The Zip Capital Group Guide to Small Business Funding Sources

Learn about the different sources of funding that have been used to finance small businesses and which one could be best for you.

www.zipcapitalgroup.com

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Executive Summary

To grow and prosper, a business needs a committed owner, a viable product or service, a strong strategy and business concept, and capital to fund growth. Using your own money to fund and grow a business may seem like the easiest way to get where you need to go, but it is not necessarily the best.

To fund your business, you may need to borrow money from friends and family, your credit card, a bank, or other sources. Each option has its own advantage and disadvantages.

Every form of funding can be broken down into two categories, debt financing and equity financing. Debt financing is borrowing money without giving up any ownership of your company, or right to future cash flows. Equity financing essentially refers to the sale of ownership interest to raise funds for business purposes. This option does entail giving up a claim to future cash flows. Each option does come with its own set of advantages and disadvantages that can be applied on a case-by-case basis.

This small business finance guide describes the most common sources of capital, the rules and requirements to apply, and the ideal scenario for each. This guide also includes a detailed comparison between debt and equity financing and several factors that a business owner should consider to help them determine the best source of funding for their business.

Learning Objectives

When you finish reading this document, you should be able to:

- Identify the different types of funding available
- Understand the differences between debt and equity financing, and
- Have a better idea of which financing option is best for you and your business.

Determining Financing Needs

You have finally decided that it is time to take the leap and open your business. What do you do now?

One of the first steps is to determine how much money you will need to start your business. Some businesses can be started with minimal upfront capital, while others require a substantial investment.

When running your business, you will also need to keep your household going. Should you include that number in your costs or keep it out? To determine how much you will need:

What are your start-up costs?

Think about:

- One-time charges – These are costs you will only pay once. Examples include incorporation costs and legal costs.
- Recurring costs – Break down recurring costs into fixed costs and variable costs. Fixed costs are costs that don't change regardless if you sell anything or not. Examples include rent, utilities, payroll and insurance. Variable costs are costs that are incurred as you sell or manufacture your products. Examples include inventory, shipping and sales commissions.
- Hidden costs – These are costs that did not anticipate. Add 10% to your budget to cover such surprises.

What is your personal equity?

One of the first questions a financial institution will ask is how much equity will you bring to the table.

What are your monthly expenses?

It is important to estimate your monthly expenses as accurately as possible through monthly cash flow projections.

Types of Funding

You, the business owner have several options to choose from when selecting how to fund the operations and growth of your business. The most common forms of financing are broken down into major categories. These categories are:

1. Personal sources of funding
2. Alternative sources of funding
3. Institutional sources of funding, and
4. Government sources of funding

The most common forms of financing broken down by category include:

PERSONAL

Personal funding sources for a business are those sources you have available to you through your assets, relationships and networks.

Your Own Assets

Funding your business using your own assets is the best financial position to put yourself into. With this option, you don't take on any additional debt and you keep 100% of the profits for yourself.

With this option, you also own of the equity in the business, meaning you keep 100% of future profits for yourself. If you sell your business, 100% of the proceeds from the sale go to you. You don't share anything with anybody else.

By not borrowing any money to fund your business, you don't have to repay anyone. There are no interest payments that will accrue or have to be paid to anybody else.

If you have jointly-owned accounts, make sure you have the other owner's consent before making large purchases, decisions or withdrawals.

Since you don't share any of the profits, future profits or equity with anybody else, you also don't share any of the losses as well. You own 100% of the losses.

Sale and Income

If you already have clients lined up before you open your business, another great way to fund your business is to use customer sales revenue. You get all of the benefits of using your own assets without depleting your bank account.

Using sales and income from future clients, you don't give up equity and take on additional debt and you won't have a loan to pay back or interest to accrue. Growth may be slower than if you use your own assets but you don't have to worry about paying back a loan.

It is very important that when using this method of financing your business, you can absolutely deliver according to your client's expectations. If not, you may find yourself not only in financial trouble but legal trouble as well. Your client's may accuse you of fraud. If this is the case, you may put yourself in the position of defending yourself against criminal charges.

Credit Cards

Funding your business with your credit cards is a risky proposition that can get out of hand quickly. Financial experts warn against using credit cards because of high interest rates and the risk to your personal credit.

For many, use of a credit card may be a more viable option than a traditional bank loan. An example would be to use a credit card to cover short-term cash problems when the income is going to be coming in shortly.

If you must use your credit card, it is highly recommended to do so when you can pay off your card each month. If you can't pay off your credit card bill monthly, interest charges are likely to escalate quickly. Additionally, you can get stuck with additional charges and late fees if you are not able to make your monthly payment on time.

For short-term cash problems, a working capital loan would be a much better option. The application process can take up to a few hours and can be completed in an afternoon. A decision is normally rendered anywhere from a few minutes to a day with the funded to your bank account within 24 to 48 hours.

Zip Capital Group specializes in working capital loans and is happy to help you with your short-term funding needs

Friends and Family

Borrowing from family members may at first glance seem like a good option. However, many a relationship has been destroyed between friends and family. As a result, you need to weigh the odds of such a funding option.

Sometimes money is given as a gift. It does not need to be repaid. Other times, money is given to buy interest and ownership in the business. If this is the case, you need to determine the arrangement ahead of time.

Will your friends and family members have a say in the decision-making process? Are they giving you the money as a loan or to buy an interest in the business? If a loan, how will they be repaid? Do they have any protections in place?

Regardless of how the relationship is defined, you need to be very careful. If the money is a gift, a loan, or to buy an interest in the business, make sure you have loan or investment papers drawn up ahead of time with clearly defined terms, ownership, and repayment terms. If you must, handle working with friends and family the same as you would dealing with a business interest.

ALTERNATIVE

Alternative funding sources are those sources that you have available outside of your personal assets and networks and those sources that are not established financial institutions.

Crowdfunding

Crowd funding as a funding option is possible because of the Internet. As a result, it has grown very quickly.

Crowd funding is also known as equity crowd financing, crowd-financing, crowd-sourced funding. It is a collective effort, largely as a result of the Internet of individuals who network to pool their money, to support efforts initiated by other organizations and people.

There is a second term for crowd funding. It can also refer to the funding of a company by selling small amounts of equity to many investors.

Crowd funding comes from the concept of "crowdsourcing". This is when an individual reaches a goal of receiving and taking advantage of small donations for many different parties. The difference between crowdsourcing and crowd funding is that the latter, crowd funding is to fund a project or a venture, rather than an individual.

Currently, the crowd funding model consists of an online platform or organization that not only markets the project or venture, but also oversees the fund raising process. These crowdfunding platforms act as the middleman between the project initiator (project sponsor) and investors (crowd).

Crowd funding platforms are compensated for their services as the intermediary between the project sponsors and investors by taking a percentage of the monies raised. Fees, services, and funding points vary by platform.

Currently, there are several crowd funding platforms competing for projects and investors. Some platforms include Kickstarter, Fundly, lndiegogo, Angellist, and Rockethub.

Peer-to-peer Lending

Peer-to-peer (P2P) lending, like crowdsourcing has largely increased in popularity as a result of the Internet. It is the practice of lending money to individuals or businesses through online services that match lenders directly with borrowers.

Since P2P lenders operate entirely online, they can run with lower overhead and provide services more cost effectively than traditional financial institutions. As a result, they may earn higher returns compared to savings and investment products offered by banks, while borrowers can borrow money at lower interest rates.

P2P lending companies often make their money by taking a fee for providing the matchmaking platform and credit checking the borrower.

P2P lending is also called crowd lending. Many peer-to-peer loans are unsecured personal loans with some of the largest amounts lent to businesses. Secured loans are sometimes offered by using luxury assets such as jewelry, fine art, buildings, automobiles, aircraft and other business assets as collateral.

Other forms of peer-to-peer lending include student loans, commercial and real-estate loans, payday loans as well as secured business loans, leasing and factoring.

Angel Investors

Angel investors are often wealthy individuals such as other successful entrepreneurs, business owners, and retired executives that invest in up-and-coming businesses.

Angel investors are like venture capitalists but are usually individuals. Like VCs, they will expect to see a return in the form of a stock or stock buyback when the business purchases outstanding stock with a period of time.

For business owners seeking out angel investors, they should seek out lawyers and accountants who often work with other business owners seeking out such investment opportunities. In larger cities, angel investors may form a group to actively seek out investment opportunities.

Vendor Finance

For established companies that have demonstrated their ability to deliver their product on time and as ordered by customers, vendor financing may be an option.

Vendor financing is when a vendor extends their terms of payment for a predetermined length of time. In essence, money that would be paid to a vendor is reinvested in your business to be repaid at a later date.

You can approach a vendor and show them your business plan and the orders that you have received. If the vendor is convinced that your business will be successful, and one of their better customers in the future, they may be willing to offer extended payment terms.

There may be an added cost with this approach in that you may have to work exclusively with your vendor for an extended period of time. Additionally, you may be required to pay a higher price for this arrangement.

Prepay Financing

Like vendor financing, prepay financing is for established companies who have demonstrated to their customers the ability to deliver merchandise on time and as ordered. For those companies, prepay financing may be an option.

Prepay financing is where a business asks some of their customers to put a deposit on a future order. The business can add an incentive for their customer by slightly decreasing the price in exchange for the deposit.

Another form of incentive is to add a certain number of free units after a minimum order has been placed. For example, 10 free units with a 100-unit purchase.

It may also be acceptable depending upon the industry to ask for a deposit from a new customer for a large or custom order. This is common in the custom software development industry.

INSTITUTIONAL

An institutional lender is an organization that lends money for an interest fee and whose loans are regulated by law, such as a bank, insurance company or a savings and loan organization. These organizations may lend money that was received from depositors as opposed to a private lender who lends his or her own money.

Banks

If your business has been around for a few years and you have established a credit history, you have a good chance of getting a loan from a bank. However, there is often a very long and tedious application process that can take weeks to complete. Additionally, it can take several more weeks for the loan to be funded.

If you are a new business, banks will often require a guarantee and personal collateral for business loans. The Small Business Administration (SBA) provides loan guarantees to banks to encourage them to work with small business loans.

With an SBA guaranteed loan, if you default, the SBA will repay the bank but you, the business owner are still responsible for the full repayment of the loan.

Working Capital Lending

Working capital loans are used to fund everyday operations of a company. Loan proceeds are used to pay for operating expenses such as payroll, inventory, raw materials, and marketing expenses.

Working capital is the cash available to finance a company's short-term operational needs. Sometimes, a company doesn't have the adequate cash on hand or asset liquidity to cover daily operational expenses. Therefore, working capital loans are simple corporate debt borrowings that are used by a company to finance its daily operations.

The advantage of a working capital loan is that it is quick and lets business owners efficiently cover any gaps in working capital expenditures. In addition to the speed, the other noticeable benefit is that it is debt financing and does not require an equity transaction. This means that the business owner maintains full control of his company.

Unsecured Business Lending

An unsecured business loan does not require collateral and is also called a line of credit. These loans are riskier for lenders due to the fact that they are not secured by collateral as a repayment guarantee. Consequently, loan amounts are for a smaller amount and interest rates are higher.

Small Business Loans

Small business loans are for businesses with few assets that generate modest annual revenue. To qualify for a small business loan, you must certain criteria.

Small businesses are defined by several different criteria including amount, value, types of assets owned, number of employees, revenue and income and years in operation.

Most lending institutions making small business loans require a guarantee and some form of collateral. While the Small Business Administration, does not lend money directly, it does offer guarantees for small business loans that qualify through finance companies, commercial banks, and government entities.

The Small Business Administration is a United States government agency that provides support to entrepreneurs and small businesses in the form of capital, contracts and counseling

Minority Business Loans

For business that are exclusively owned, or majority owned by individuals with a minority background, there are minority business loans.

Minority loans are not just for small businesses. Larger businesses may qualify as well. Applicants are required to comply with the lender's requirements for the loan. Requirements may be based on minority ownership or being located in largely minority occupied communities.

It is not only for-profit financial institutions that offer minority business loans. Some non-profit entities that advance and support minority groups may have small business loan programs available.

GOVERNMENT

Federal, state and local governments can also make loans to small businesses. A government-backed loan is a loan subsidized by the government, which protects lenders against defaults on payments, thus making it easier for lenders to offer potential borrowers lower interest rates.

Federal Grants for Small Business

The Small Business Administration may guarantee a loan or provide grants to businesses that meet the size standards set forth for companies in most industries across the economy. The common size and revenue standards are:

- 500 employees for most mining and manufacturing industries
- $6 million for most retail and service industries
- 100 employees for all wholesale trade industries
- $0.75 million for most agricultural industries
- $12 million for all special trade contractors
- $28.5 million for most general and heavy construction industries

The size and revenue standards set forth by the SBA are for the most part, used by all federal agencies and most state and local governments. There is a great deal more information on the small business administration (sba.gov) website.

State Grants

The State where your business is located is a great place to start your search for small business grants. Many states have agencies designed to offer grants and business assistance in order to encourage small business growth and development.

Most states will have a Small Business Development Center (SBDC) that is associated with local colleges and universities. SBDC's provide training and advice to small businesses on all aspects of financing, starting a business and keeping it going. They are also part of a larger nationwide network of sites.

You can find more information by visiting the Association of Small Business Development Centers (ASBDC) www.asbdc.org.

Equity vs. Debt Financing

Financing can be broken down into two different types, equity financing and debt financing. The table below outlines the differences of each.

	EQUITY FINANCING	DEBT FINANCING
DEFINITION	Equity financing is the process of raising capital through the sale of shares in an enterprise. Equity financing essentially refers to the sale of an ownership interest to raise funds for business purposes.	Debt financing means borrowing money and not giving up ownership. Debt financing often comes with strict conditions or covenants in addition to having to pay interest and principal at specified dates.
WHO USES THIS FORM OF CAPITAL?	Businesses with a conventional approach to management, profitability, and/or poor credit ratings rely on equity funding. Start-ups and new businesses that don't have a track record of success or face uncertainty also use equity funding.	Well established businesses that have shown steady sales, solid collateral, and profitable growth rely on debt financing.
SOURCES OF FUNDING	▪ Personal funds from savings, credit cards, retirement accounts, equity, and property ▪ Friends and family ▪ Venture capitalists and angel investors ▪ Investment banking firms ▪ Insurance companies ▪ Large corporations ▪ Government-backed Small	▪ Loans through the Small Business Administration ▪ Commercial banks

	Business Investment Corporations (SBIC)	
REQUIREMENTS	• Well-detailed business plan and clearly defined exit strategy • Good credit history • Borrowers must demonstrate their business is in high-growth industry with the potential to generate a large return on investment.	• Borrowers must show potential lenders that they are willing to invest in the business using their own money. • The borrower must have an exceptional credit history.
ADVANTAGES	• Equity enables the business owner to obtain funds without taking on debt. This generates a higher cash flow. • Business owners can focus their attention on their business rather than paying investors back. • Additional cash flow generated can be reinvested rather than applied towards paying down debt. • Enables the business owner and investors the opportunity to develop a long-term relationship over the duration of the investment. • Borrowing from family and friends can be a low-cost way of securing funds	• The lender does not gain ownership. As a result, the business owners retain maximum control over the business. • The interest paid on debt financing is tax deductible. • The business owner has no obligation to the lender other than repayment of the loan. Once repayment has been made, the relationship ends. • Repayment of the loan is often a fixed or monthly expense, depending upon the terms of the loan.
DISADVANTAGES	• Financial reporting required of investors can be quite complex. • Relationships with family and friends can strain if the investment goes bad. • Dilution of ownership can occur leading to a loss of control. • Angel investors and venture capitalists are likely to be involved in every business decision. • The use of too much equity can suggest that borrowed funds are not being used effectively. • The use of too little equity can suggest that business owners are not committed.	• Often limited to established businesses with a solid track record of success. • Bad credit records can result in the inability to pay back borrowed funds, limiting the ability to secure additional capital. • Some of the cash flow will be directed to service the debt, leaving less capital for reinvestment. • Requires a monthly payment that limits capital available for reinvestment.
APPLICATION PROCESS	• Angel investors and venture capitalists will put the business owner and business through a thorough and exhaustive due diligence process. • Family and friends will not usually require an application	• A formal application must be filled out either in person or online.

	process	
CREDIT CHECK	• Angel investors and venture capitalists may run a credit check but may rely on the potential return on investment. • Most family and friends will not run a credit check	• Yes, the higher the business owner's credit score, the better the chance of securing the loan.
FUNDING TERMS	• Angel investors and venture capitalists will usually invest for a 3 to 7 year time horizon.	• Short-term debt financing: Total repayment of debt in one year or less. • Long-term debt financing: Total repayment of debt in over one year.
ADDITIONAL	• Another form of equity financing is to sell stock to employees. Employee Stock Ownership Plans (ESOP), share control of the company with employees rather than outside investors.	• A balloon payment is an additional form of long-term debt financing. At the end of the team, the borrower and lender negotiate a new amount from what is left of the loan. • Long term financing is usually variable meaning the interest is usually adjusted up or down according to the underlying index.

Things to Consider

Credit history

A credit and financial history shows prospective lenders a borrower's ability to manage their finances. For most lenders, a credit history is very important. However, working capital lenders will rely more upon the underlying fundamentals of the business and cash flow, rather than a credit history.

Ability to repay the loan

Consider how you will pay back what you borrow. The interest rate applied to the loan is directly related to the borrower's ability to repay the loan. If your credit history is not good, you will be perceived to be a bigger risk and will be charged a higher corresponding interest rate.

Expertise and experience

Lenders look at industry experience as well as relevant education that can be directly applied to your business. If you have management experience or hire key managers, lenders will look at such development favorably.

Diversify your customer base

Make sure that you are not depending upon only one or a few customers for your business. If one or a few customers leave, it can be devastating to your business.

Incorporate your business

If you have not yet incorporated your business, think about doing so before too long. Incorporation shows prospective investors and lenders that you are serious about what you are doing and have invested in taking your business to the next level.

Contingency plans

Talk to your investors and lenders about what happens when you don't reach profitability and closure is inevitable. You could arrange to continue making loan payments by selling your business assets. Your investors and lenders may be able to help you develop plans to pay down your debts.

Insurance

Protect yourself, your family, investors and lenders from catastrophic events.

Sources

Peer-to-peer lending

Small Business Administration, www.sba.gov

Association of Small Business Development Centers

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