



## FROM A LOCAL SHOP TO A GLOBAL CONGLOMERATE



### **Small Business Financing Options**

#### **- The Ten Most Common Types of Small Business Financing -**

**(Please see the beginning in the previous issue)**

The right choice of financing can play a key role in the successful development of any business, especially a small business. In this issue we are going to review the ten most important and most common forms of financing for small businesses in the United States.

- 1. PERSONAL SAVINGS.** Think beyond the obvious cash in the bank. Other short and long-term assets can be liquidated or further leveraged to pull out the necessary cash for a new business venture. Consider your holdings in stocks, bonds, retirement plans such as IRAs and 401k plans, cash-value life insurance policies, and collectibles. If you have decided to start a business and believe in its future success, your savings are most likely going to be best utilized by investing into your own business. There are many theories out there that stipulate using other people's money is always more beneficial than using your own money in starting any new venture. But the truth of the matter is that if you have no alternative where to invest your own money which would yield a higher return given the same level of risk as your own business concept, then you need to invest in your own business. If you *do* know of an opportunity that will most likely yield higher returns than your business given the same levels of risk, then your venture is probably not a very good idea to begin with. Additionally, most investors (whether for debt or equity) will want to see that you have at least some of your own "skin in the game" before they will fork over their capital. So if you think that you will just be able to use somebody else's money to fund 100% of your business concept, you are most likely going to be disappointed. In fact, the greater the ratio of your own funds to the total funds required, the greater the chance is of your obtaining the required financing from other sources. Sadly, if your cash balance is currently at zero, you will need to wait and save up some money before starting your own business, regardless of how incredible your business idea is. Keep in mind, that you don't necessarily need the capital to be in liquid form since it could be in an existing IRA, 401K, stock portfolio, or other such investments you could leverage to provide the necessary funding for your venture. Finally, you must always remember that any new business will always, as a rule of thumb, take twice



as long to get off the ground as you had anticipated, make half as much, and cost three times more than you budgeted for. Thus having a cushion of some cash savings to last you through the down time is not only prudent but simply crucial. I have seen many very promising businesses fail simply because the founders did not have enough cash to last them through the lean period and were thus forced to abandon their projects entirely.

2. **FAMILY AND FRIENDS.** Be sure to consider all of your personal connections including various acquaintances, religious groups that you belong to, co-workers, neighbors and friends of friends.. After your personal savings, this will be the next cheapest and likeliest source of capital for a new venture. If you can't convince the people in your sphere of influence that this is a great opportunity, then you will most likely fail at convincing any potential investors or bankers. In other words, if your mom won't give you a couple of grand to get your venture off the ground then what luck are you going to have with strangers? This should be the very next place you go to for capital, especially during the seed financing of a new business when every dollar counts and could mean the difference between success and failure. Keep in mind that sometimes your local community can be the best source to tap into, whether it's a church, a synagogue, a community center, or your ESL class. The best philosophy to utilize is that anyone and everyone can be useful, unless proven otherwise.



3. **SELLER FINANCING.** This is a very common approach when purchasing an existing business, particularly for smaller businesses that are typically more difficult to finance through other means. Most of the businesses that were previously mentioned in our last issue would qualify for seller financing. In such a case, a down payment will normally be required from the buyer somewhere in the neighborhood of between 20 to 80% with the remainder being financed over a period of 3 to 10 years (5 to 6 is average) through the business owner. The terms of the agreement are highly flexible since you are dealing with an individual rather than an institution and thus it is basically just a matter of what you can both agree to. The interest rates are often similar to what a business loan from a bank would cost. Depending on your credit rating, down payment, and various other factors, your rate may be two to five percent higher than a typical mortgage loan for the same individual. Moreover, the payment schedule can be structured on a bi-weekly basis, monthly, quarterly, annually, or with a single balloon payment at some pre-agreed upon future point in time. Such flexibility allows you to work out the best possible arrangement given the peculiarities of the business and your specific finances. Finally, one of the best reasons to finance through the seller is that the seller typically knows more about the business than anyone else. As a result, this prolongs your contact with the previous owner and allows you to have a permanent resource for guidance from someone who wants to see you succeed. More importantly, if the seller is willing to accept financing his own business then he must be relatively confident in its profitability and your continued ability to make the regular payments, which is typically a good sign about the viability of the business.

4. **CREDIT CARDS or CREDIT LINES.** *Warning!* This is typically not a very good form of financing and should only be utilized for short-term needs in the worst case scenario. Typically unsecured debt such as credit cards carries with it a very high interest rate and if not paid on time will significantly reduce your credit rating and should be avoided in most cases. It can be used in rare instances for short-term financing to tie you over, but only when you are certain the cash



flows will be coming in within a couple of weeks. But even this is not advisable due to the possibility of various circumstances arising which would inhibit you from making the required timely payment and thus ruining your credit score. These leverage tools should never be used to finance the purchase of a business but merely as interim cash-flow financing.

5. **HOME EQUITY.** Given the low mortgage interest rates combined with the overheated housing market in the United States in the last few years, home equity lines of credit or cash-out loans (as they are known in the industry) have become a very good source of additional business financing. Home equity is currently being built faster than at any time in the last fifty years in U.S. Real estate fortunes are not reserved only for the likes of Donald Trump but are made by our countrymen everywhere. This situation in the housing market provides for a great

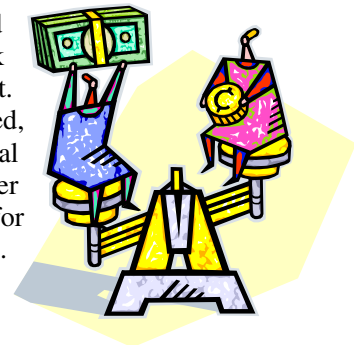


opportunity to use your existing real estate assets as sources of financing and leverage at rates that are substantially lower than most other financial vehicles. Not only is this a much better source of capital than credit cards but it is typically the cheapest source of money outside of personal savings and friends' and family's contributions. However, I must caution the reader to always be very careful in not getting overleveraged. There is a fine line that should not be crossed when it comes to debt. Too much of it can increase the risk of bankruptcy and insolvency whereas too little might not be prudent

either since it can be viewed as underutilization of existing resources. Moreover, mortgage interest is tax deductible and will have an overall positive impact on your finances, making it a prudent source of funding (up to a limit) for business purposes. Keep in mind that it is preferable not to leverage your personal residence if you have investment properties available, since the down side would be losing your home if your business were to fail. *CAVEAT EMPTOR!!*<sup>1</sup>

6. **SBA.** (Small Business Administration - [www.sba.gov](http://www.sba.gov)).<sup>2</sup> With a portfolio of business loans, loan guarantees, and venture capital instruments worth more than \$45 billion, the SBA is the nation's single largest financial backer of small businesses. The SBA is a small, independent federal agency of the United States government with a mandate to aid, counsel, assist and protect the interests of small business concerns, preserve free competitive enterprise, and maintain and strengthen the overall economy of the nation. Given the size of the organization and its mandate, it is certainly advisable to establish a relationship with it for any small business entrepreneur, whether for financing or just general guidance. There are numerous resources available on the website in many languages, including Russian.

7. **BANK LOANS & FACTORING.** As previously mentioned in the description of the two main categories of financing, bank loans for new start-up businesses are virtually non-existent. Banks are normally only willing to lend for highly structured, fixed income, safe investments due to their charters and federal regulations. Banks usually only lend money for larger businesses that have a proven track record, or in some cases for smaller businesses, given the presence of sufficient collateral. Therefore this is not usually a good resource for the new small



<sup>1</sup> Latin for "Buyer beware!"

<sup>2</sup> <http://www.sba.gov/aboutsba/international/SBA%20Overview%20Russian1.pdf> Russian description of the SBA services.

businesses. Another option banks and various other financial institutions can often offer is a service known as factoring. Factoring is the purchase of accounts receivable at a discount. Accounts receivable purchasing/factoring is often the fastest way for a business to collect on generated invoices. Typically, a business or company must wait 30-60-90 days to collect on invoices generated for products delivered or services rendered. A key finance concept is that “a dollar today is always worth more than a dollar tomorrow” and sometimes the expected revenues of tomorrow must be sold at a discount today in order to successfully operate the business. The process is simple, fast and does not create debt. Accounts are usually funded within two to three days by wire to the client company’s bank. The banking institution collects on the invoices and will furnish regular aging reports. Most factoring companies do not require the client company to sell all their invoices to the factor. This service is obviously very beneficial for any company that has regularly scheduled accounts receivable, especially if they constitute a high percentage of total revenues. The actual discount amounts can vary drastically, depending on the financial institution, type of receivable, regularity of receivables, and the company’s credit rating. I advise the reader to contact a professional to determine whether factoring is right for your business.

8. **STRATEGIC PARTNERS.** A strategic partner can be a supplier, customer, vendor, or anyone else who is interested in the actual success of your business for any reason. This financing resource is very often overlooked by entrepreneurs while it presents a great possible source of financing. If you have an existing relationship with a customer who loves and depends on your product or service *and* has deep pockets then he or she will often be a great source of support for your business. This support can come in a variety of ways such as in terms of validating your offering, adding invaluable credibility to a start-up, and as a source of financing. The same can be said for anyone who has a vested interest in the future of your endeavor. For example, if you open up a restaurant specializing in certain kinds of dishes which use a lot of one particular ingredient and if you purchase that ingredient from a single vendor, the vendor will obviously not want to see you leave as their customer and will sometimes be willing to get involved in your venture. This can even sometimes work with your main competitors. If you have something they do not or vice versa they might want to capture some synergies by establishing a strategic alliance, in which case they could provide you with some initial capital in exchange for discounted outsourcing rates, first rights on your technology, agreements to operate outside of their primary area of business, or anything else for that matter. These kinds of partnerships typically create positive sum games where both sides win, rather than zero sum games where only one of the parties wins, while the other loses and thus are highly recommended by our firm.

9. **ACCREDITED “ANGEL” INVESTORS.** Volumes can be and have been written on this and the next entry. Professional equity investors are a great source of financing for many different reasons. They are typically very experienced. They have gone through the ups and downs of operating a successful business and can thus be a great source of information, guidance, and support. Moreover, they are typically very well connected in their communities and can make much needed introductions to the key professionals (attorneys, accountants, bankers, etc.) you would need in order to successfully operate your business. Most importantly, these people are interested in reviewing new business plans, unique concepts, and meeting other like-minded entrepreneurs. If they do end up liking your business venture and investing capital then it’s more than just having someone bankrolling your idea, it is like having a true partner, who is interested in the long-term success of your business. Your



interests become aligned: they profit if you profit. As a result they will be there with you every step of the way making sure you don't repeat the same mistakes they have previously made and assisting you with making your business concept a reality. Angels are certainly great people to have at your side, but where do you find them and how do you approach them? The two most recommended methods for making the connection are through existing angel alliances (basically partnerships of many such individuals who regularly meet to review new business opportunities) or professional consulting companies, such as ours. Many resources are available online and in public libraries but the very best way of getting in front of these people is through some sort of a personal connection. Angels typically get dozens or even hundreds of business plans sent to them every month and thus the best way of making sure that yours is noticed among the many others is to have someone that they know and trust make a personal recommendation. Getting a key to the kingdom is an essential first step, but be sure to honestly review the quality of your presentation skills, business plan, financial projections, and other important documents. Will you be able to impress them enough to gain their sincere attention? If you have never done this before you may miss providing some details essential to their even considering the opportunity. Your chances are obviously much higher if you were to enlist the services of experienced professionals – attorneys, accountants, and yes, management consultants.

10. **VENTURE CAPITAL (VC) FIRMS & VENTURE FUNDS.** These are unlikely to be good sources of financing for small businesses. First, VCs typically invest only in seven-figure deals since the amount of due diligence and returns on investment are not appealing enough for smaller deals. Second, they typically invest in companies with a very unique niche product or service offering, rather than an average, run of the mill coffee shop around the corner. Third, they typically work with companies that already received some seed financing and have reached some milestones and are thus more of a secondary investment vehicle for companies that already have some traction. However, that being said, if your concept is unique enough, addresses a major problem for a large enough group of consumers, has some preliminary seed financing, has a developed product or service, has a professional and competent management team in place, has some operating history, and a few other important factors, then VCs can be a potentially wonderful vehicle for equity capital. They are professional companies made up of money managers, talented entrepreneurs, and investors who are actively searching for promising companies to invest in and can be the most potent form of fundraising for young start-up ventures. Keep in mind they will typically want to have a very large stake in your business – nothing comes free. If you want to approach these professional investors we recommend first contacting other professionals in your area who could make the necessary introductions and provide you with advice, such as attorneys, accountants, and once again, management consulting firms.



Please keep in mind that financing is a creative sport and many times requires thinking outside the box. I recommend that a combination of various forms of financing structures described above be used in order to diversify away as much of the risk as possible. In other words, you never want to rely on any single source of financing for your business if you don't have to.

I hope that I have been able to shed some light on this important business topic for our audience. If you have any further questions please contact us directly at [info@aginskyconsulting.com](mailto:info@aginskyconsulting.com).

In our next issue we will discuss the importance of business planning and where to begin the process. I will discuss such topics as what constitutes a professionally created business plan and what the purpose of it is. Until next month,

Your personal business consultant.

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