FUNDING SOURCES

For Small Businesses

The following funding sources can help you start a small business. Some of these funding sources can be used by anyone. While others, like factoring or leasing, can be used only by certain types of businesses.

There are a bewildering number of places to get money, and a truly amazing variety of ways to structure it. Some of it is simple; some is difficult and takes some time to fully understand.

Either way, finding the RIGHT kind of money for your company is very important. Conversely, finding the wrong kind of money can be fatal for your company. If you can find an organization such as Hidden Star or SCORE that will give you guidance, great. If not, you owe it to yourself to take the time to think about and understand the dynamics of getting money for your company.

SOURCE #1: YOUR SAVINGS

Most entrepreneurs start their companies by investing their own savings. This source of financing can be ideal—if you can afford it. It puts you in full control of how much you are going to get and keep. Furthermore, you never have to justify yourself to investors. This last point is an important benefit. You have the freedom to operate as you see best. There is a trade-off, though. This freedom usually comes at the expense of having little or not enough money.

Saving up to start a business takes determination and sacrifice. Save a portion of your income every month. Save as much as you can for as long as you can. You will need every dollar you can get your hands on. Consequently, you may have to give up luxuries—such as vacations and new cars—for a while. The reward is the ability to launch your startup and keep more ownership.

SOURCE #2: YOUR CREDIT

Many entrepreneurs also use their credit—either through credit cards or a home equity loan—to start their small businesses. Be very careful about using these sources, as you could ruin your personal credit, risk your home, or both. If possible, avoid using a home equity line of credit as the risk is too high.

Credit cards are best used to pay expenses directly related to a project. Once the project is completed and the client pays, pay the credit card back. It’s best not to use credit cards to pay for startup company expenses not related to a specific revenue-generating project. This strategy limits the chances of something going wrong that could damage your credit.

SOURCE #3: FAMILY MEMBERS AND FRIENDS

One common way to finance a business is to ask friends and family members for an investment. Generally, we recommend against it. The problem is if things go wrong, your friend/family relationship is affected—and in any startup business, you are guaranteed things will go wrong at one point or another. If you are careful and upfront about the risks and uses of the money; family and/or friends can be fine, but you need to have a candid conversation before borrowing.

If you start your small business using friends and family investors, decide whether to sell them equity or take a loan from them. Both have advantages and disadvantages. Investments from selling equity don't have to be paid back. However, the person to whom you sold the equity becomes an owner and shares the profits. Loans, on the other hand, have to be paid back. However, once the loans are paid, the transaction is concluded.

Regardless of which structure you use, have an attorney draft a formal agreement or use a legal service such as LegalZoom.com. Lastly, separate the personal relationship from the business relationship—treat all investors professionally. Whether they are family, friend, or stranger, anyone who invests money in your company deserves your full dedication and full and regular reporting.

SOURCE #4: CUSTOMERS AND SUPPLIERS

Two great funding sources for small businesses are actually your customers and your suppliers. Customers can finance your business by prepaying for orders—or by giving you an advance. Obviously, you use these funds to handle their transaction. This funding is not easy to get, but customers may be willing to prepay if your service is unique enough or if they really need your products.

Another great source of financing is supplier credit. Basically, suppliers give your company 30 to 60 days to pay an invoice. Getting supplier credit is similar to getting interest-free financing for 30 to 60 days. It takes a little effort to get supplier credit, but it is definitely worthwhile. Learn more about getting credit terms from suppliers.

SOURCE #5: SMALL BUSINESS ADMINISTRATION

One interesting source of small business funding is the Small Business Administration (SBA). The SBA has a special program that offers microloans to small business owners. Microloans can reach $50,000 (varies by state) and tend to be easier to get than conventional financing. They also come bundled with business training, which can be very useful for first-time entrepreneurs. The SBA also works with banks to provide 7(a) loans. These loans are larger than microloans and have stricter underwriting criteria.

Whether you get funding from them or not, the SBA is a great resource and is dedicated to helping you succeed.

SOURCE #6: PEER-TO-PEER LENDERS

Peer-to-peer (P2P) lenders offer a platform that allows people to seek financing from other individuals. The P2P platform acts as a matching service and provides basic due diligence. Like microloans, most P2P loans are small. They usually cap at $25,000 to $35,000.

In a P2P loan, individuals are usually not lending money to your business. Instead, they lend money to the entrepreneur (personally), who then invests the funds into the business. Your personal credit matters since this loan is a personal loan.

SOURCE #7: FACTORING COMPANIES

Many small businesses encounter financial problems because their commercial clients ask for payment terms. As a small business, you may have to give them 30 to 60 days to pay an invoice. Otherwise, you could lose the client. The problem is most small businesses cannot afford to wait up to eight weeks to get paid.

You can improve your cash flow and get paid sooner by factoring (or pledging) your invoices and accounts receivable. Factoring allows you to finance slow-paying invoices, which provides your company with immediate working capital. You take your slow-paying invoices to the factoring company and they give you, let's say, 80% of the total right away. You can use these funds to run the company. When the client pays the factoring company, you will receive the rest of the money, minus the financing charge.

The advantage of factoring is it allows you to finance your business by leveraging the commercial credit of your clients. This method is a great option for small businesses with a strong roster of clients. The disadvantage is it is very expensive money. If you use a factoring service, you will want to move away from them as fast as you can.

SOURCE #8: LEASING

Small businesses in certain industries need equipment to get started. One way to finance the equipment is to lease it through a finance company. Most equipment leases are structured so the finance company buys the equipment and rents it to you for a monthly payment. Once the term of the lease concludes, you can buy the equipment from the finance company for a fairly modest cost.

SOURCE #9: CROWDFUNDING

Crowdfunding is a new way of financing businesses and is often misunderstood. Typical crowdfunding can be used to finance only certain types of businesses. Think of crowdfunding as a platform on which you can pre-sell your products to consumers. If enough customers pre-purchase your product, the transaction clears and you can move forward.

Example: If you want to build a brand new type of bicycle but do not have the funds to do so; you could start a crowdfunding campaign on a popular crowdfunding platform such as Kickstarter.com or Indiegogo.com. On their platform, you outline the details of exactly what the buyer gets for their money, upload a video, provide pictures, set your goal, and launch.
NOTE: There are a LOT of people who can give you great advice on how to run a crowdfunding campaign such as this.

So let’s say you want to sell your new, innovative bicycle for $1,000 and it will cost you $600 to produce. You launch your crowdfunding campaign with a goal of selling 100 bicycles. At $1,000 each, your goal is $100,000 in sales. Let’s say you sell exactly 100 bicycles and meet your goal.

You would then have $100,000 in cash in your account but you would need to produce and deliver 100 bicycles to the people who bought them. That will cost you about $60,000, for a gross profit of $40,000. That is all good. However, now you have an obligation to deliver 100 bicycles to the folks who pre-paid for it.

If, for whatever reason, you are unable to produce the bike you will need to return all of the money to the customers. Or, if it costs you more than $1000 to make the bicycle, you will lose money. So make sure you can live with each of these alternatives.

Crowdfunding is a great platform if you are selling an innovative product that could have mass appeal, and the usable cash is the profit margin from people pre-purchasing the product.

A new kind of crowdfunding is quite different. In this model, you are not selling a product, you are actually selling some of your company’s stock (equity). This is a little trickier and you will need to spend more time on this, but for many it is a far superior option. One of the reasons is it totally shifts your risk. If someone buys a bike from you, they do not assume any risk; you do. If they buy stock, they share the risk with you.

If someone buys—let’s say—5% of your company that is going to build this new bicycle, they assume the risk you might not be successful in your endeavor—you do not have to pay back their money if you fail. Another advantage of this type of money raising is individuals cannot command/demand the unpleasant concessions you might have to make if you were dealing with a very sophisticated venture capital firm or private equity firm.

FUNDING SOURCES THAT *DON'T* USUALLY WORK

There is nothing wrong with these sources, per-se, they are just typically not the right source of money to start a new small business.

SOURCE #10: THE BANK

After you are established and have cash flow, a bank can be a great source of capital to expand your business, but very few new companies qualify. It can lead to tremendous frustration and a giant waste of precious time.

Far too few people understand the business a bank is in—or more accurately, what business a bank is NOT in. Banks are not in the risk business. Generally, a bank is more open to loaning you money only after you can show them your business is sound, will produce cash flow, AND you can show the bank several ways they would get their money back.

This makes sense, since they are loaning out the life savings of little old ladies and men who cannot afford to lose their money by making a bad loan to you or any other entrepreneur. Yes, the deposits are insured, but still, this is how you should think about it.

For some reason, many business books recommend you consider a bank loan to start a business. This approach may work well in theory but not in practice. Banks typically lend only against assets or cash flow. Unless you have a business with assets or you have substantial personal assets, you will not qualify for a commercial line of credit or bank loan. However, bank loans may be a good or very good source of funding later on, once your business has grown.

A lot of new entrepreneurs waste a lot of time trying to get bank financing long before their business is a good candidate for bank financing. There is an old adage something like, "A bank will loan you money only after you prove you don't need it."

Remember, Facebook was five years old before it could have supported any debt at all.

FUNDING SOURCES THAT *DON'T* USUALLY WORK (continued)

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SOURCE #11: VENTURE CAPITALISTS & ANGEL INVESTORS

Venture capitalists and angel investors can be a great source of financing if your company has the right opportunity for them. Consider venture financing only if you have an innovative concept with high margins that can scale quickly.

Venture capital and private equity investors are private investor firms that invest in, typically, early-stage private companies. These firms are generally populated with very smart, very sophisticated professional investors. They can be great; they can be terrible. Watch out.

Angel investors are typically high net worth (rich) individuals investing their own money.

Getting this type of funding is notoriously difficult. As a matter of fact, many entrepreneurs spend weeks or months creating presentations and pitching to venture capitalists and end up with nothing to show for their efforts. Worse yet, they have lost the most precious asset: time.

SOURCE #12: GOVERNMENT GRANTS

Usually, the government does not provide grants to start or operate a for-profit business—unless the business is in a specific industry or serves a very targeted cause.

Remember that the government is investing your tax dollars and is very strict and careful when spending them. The government won't be able to help you if you need money to:

- Start a business
- Pay operational expenses
- Settle business debts

Unfortunately, trying to get this type of funding is a waste of time for most people. Your time is better spent looking elsewhere. Having said that, there are some exceptions.