Checking Out All Your Financing Options

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If you were to ask random people on the street where they thought most small businesses got their start-up money, they’d probably answer, “From banks.” They’d be wrong. Although banks might be eager to step in after your infant business has started to walk, they’re likely to remain notably absent during its labor pains and birth. Most small businesses need to make creative use of personal resources, draw on their credit cards, and get financial help from friends, family, and associates in these early stages. And that’s not necessarily a bad thing. This book was written to help you understand why money from people you know is the best financing option for many start-up businesses—and how to make it work for you.

UPS Began With a Loan From a Friend

In 1907, Jim Casey borrowed $100 from a friend to start a bicycle messenger business in Seattle, Washington. In 1919, the business expanded from Seattle to Oakland and changed its name to United Parcel Service. Today, UPS is the world’s largest package delivery company, with over $36 billion in sales. (See www.ups.com/content/corp/about/history/1929.html.)

If you do a little digging into business history, you’ll find that borrowing money from family and friends is the stuff of entrepreneurial legend. But these success stories don’t mean that you should just start ringing up wealthy relatives, or hitting up neighbors at the block party, without some preparation. Whether your business is at the dream stage, at the planning stage, or actually up and running, you essentially won’t know what to ask for until you take stock of all your options for financing your business start-up or expansion. This chapter provides a crash course in small business financing that will provide a strong foundation for your fundraising efforts.
Small businesses are the backbone of the economy. Small businesses (defined as having fewer than 500 employees) in the United States represented 99.7% of all businesses and generated nearly 80% of new jobs in the past few years. (Source: Small Business Profiles for the States and Territories, 2009 Edition, U.S. Small Business Administration.)

Your Choices for Small Business Financing

Money from friends, relatives, and associates is only one of many sources that entrepreneurs like you might use to launch and grow a business. Let’s take a closer look at all your possible sources, to see where this particular type of financing fits in.

The first table in this section (“Primary Sources of Financing for a Growing Business”) lists sources of capital—loans or equity investments (purchases of ownership shares)—generally available to businesses. The second table (“Typical Sources of Financing by Stage of Business”) matches each source of capital with the stage at which it becomes a realistic option for a growing business. You won’t be surprised to see that most entrepreneurs use their personal resources (such as credit cards), help from family and friends, and similar informal sources to get their business going.

The reason for this is that, put bluntly, most entrepreneurs don’t have any other choice. Even if you’re still wary of asking for money from people you know, they may be your most realistic option while your business is young and you have no or very few customers. Until your business begins generating significant revenue, you are only the tiniest dot on the radar screen of banks, venture capitalists, and other institutional investors. Research and common sense reveal that your best bet at this early stage is to seek the money you need from within your own resources, any business assets you’ve already put in place, and your circle of contacts.
### Primary Sources of Financing for a Growing Business

<table>
<thead>
<tr>
<th>Source of Financing</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entrepreneur’s personal resources</td>
<td>Salary from current job, savings, home equity, retirement plan, credit cards</td>
</tr>
<tr>
<td>Relatives</td>
<td>A gift, a loan, or an equity investment</td>
</tr>
<tr>
<td>Friends, mentors, former employers, business associates</td>
<td>A gift, a loan, or an equity investment</td>
</tr>
<tr>
<td>Suppliers</td>
<td>Extension of trade credit</td>
</tr>
<tr>
<td>Business angels</td>
<td>Loan or equity investment</td>
</tr>
<tr>
<td>Banks and commercial lenders</td>
<td>Commercial loan</td>
</tr>
<tr>
<td>Venture capital</td>
<td>Equity investment</td>
</tr>
</tbody>
</table>

### Typical Sources of Financing by Stage of Business

<table>
<thead>
<tr>
<th>Stage</th>
<th>Research</th>
<th>Commitment to Start Business</th>
<th>Product Development</th>
<th>Launch</th>
<th>Early Growth</th>
<th>Growth Problems/Barriers</th>
<th>Midlife Growth</th>
<th>Maturity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level of revenue</td>
<td>0</td>
<td>0</td>
<td>Under $100K</td>
<td>Under $100K</td>
<td>Under $500K</td>
<td>$500K–$1M</td>
<td>Over $1M</td>
<td>Over $5M</td>
</tr>
</tbody>
</table>
Minimizing the Amount You Need

Before you start planning to ask your Aunt Millie for a million dollars, think pragmatically about how much money you really need to launch your business. Experts recommend you start on a shoestring. Pouring too much money into a business at the beginning can be a mistake—and it’s a mistake that many entrepreneurs make. A fair number of small businesses fail in their first year, so you’re only asking for trouble if you raise and spend a lot of money, particularly for an untested business idea.

Starting on a shoestring means making the most of every dollar you have and not incurring costs that aren’t absolutely necessary. For example, do you really need that corner office in the newly renovated industrial building downtown, or can you get your enterprise going from your garage? Do you have to buy a new computer, or can you use the household computer after the kids’ homework is done? Can you lease, rather than buy, space and equipment? Some say that a true entrepreneur sees an opportunity where others see a resource shortage. The more you can do with less, the further you’ll be able to grow your business, and the better your prospects will look when you begin seeking external money.

TIP

**Starting your business on the side?** Check out *Running a Side Business: How to Create a Second Income*, by Rich Stim and Lisa Guerin (Nolo) for advice on launching a new business while you’re still working at another job.

Leasing rather than buying expensive equipment is one of the most cost-effective ways to avoid sinking too much money into an untested business. For example, your fine textiles business may depend on that 19th century, $45,000 loom you found; but until you’re actually selling the $500 all-natural blankets it can produce, you might be better off leasing the loom (on a monthly basis) from the owner first. By lowering your monthly outlay, you also save your start-up cash for other items that you have no choice but to purchase with cash, such as printed materials and office supplies.
TIP

You may need less total start-up capital than you think. According to an Inc. 500 analysis of America’s fastest-growing companies in 2002, over 40% of the CEOs surveyed had launched their companies with less than $20,000:

- 14% started with less than $1,000 in capital.
- 27% started with $1,000 to $10,000 in capital.

Tapping Into Your Own Resources

You probably already have firsthand experience digging into your own pockets to get your business going. Typically, at the earliest stages, entrepreneurs rely on personal resources, including savings and credit cards, existing business assets, or personal contacts. Here are some of the places you might go for start-up money of your own.

Check All Your Pockets for Cash

To make sure you haven’t forgotten any possible sources of your own money, consider these options:

- **Your salary.** Don’t give up your day job! A steady income, even if you reduce from full-time to part-time as you get your business off the ground, can keep you solvent.
- **Personal savings.** You might use savings accumulated over the years, or a lump sum payment you’ve received, such as an inheritance or a severance package.
- **Equity in your home.** You can use the equity in your home—the difference between what the home is worth and the remainder due on the mortgage—to generate cash in a few different ways. You could refinance the home with a larger mortgage that pays off the old one and yields some extra cash for you. Or, you could get a line of credit, where the bank takes out a second mortgage on your home and gives you a checkbook allowing you to write checks up to the amount of your loan.
- **A loan from your retirement plan.** Check the terms of your plan carefully, but if loans are allowed for business purposes, this
may be a good use of your own money. Plus, you’ll be paying interest back to yourself. But be careful in borrowing from an IRA; it may be treated as a withdrawal and you’ll have to pay a penalty tax to the IRS if you’re not yet 59½ years old. For more information, see the article “Getting Your Retirement Money Early—Without Penalty” on Nolo’s website at www.nolo.com.

• **Your credit cards.** Credit cards are a convenient, short-term way to finance your business. In fact, nearly three-quarters of U.S. small business owners say they have relied on credit cards for business purposes at some point. Obviously, credit cards are a terrible long-term method, since their interest rates can exceed 20% if you take a long time to pay. Plus, these days the credit crunch has translated to lower credit limits and tougher access to these cards for business owners.

But do you have to dig into your own pockets? The short answer is “yes.” No one else is going to believe in your business if you don’t—and to prove your belief, you’ll need to put your own “skin in the game,” at least to the extent you can afford it. Some lenders may want to see you exhaust your savings account, max out your credit cards, and borrow against any home equity, 401(k), or other retirement accounts before you begin reaching for their money.

Just how deeply you dip into your personal well will be used by some private lenders as a criterion for getting involved. I’ve heard it referred to as a “straight-face” test: Can you honestly ask others to put their money at risk if you (and your family) have not done the same? Furthermore, lenders believe that you’re less likely to walk away when the going gets rough if a sizable amount of your own money is at risk.

Of course, risking your own skin doesn’t mean bleeding yourself dry. You’ll need to establish a reasonable limit on the level of your personal investment and then stick to it. If you find yourself in discussion with prospective lenders who are pushing you to overextend yourself by borrowing against a retirement plan or taking a second mortgage on your home, step back and reevaluate your plans.
**TIP**

Look before you leap into a new home mortgage to finance your business. This is your home that you’re putting on the line—don’t borrow so much that your very ability to make your monthly payments is put at risk. Your payments should remain low enough that even if your business is slow to get going, you’ll be able to cover them. Also remember that every new mortgage comes with fees and closing costs. Make sure these don’t add up to a thousand dollars or more if your goal is to borrow only $5,000 to $10,000 for your business.

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**Find Cash in Existing Business Resources**

You may not think you have much in the way of business resources, especially if you’re operating on a shoestring out of your home, garage, or barn. But look around again at the customers, suppliers, and equipment that you’ve accumulated so far, and you may be pleasantly surprised. A little creativity will lead you to ways to make the most of the business resources—the assets and the relationships—that you already have in place. Here are three suggestions.

**Make good use of trade credit.** Find out whether you can buy the goods or services you need on credit, meaning that the supplier won’t require you to pay your bill for 30 or 60 days. This gives you some time to earn the income you’ll need to pay back the supplier. A supplier with whom you’re on good terms may even allow you to spread your payments out across several months with no finance charges, as long as you keep up. Even if the supplier charges an interest rate, the rate may be considerably lower than you’d have to pay if you used your credit card to finance the purchase. Nearly two-thirds of U.S. small businesses reported in a recent study that they use trade credit as a form of business financing.

**Explore the possibility of sale- or lease-backs.** If you already own a piece of equipment or real estate, you can sell it to someone else, and then lease it back for your business use. Be cautious with these transactions, however. Make sure the fees are affordable, and look carefully at the fine print: Some overly clever buyers put in a contract clause saying that you can lose the asset if you’re late on a payment.
Enter the complex world of factoring your accounts receivable. If you already have customers, you may have accounts receivable—that is, a money owed you for products or services you provided. Accounts receivable are business assets and you may be able to sell them to a factoring company. The factoring company advances you 80 to 90% of the value of your receivables and collects on them as they are paid. If you go this route, shop around for the company that will give you the best rate, and be careful of signing away additional business assets as collateral.

Ask Family and Friends for Money

Asking family and friends for money—the main topic of this book—is often the next stage in your quest for start-up capital. A gift or loan from someone you know can fill a critical gap in the growth of your business. It allows you to lean on your friends’ and family’s trust and support to grow your business to the point where you’ve amassed the revenue, assets, and credit history usually required before banks or professional investors will invest.

TIP

Did you know? Private loans are such a common source of small business financing that MBA students and finance professionals put a name to the practice. They use the phrase “the 4Fs” when referring to money put into a new business by “founders, family, friends, and foolhardy strangers.”

Borrow From a Family Trust

Setting up a trust is a common estate planning practice; however trusts have limited withdrawal capabilities. One way to access this capital is to set up a loan from the trust. A disbursement structured as a loan and repaid to the trust may be feasible, depending on the type of trust, but check with your attorney to see if this option is viable for you.
Borrow From a Self-Directed IRA

Self-directed IRAs are just that: IRAs where you get to choose your own investment vehicles, rather than picking from some list prescribed by the company that holds your account. Though the IRS rules governing such loans are highly specific and must be followed precisely, in some cases siblings, aunts, and uncles can lend to your business from their self-directed IRAs. See “What to Tell Your Prospect About Self-Directed IRAs” in Chapter 8.

TIP

It’s never too early for a business plan. Be sure you have a clear idea of the market and product and services you want to offer, and a good estimate of start-up income and expenses, before checking out any potential financing sources. Chapter 5 explains how a solid business plan is crucial to your fundraising efforts.

Connecting With a Bank or Other Institutional Lender

Although banks themselves can be found on virtually every street corner, bank money to launch your business can be harder to come by. Once you’re up and running, bank financing is an important resource. But until your business has launched a product or service and has paying customers, your average bank or other traditional lender will probably view you as too great a risk for a commercial loan. Of course, if you’re willing to put your personal credit rating at risk, you can go to a bank for a personal credit card, a personal loan, or a line of credit secured by the equity you have in your home or other collateral. Many entrepreneurs do this to get started, as described above.

If you’re applying for a commercial loan with your business as the borrower, the bank will typically want to see that you’ve figured out how to make a profit and that you have the business assets to protect
the loan. Many businesses don’t reach that stage until as late as their third year of operation. When you get to this point, you’re considered “bankable.” It’s getting to this point that can be a challenge. See “How Banks Choose Whom to Lend Money To,” below, for the five hurdles institutional lenders tend to set for business loans. If you can’t fly over the bars, you’re out of the race, at least until your numbers improve.

Although traditional bank loans tend to be reserved for established businesses, some banks and other financial institutions do offer small business loan programs, because they can get help from the federal Small Business Administration (SBA) to lessen the risk you represent. Once you’ve hung out your shingle, take a trip to the bank (either the neighborhood, credit union, or the mega-variety, in person or online) and ask whether it has a small business loan program.

TIP

It’s never too early to strike up a relationship with a local loan officer. A local banker will have a good sense of the financing options available to you and can help you see the larger picture when it comes to the financial structure of your business. Your banker will also probably have experience helping other entrepreneurs in your community launch businesses and can recommend resources you should take advantage of. It’s in the banker’s interest that you successfully get your business off the ground and grow it until you run through your sources of informal capital—at which point you will presumably return to your friendly banker for bank capital.

CAUTION

Has a bank rejected your loan application? If you’re raising private money from people you know because you have, in fact, been rejected by a bank or other lender, make sure that you understand and address whatever concerns led to the refusal—before you ask anyone else for money. It’s worth taking the time to fix any problems, whether the problems relate to your business plan, a poor credit history, or your personal financial situation. If you don’t do this vital repair work, you may end up subjecting your friends and family to risks that professionals spotted—and you knew of but did nothing about.
How Banks Choose Whom to Lend Money To

Banks exist to make money. That means that, whatever their ads may promise, before a bank lends money, it takes steps to ensure that it will be paid back. The criteria that banks use to evaluate applications are traditionally referred to as the “five Cs” of credit. You’ll want to understand these criteria for two reasons: First, to appreciate how much more flexible private lenders will probably be, and second, as preparation. By mimicking the type of application you’d prepare for a bank when approaching friend-and-family lenders, you’ll enhance your appearance of professionalism and be prepared to allay their possible concerns.

- **Capacity** to repay is the most critical of the five factors. Any prospective lender, whether it’s a bank or your Cousin Jane, will want to know exactly how and when you intend to repay the loan. To measure your capacity, banks will examine your business’ expected cash flow, your intended schedule or timing for repayment, and your own personal trustworthiness when it comes to repaying loans. For that last piece of the analysis, the bank will look hard at your payment history on existing credit relationships—both personal and commercial.

- **Capital** is the money you have personally invested in the business. Lenders will want to know how much you stand to lose should the business fail. Prospective lenders and investors will expect you to contribute your own assets and to undertake personal financial risk before asking for outside funding. It stands to reason that if you have a significant personal investment in the business, you’re more likely to do everything in your power to make the business successful.

- **Collateral** is an additional form of security you can provide the lender in case you can’t repay on your own. Collateral means assets such as equipment, buildings, accounts receivable, and, in some cases, inventory that the bank can sell for cash. Most commercial lenders will require collateral on a risky start-up loan. Both business and personal assets can be used as collateral for a loan.
### How Banks Choose Whom to Lend Money To (continued)

- **Conditions** refers to the use of the loan money. Lenders understandably want to know how their money will be spent. Many banks prefer to know that the money will go directly toward making more money by building assets for your business, such as working capital, new equipment, and inventory. They are not as keen on paying for salaries, market research, or your overhead costs.

- **Character** is the personal impression you make on the potential lender or investor. The lender decides subjectively whether or not you are sufficiently trustworthy to repay the loan or have sufficient business skills to generate a return on funds invested in your company. A bank will review your educational background and experience in business and in your industry. It will also judge the quality of your references and the background and experience of your employees.
Florist Uses Family Loan to Overcome Poor Credit Rating

When Jack needed funds to open his flower shop, he approached his sister for a loan. “To own my own business—a creative business—has been my dream from a fairly young age,” said Jack. Unfortunately, though a master at dreaming, Jack wasn’t always good at handling money. He’d racked up a history of not paying his bills on time, which had led to repossession of his car and a less-than-mediocre credit rating.

So, when Jack felt ready to raise funds for his flower business, he figured that going to a bank would involve “a lot of paperwork and possibly end in rejection.”

But Jack believed that his older sister, Grace, would support his plans. To prove that he was serious about paying her back, Jack wrote up a formal loan request and proposed a repayment schedule that he knew he could meet. Grace agreed to the loan. “Where Jack is concerned, my head said, ‘Uh-oh, don’t do this,’ but my heart said, ‘He’s my brother.’ I ended up bridging the conflict between my heart and my mind by formalizing the loan with a promissory note,” Grace says. She knows loaning her brother money is always a gamble, but she says he has a special kind of collateral. “I won’t be happy if he defaults on the loan. I really don’t expect it, but it’s not like I will kick myself for loaning my brother money. I love him and was able to help him and it’s all good karma.”

The pair set up a $10,000 loan with 7.4% interest, to be repaid monthly for four years. Jack successfully repaid the entire loan. His reliable repayment record led his sister to make him a second loan a few years later, to open up a second shop in a nearby town.

Jack’s Flowers is now doing well and, most important, so is Jack and Grace’s relationship. Of private lending, Jack says, “I think it’s a good way of borrowing money, of getting the capital you need to get past some sort of financial obstacle, without going through a bank.”
Small Business Administration (SBA) Loan Programs

Most small business loan programs are associated with the Small Business Administration (SBA), the federal agency charged with supporting U.S. small businesses. The SBA encourages banks, credit unions, and nonprofit financial intermediaries around the country to lend to small businesses. The SBA sets guidelines for the loans while bank lenders and nonprofit development finance institutions actually make the loans to small businesses.

SBA 7(a) Loan Guaranty Program

One of the most popular SBA programs is the 7(a) loan. Here’s how it works: You can receive up to $750,000 from your local 7(a) lender, with a partial guarantee from the SBA. The SBA doesn’t actually lend you any money, but provides backup to the bank or lender who does, to reduce the amount of risk that your lender takes on. For loan amounts and interest rates, see “Interest Rates Under the SBA 7(a) Loan Program,” below.

RESOURCE

For details on SBA programs, see www.sba.gov which offers a wide variety of resources, tools, and services to small businesses. The “Finance Start-Up” section under the Small Business Planner tab (see www.sba.gov/smallbusinessplanner/start/financestartup/index.html) has lots of useful information on SBA programs, such as the 7(a) loan program.
Interest Rates Under the SBA 7(a) Loan Program

The interest rate charged on a 7(a) loan is decided between the borrower and the lender but is subject to SBA maximum levels. These limits are determined by adding a set number to the prime rate (the rate at which banks lend to their most creditworthy customers). The SBA allows lenders to charge you any rate as long as it doesn’t exceed the limits they set, which vary with the prime rate. Over the last ten years the prime rate has ranged from less than 4% to a high of 9.5%. You can look up the current rate by doing an Internet search on the phrase “prime rate.”

To determine the maximum interest rate you could be charged for an SBA 7(a) loan, you need to know three things:

- the current prime rate
- how much money you need to borrow, and
- how long it will take you to repay it (less than or more than seven years).

The table just below shows you how much to add to the prime rate given the amount and the term of your request.

<table>
<thead>
<tr>
<th>SBA 7(a) Loan Program Maximum Addition to Prime Rate</th>
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<table>
<thead>
<tr>
<th>Loan Term</th>
<th>Loan Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>&lt;$25,000</td>
</tr>
<tr>
<td>Less than 7-year term</td>
<td>+4.25%</td>
</tr>
<tr>
<td>Greater than 7-year term</td>
<td>+4.75%</td>
</tr>
</tbody>
</table>

The next table uses the current prime rate to show you what July 2009 interest rates for these types of loans look like. For example, a loan for $40,000 with a term of less than seven years could have cost you as much as 6.5% in July 2009.

<table>
<thead>
<tr>
<th>Maximum Interest Rate Charged If Prime Rate Is 6.25%</th>
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<table>
<thead>
<tr>
<th>Loan Term</th>
<th>Loan Amount</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>&lt;$25,000</td>
</tr>
<tr>
<td>Less than 7-year term</td>
<td>7.5%</td>
</tr>
<tr>
<td>Greater than 7-year term</td>
<td>8%</td>
</tr>
</tbody>
</table>

For information on SBA loans, see www.sba.gov/financing/index.html.
Nonprofit and Community Lenders

In most parts of the country, there are nonprofit organizations that can provide you with business capital and sometimes also free business assistance in the interest of economic development for the community. Many of these organizations serve as financial intermediaries (known as community development financial institutions (CDFIs) and micro-lenders) between the entrepreneur and government and foundation capital sources, and specialize in loans that create jobs and business ownership for disadvantaged groups and communities.

The fact that these are “do-good” nonprofits doesn’t mean you should expect a handout. The interest rates they charge for a small business loan can be just as high as banks, and sometimes as high as credit card rates when they take a risk on a business that banks won’t touch. However, often these loans also come with technical assistance to give you and your business the best chance of success.

In other words, these organizations provide access to capital for individuals and businesses who might not otherwise be able to get it. Many reach out to the smallest businesses, sometimes known as microenterprises, for certain groups—for example, women, veterans, and immigrants (see “Does Your Business Qualify for Microenterprise Assistance?” below). Others aim to support medium-sized firms that achieve community development goals, like job creation or minority business ownership. Many of these organizations serve a particular region (like an urban neighborhood) or a particular group (like immigrant entrepreneurs). Whatever their mission, they have a common purpose: to “level the playing field” and encourage economic growth among entrepreneurs whom traditional lenders might not consider bankable.
Does Your Business Qualify for Microenterprise Assistance?

A microenterprise is, as you might guess, a very small business. Specifically, it’s a business with five or fewer employees that requires $35,000 or less in start-up capital and that lacks access to the traditional commercial banking sector. In addition, the term microenterprise tends to be used to describe businesses run by entrepreneurs who are low income or are struggling to make ends meet. There may be at least 20 million microenterprises in the United States, and possibly more. The good part about being so small is that hundreds of nonprofit organizations around the United States are eager to provide a helping hand. Many of these are the lenders for the SBA Microloan (7m) Program, a start-up loan program to which even the newest businesses can apply. Although the maximum loan under this program is $35,000, the average loan is approximately $10,000. One catch is that microloan borrowers typically have to enroll in technical assistance classes administered by the nonprofit intermediary making the loan. For some entrepreneurs, this is a great resource, providing cost-effective business training.

RESOURCE

More information on microenterprises:

- **SBA Microloan Program.** To find a microloan lender in your state, search the SBA site (www.sba.gov) for microloans. See www.sba.gov/services/financialassistance/sbaloantopics/microloans/index.html for a list of SBA microloan intermediaries.
- **MicroMentor, www.micromentor.org.** If you’re just getting started, this website will help you locate a business mentor.
- **Association for Enterprise Opportunity (AEO).** This organization helps entrepreneurs connect with local microenterprise resources. See www.microenterpriseworks.org and check out “Find an AEO Member Near You” for details.
How to Check Out Social Lending Networks

Recently, more and more entrepreneurs are turning to online networks to raise business capital. Prosper.com and LendingClub.com are two online networks that enable entrepreneurs to post a request for a loan much like a classified listing. Borrowers list what they want to use the money for and undergo a credit assessment. Investors then evaluate which borrowers they want to finance. Online networks are relatively new and only a small percentage of entrepreneurs who post listings successfully get funding, usually at interest rates of 15% to 20%. However, online networks are gaining in popularity and they are part of a global trend of applying social networking to banking. Entrepreneurs should consider comparing rates available from these networks with other options.

Equity Financing and Angel Investors

You’ve probably heard stories from the once-promised land of professional equity investing or venture capital—million-dollar investments from high-rolling companies with endlessly deep pockets, and the like. Putting aside the hype, the basic idea is that, after an exhaustive review of your business opportunity, a venture capitalist gives you cash (usually $1 million or more) in exchange for shares in your business. (The actual price of the shares depends on how much you and the investor agree the business is worth—known as valuation—at the time the investment is made.) If all goes well, the investor eventually (usually, in three to seven years) exits the company by selling the shares to new investors, at many times the original price he or she paid you. If the ending is not so happy, venture capitalists get lower-than-expected returns (or no returns at all) and disappoint the people who invested in their venture capital firm.

The best part of equity investing from your perspective is that you get all the money up-front, you don’t have any payments along the way, and your investor gets money back only if your company does so well that all the owners are grinning. Sounds like a great deal, right? Well, hold on a minute. If you’re contemplating sending your business plan to
a list of venture capital firms you found on the Web, you may want to save your time.

The allure of venture capital beckons to most entrepreneurs, but in fact only a small group of companies with rapid growth potential actually get funded, and fewer yet are start-up and early-stage businesses—increasingly, venture capitalists direct their investments toward established and expansion-stage companies that are already profitable.

However, this doesn’t mean you should write off equity capital as a source of money to start or expand your business. Although venture capitalists are probably an unrealistic target for most start-up businesses, there are other people out there who may want to invest in, rather than lend money to, your young business. You may be lucky and have some wealthy friends, family, or colleagues who can make an equity investment in your business. Or you may find a “business angel,” an affluent individual, often a successful entrepreneur, who invests in up-and-coming entrepreneurs like you.

**RESOURCE**

To learn more about angel investors, visit the Angel Capital Education Foundation (www.angelcapitaleducation.org). The “For Entrepreneurs” section includes a listing of angel groups nationwide.

Should equity financing become a serious possibility for your business (or someone asks about it when you approach them for a loan), you will need a solid business plan and an experienced attorney to craft a legal agreement unique to your financing situation and help you comply with securities laws. (Securities laws regulate the offering of corporate shares and (usually) LLC membership interests.) But only do so, after you get some solid business advice and consider all the issues, including:

- whether or not you need to change your legal structure (only a corporation or an LLC can sell an ownership interest), and
- the pros and cons of sharing of management and decision making (and ultimately any profit, assuming you succeed) with an outside investor.
TIP

Even if no one in your current circle is a likely equity investor, keep this type of financing in mind. If your business does well, it may not be long before you begin generating the revenue and showing the profit potential to attract professional equity capital. If any close relatives or friends want to invest in your company, make sure they understand all the risks and don’t get in over their heads. (You’ll also want to make sure that they have the right temperament and experience to join your business venture.)

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<thead>
<tr>
<th></th>
<th>Loan Capital</th>
<th>Equity Capital</th>
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<tbody>
<tr>
<td><strong>Advantages</strong></td>
<td>The lender has no management say or direct entitlement to profits in your business.</td>
<td>Investors are sometimes partners or board members and often offer valuable advice and assistance.</td>
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<td></td>
<td>Your only obligation to the lender is to repay the loan on time. Loans from close relatives can have flexible repayment terms.</td>
<td>You can be flexible about repayment requirements.</td>
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<td></td>
<td>Interest payments (but not principal payments) are a deductible business expense.</td>
<td>If your business loses money or goes broke, you probably won’t have to repay your investors.</td>
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<tr>
<td><strong>Disadvantages</strong></td>
<td>You may have to make loan repayments when your need for cash is greatest, such as during your business’s start-up or expansion.</td>
<td>Equity investors require a greater share of your profits than interest on a loan.</td>
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<td>You may have to assign a security interest in your property to obtain a loan, which may place your personal assets at risk.</td>
<td>Your investors have a legal right to be informed about all significant business events and a right to ethical management.</td>
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<td></td>
<td>Under most circumstances, you can be sued personally for any unpaid balance of the loan, even if it’s unsecured.</td>
<td>Your investors can sue you if they feel their rights are being compromised.</td>
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How Business Advisers and Mentors Can Help With Your Financing

This book provides lots of useful advice and resources for raising money for your business. An experienced, trusted adviser can be invaluable in your fundraising efforts (among other key tasks in starting a business). Here are some ideas for finding one.

**Mentors.** To find a local mentor, ask for referrals from friends and colleagues, or look into mentoring programs offered by local industry groups. You can also access free business advice through the SBA’s national network of Small Business Development Centers (SBDCs). For example, SBDCs commonly offer free workshops and can arrange for a business counselor to meet with you to review your business plan (more on business planning in Chapter 5). SCORE, the Service Corps of Retired Executives, is another nationally organized network that provides quality business advice to entrepreneurs. Better yet, SCORE advisers will meet with you one on one, for free. Both the SBA and SCORE have excellent websites worth a visit: www.sba.gov and www.score.org. Search for mentors or counselors, or see www.sba.gov/services/counseling/index.html for these and other resources, including special programs for women entrepreneurs.

**Advisors.** Some businesses choose to form an advisory board. If you decide to go this route, you’ll need to clearly set your expectations of the members in advance. Otherwise, you’ll find that most advisory board members expect to be little more than figureheads, lending their impressive names to your publicity materials. Rarely do such folks actually roll up their sleeves and help you figure out how to balance paying your employees and paying the rent.

Follow these priorities when looking for advisers:

- Find someone with skills, information, or contacts you’ll need in the short term. You’ll need help leaping the hurdles you face in the next three months before you think about the next three years.
• Find someone well known in your field who can lend you credibility when you most need it to attract customers, good employees, and investors.

• Find an adviser who is content to receive a free lunch on the day of a meeting rather than one who insists on receiving shares in the company. As your company grows and takes more of the adviser’s time, you should consider instituting both cash and stock compensation schemes.

Create a Paper Trail of Your Financing Activities

Now’s the time to get organized about documenting and filing the records that prove your version of where the money came from and where it has gone. Whether you receive financing in the form of a gift, loan, or an equity investment, make sure you have the proper letters and agreements for you and your lender or investor to share with the IRS.