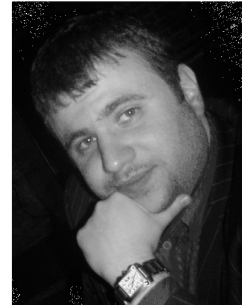




FROM A LOCAL SHOP TO A GLOBAL CONGLOMERATE



Small Business Financing Options

Thank you to all who read and commented on my first column in this series. Your overwhelming response requesting information on financing options for start-up enterprises and business purchases is no surprise. This is a topic on the mind of every entrepreneur, regardless of their ethnicity, experience or business focus.



Every new business requires some start-up capital, regardless of what that business may be. Just as Fortune 500 companies require hundreds of millions of dollars to build a new factory, launch a new product, or market a new service, very small businesses also require financing. Think of a lemonade stand that is started by a few kids. Before they can sell their first cup, they will have to spend money on buying the lemons, ice, blenders, containers, and signs to put around the neighborhood. Even though the business venture is very small it will still require an up-front investment.

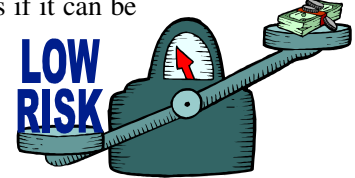
Thus the age-old proverb rings true – “you need to spend money in order to make money.”

I am assuming the readers of this column are mostly interested in purchasing or launching small businesses, larger than a lemonade stand but not quite big enough to be publicly-owned. My column in this issue will concentrate on such available financing sources as would be available for the small privately-owned business. But before I get into the many actual types and forms of financing that are available I would like to first discuss several major financial concepts.

First of all, the kinds of business that I outlined in the first issue of this column will typically be able to obtain one of only two categories of financing, or sometimes a combination of both, which are debt or equity capital. **Debt** is typically issued by a company in order to raise money with a promise to pay a specified sum at a fixed time in the future and carrying interest at a fixed rate. It can be in the form of bonds or as a loan, which can also be considered as an arrangement in which a lender gives money or property to a borrower and the borrower agrees to return the property or repay the money, usually along with interest, at some future point(s) in time. Usually, there is a predetermined time for repaying a loan, and generally the lender has to bear the risk that the borrower may not repay a loan (though modern capital markets have developed many ways of managing this risk).



Equity is an ownership interest in a corporation in the form of stock. It is the risk-bearing part of the company's capital and contrasts with debt capital which is usually secured and has priority over shareholders if the company becomes insolvent and its assets are distributed. Thus whereas debt capital has to be repaid, equity capital does not. However, equity capital is the most expensive form of financing that any business will ever get (for various reasons which are beyond the scope of this column; it has been mathematically proven by several Nobel Prize winners in the field of finance) and thus if it can be avoided, it should. That being said though, most start-ups and very small businesses, due to their higher levels of associated risk will be more likely to receive an equity investment rather than a loan. Debt investors are typically more risk-averse and will thus rarely invest into start-up businesses that have no proven track record. However, along with that comes another important business lesson – the greater the risk, typically the higher the reward.



The United States is considered to be one of the most efficient markets in the world where every risk profile (which can be mathematically measured) carries with it a certain level of reward that is specifically commensurate with that risk. Therefore, you will not find nearly risk-free investment opportunities carrying relatively high rewards in U.S., as you may in other less efficient and underdeveloped global economies. One of the least risky (nearly risk-free) investments that exists in United States are government bonds and treasury notes, which typically carry the lowest return for the investors which is commensurate with the virtually non-existent level of risk. From there the risk increases gradually when you move towards corporate bonds and other types of debt instruments and then becomes even higher when you get into equity investments, such as stocks. Therefore, equity investors typically have a much greater appetite for risk and thus often reap higher returns from their investments.

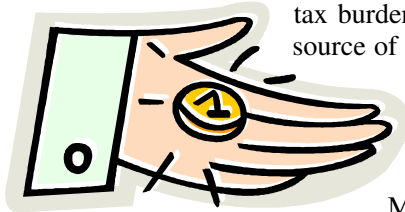
As an entrepreneur it is very helpful to know what your financiers would want to see or how they will evaluate your investment opportunity. Obviously they will want to reap financial gains from your investment (unless they are a government entity or a not-for-profit lending institution), but more importantly, they will want to make sure that the returns they will be able to make on their investment will be in line with the level of risk of the investment. For example, if you promise an investor a 5% annualized return on their loan to you for your business you also have to take into consideration their alternatives. They would compare the profit from lending you money with where else they potentially would be able to make the same exact return (or higher) by investing into a less risky venture, such as the U.S.



government, for example. Likewise, if you promise your investor a rate of return that is 10 or even 100 times higher than that of government bonds, the investor will also have to take into consideration such factors as the likelihood of receiving the money back (i.e. likelihood of your success), the amount of time that it will take to get it paid back, probability of you actually being able to make that high of a return on the investment, and numerous other similar considerations. Moreover, perhaps the investor can make the same exact high return by investing into **less risky** ventures than yours or make a **greater return** by investing into other ventures that the investor will deem as having an equal level of risk.

Understanding such concepts is not only crucial to obtaining financing but also to figuring out what is fair and what is not when paying for such financing. There exist usury laws in the United States that do not allow institutions to charge “unreasonably” high rates of interest, but what is unreasonable for one might not be so for another. One of the best ways to gauge the value of the financing proposal is to compare it to other such similar deals. If information is not readily available I would urge the reader to contact a professional in this area (such as Aginsky Consulting Group) who would be able to specify how to best structure a certain deal and assist you in negotiating terms. This is especially useful in the field of finance where there are no clear-cut boiler-plate approaches and this is even more so when it comes to business financing. Each deal is always different and thus requires a different approach.

Overall there are dozens of different financing sources available to entrepreneurs. All of them are obviously different, carrying with them different conditions, opportunities, and etc. There is no way to say which source of financing is best because different financial instruments should be used for different purposes. For example, if you plan to start a business that will be a cash-cow (in other words have high profitability and high positive cash flows) according to your preliminary estimates, then it might make sense to accept a high interest rate loan vs. an equity investment. Also, it could be prudent to extend the repayment terms for as long as possible since loan interest is tax deductible (for corporations) thus allowing your business to have a lower tax burden.



Another example of the importance of selecting just the right source of financing could be in the case of the sales cycle of your business being rather long but predictable, in which instance you would want to structure the loan in such a way as to make payments less often (quarterly or even annually, if possible, rather than monthly) and line them up with your cash flows schedule.

Many very profitable businesses have failed for this reason alone – when working capital for supplies, salaries, overhead, and etc. was due monthly, for example, and the revenues were generated quarterly, thus not in sync, eventually forcing the companies into bankruptcy.

How does all this affect you, the typical entrepreneur who is contemplating organizing or purchasing a small business? Exactly where will your start-up capital come from, you wonder? In the next issue I will outline the *ten most common* types of small business financing.

Your personal business consultant

TO BE CONTINUED IN THE NEXT ISSUE

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