaranteed in towns with a population of 50,000 or less or in suburban areas where the population density is no more than 100 per square mile. Use of the loans varies considerably; loans have been made to enable a grocery clerk to buy the store he worked in and for someone to buy a McDonald’s fast food franchise. Rural Development loans are normally made through a local bank. For information on these loans click “Loans” at the USDA Rural Development website (www.rurdev.usda.gov). At the website you can also locate the nearest USDA Service Center. Loans under this program often take months to complete, so allow plenty of lead time.
Economic Development Administration (EDA)

The EDA, which is part of the Department of Commerce, makes or guarantees loans to businesses in redevelopment areas—city areas with high unemployment. Eligible areas are listed in a publication available quarterly from the regional EDA director. Contact your local SBA office to locate the regional EDA director. If you’re in one of the designated redevelopment areas, this program bears looking into. For more information, check online at www.eda.gov.

Federal, State, and Local Programs

Other federal programs are published in the Catalog of Federal Domestic Assistance, available from the U.S. Government Printing Office, Washington, DC 20402, or at your library, or online at http://bookstore.gpo.gov. There always seems to be a variety of programs available from the federal government, so this directory is worth checking if you’re interested in government money.

All states and many local governments have a number of aid programs available to help businesses create jobs. These are normally called development agencies or development administrations. You can find out about them by contacting your local Chamber of Commerce or by asking a banker.

Overseas Private Investment Corporation (OPIC)

OPIC is a self-funded U.S. government agency that makes direct loans and loan guarantees and insures private businesses against political risks in developing countries. The ideal candidate for assistance is an American company that enters into partnership with a well-established foreign business. To learn more about this agency, check online at www.opic.gov or call 202-336-8400.
Insurance Companies and Pension Funds

You may have heard about the possibility of borrowing money from insurance companies or pension funds. Normally, neither is a viable lending source for small businesses. Some insurance companies have a small fund they can invest in businesses, especially if you can offer a combination of loans and investments. However, most small businesses will find money from less restrictive sources long before they make an application to an insurance company.

Advertising Your Project and Selling Stock to the General Public

Advertising and selling corporate stock to the general public through a public offering is very different from selling stock to your friends, relatives, and business acquaintances. Unless your corporation qualifies for an exemption, you must register every issuance of corporate stock with the federal Securities and Exchange Commission (SEC) and the state securities agency. Registration takes time and costs money. Following any of these procedures requires a knowledgeable attorney—don’t try it without help. It can be an expensive, time-consuming process that can easily cost $200,000 in attorneys’ fees, accountant fees, and printing expenses just to meet government filing costs.

Fortunately, however, smaller corporations usually qualify for state and federal securities laws exemptions. For example, SEC rules permit the private sale of securities without registration if all of the shareholders reside in one state and all of the sales are made in the state. This is called the “intrastate offering” exemption. Another federal exemption allows a “private offering” of shares without registration. A private offering can be a sale, without advertising, to a limited number of people (35 or fewer is often used as a yardstick even though the federal statute does not mention a number). Another way to qualify for a private offering exemption is to only sell, without advertising, to persons who, because of
their net worth or income-earning capacity, can reasonably be expected to take care of themselves—that is, they can adequately assess the risk and bear the cost of investing in the business, without needing the protections afforded by the registration procedures of the securities laws. Most states have enacted their own versions of these popular federal exemptions.

For more information about SEC small business exemptions, visit the SEC website at www.sec.gov. The question and answer portion of the small business information section contains a great deal of useful information, in easy-to-understand language.

**Conclusion**

There you have it—the primary and some secondary sources of finding money to start your business. If you really believe in your idea, complete the business plan outlined in the rest of this book. Then contact all the sources listed above. If you have a good plan and refuse to take “No” for an answer, you will find the money you need. The Chinese say the longest journey begins with a single step. Let’s get started.