

"Common Sources of Financing for Small Business"

By Jeff Schein

The choice of financing is an important determinant of whether a product reaches the market, or whether an existing business can survive. The choice of financing is an important part of being an entrepreneur and business owner, and the ability to raise cash when you have no or limited history takes skill and creativity. There are a number of sources of financing. The suitability of the alternatives depends on what stage you are at, and will change as the company matures from stage to stage. The following outlines the most typical forms available.

Yourself, Family and Friends

The most obvious and common start is for people to self finance. That means they either draw down on their savings or they use personal debt such as credit cards, credit lines or equity mortgages to finance their business. Family and friends are often used as a source of financing. Although they are not always in a position to properly evaluate the business venture, family and friends have long-time relationships and experience with the entrepreneur and are knowledgeable about his/her reliability and ability.

Strategic Partner

Strategic partners can not only provide a source of financing, but often they can provide an area of expertise that the entrepreneur does not bring to the table, such as operational or marketing skills. Naturally, the pitfall of a partner is that you do not maintain full control over the company and that sometimes there is a falling out between the partners. So it is important that you do your homework and choose your partner carefully.

Angel Financing

Angles tend to be freelance financiers interested in loaning smaller amounts of money, say between \$50,000 - \$500,000. They can often provide the seed capital required to develop an idea to get to the point where a firm can obtain formal financing. Angel investors will also invest in growing companies that may have a strong revenue base, but are not yet established enough to get bank or other financing. Another benefit of Angels is that they can bring a lot of experience and industry contacts to the table.

Venture Capital

When firms approach venture capitalists, they are generally developed to the point where a venture capitalist can add value. The venture capitalists will generally sit on the board of directors, provide expertise and provide funding based on the attainment of milestones. They are generally interested in firms that can generate rapid growth – and returns – over a few short years; your

time horizon is generally 3-8 years.

Trade Credit

One of the largest sources of short-term financing, trade credit occurs whenever you purchase from a supplier but do not need to pay for the merchandise for 30 days (or whatever the terms are). Trade credit can be expensive if you are foregoing discounts, but a new firm may not have much of a choice.

Factoring

Factoring is also a popular source of financing for growing firms. When you generate a receivable you may sell it to a factor who will then collect the receivable for you. Typically, you will get between 75%-90% upfront for the receivable and the remainder when the factor collects, less a fee.

Asset Based Lending

Asset based lenders will lend to businesses that lack sufficient cash flow to support unsecured financing, but have sufficient assets that can serve as collateral. Typically, the assets are accounts receivable and inventory, but can be equipment or other similar assets. The lender relies on the assets to repay the loan, not the cash flow of the firm. Fast growing firms who cannot get sufficient financing from a financial institution will be a typical client of an asset based lender.

Mezzanine Financing

Mezzanine financing is subordinated debt, a type of hybrid between senior debt and equity. As Mezzanine financing is typically high risk, it can be expensive. A typical target company generally has been in business for a number of years and has an established revenue base and positive cash flow stream. Often, a company may have reached its maximum level of financing from a lending institution and will obtain mezzanine financing to bridge the gap and finance their growth. The Mezzanine financier will subordinate its debt to the main lender.

Banks

By the time a firm can approach a bank they usually have been in business for a couple of years, have developed solid revenue, are earning profits and have a reasonable balance sheet. The bank will provide daily operational financing as well as long-term financing. Generally the cheapest form of financing, it can also be the hardest to get.

About The Author

Jeff Schein is a CGA and offers advisory services in the areas of business planning, business modeling, strategic planning, business analysis and financial management for new ventures and growing small businesses.