

Which type of funding is best for my business, debt or equity? Should it come from banks, angel investors, or venture capitalists?

Debt Financing

Commercial loans are attractive because they don't require entrepreneurs to turn over equity or company control. But servicing debt can drain a young company with limited cash flow.

Banks will expect you to present your previous three years of financial statements, along with a complete business plan. Many of the Resource Partner's in the KCSourceLink Network assist small companies and individuals in building business plans.

U.S. Small Business Administration loan programs

The Small Business Administration has several loan programs which make it easier for banks to provide loans to small business, but the federal agency loans no money directly. The SBA instead guarantees 75 percent of individual loans made by private lenders, up to \$750,000, but a business must first show that it cannot obtain conventional financing at reasonable terms. Because of this guarantee, fees associated with SBA loans make the loans more expensive than a non-SBA backed commercial loan. SBA loans are therefore ideal for businesses that might be considered too high of a risk for traditional business loans. Business owners must personally guarantee SBA loans and must also show cash flows sufficient to repay the loan. Most commercial banks offer information about SBA loans.

For more information on SBA loan guarantees, [click here](#) to visit their website.

[Click here](#) for a list of SBA certified/preferred lenders in your area.

What Banks Like

In general, banks prefer to make loans of over \$10,000 or so, as the administrative cost on a small loan is too high to make it profitable from the banks perspective. Businesses seeking loans of smaller amounts often obtain personal loans (see "other types of debt financing" below).

What banks like to see in loan an application:

- Good credit
- A solid business plan
- Ability to repay the loan
- Collateral

A line of credit

An arrangement in which a bank extends a specified amount of credit to a specified borrower for a specified time period (also called credit line).

A line of credit is best suited to help cover expenses that tend to fluctuate throughout the course of a year. This type of loan is not "termed" or does not have a fixed monthly payment or term of repayment.

How much can you expect a bank to loan against different types of collateral

- Percentages used by one area bank:
- 50% of receivables
 - 50% of inventory
 - 80% of new equipment
 - 0% of works in progress—a coffee cup that is only 50% complete doesn't have much value
 - 50% of used equipment
- 80% of commercial real estate Other banks will vary, but this should provide a basic guideline.

Banks like to match the duration of the loan to the duration of the collateral. For example, they would not want to finance a new building that has a life span of 40 years with receivables that only have a duration period of 3 months.

Other types of Debt Financing

Home Equity Loans

Home equity loans are a cost-effective alternative to other types of loans because they offer some of the best interest rates available. But you may not want to risk your family home to launch your business venture. Before going this route, you should carefully consider the risks involved.

Credit Cards

Cash advances from credit cards are an easy and quick way to gain access to cash. But as a long-term financing method, they can be expensive -- credit card interest rates typically run much more than the 1 to 3 percent "over prime" you would likely pay on a bank loan. If you use credit cards, shop for the best interest rate. Introductory "teaser" rates often give you a bargain for up to six months. If you have the time and energy, you can roll over your debt to a new card every six months, taking advantage of a new teaser rate.

Equipment Leasing

Equipment lease financing is an option for many cash-starved businesses. Equipment leases give you access to many types of equipment -- computers, copiers, fax machines, cars and trucks -- without tying up your cash or credit lines. Although it doesn't bring in cash, leasing reduces the amount of cash you otherwise have to raise. Leasing generally proves more costly than buying in the long run, but if cash flow is an issue for your company, it's definitely something to consider.

Equity Financing

What is Equity Financing?

Equity financing requires that the business sells a portion of the business in exchange for capital. The biggest problem with obtaining equity financing is often finding investors willing to buy into the business. The second limiting factor is wrestling with the fact that you must turn at least some of the control of your business over to the equity investor.

Angel Investors

Of the 500,000 start-ups each year, only 500 receive venture capital investments. The MAJOR source of equity for a new business comes from friends and family. Ninety percent of the investment outside of friends and family comes from angel investors.

Angel investments are similar to venture capital (discussed below) in that they are equity investments, however Angels tend to invest smaller amounts and tend to invest in younger companies than do VC's. Angels also tend to invest close to home and can be difficult to locate.

The Angel Capital Association provides a list of angel networks across the country on their website (http://www.angelcapitalassociation.org/dir_directory/directory.aspx), but is not an actual source of equity itself.

The desired investment profile for an Angel:

- A novel (new) or disruptive business concept
- A realistic business plan
- Technological Superiority
- Realistic Valuation As with venture capital and loans, a solid business plan must be presented to potential angel investors.

Venture Capital

Venture Capital firms tend to be specialized in specific industries and tend to only invest in those industries. Kansas City Equity Partners, for example, invests in the following industries:

- Consumer Products (Build-A-Bear)
- Communications (Birch Telecom)
- Natural Resources (natural gas)

Companies should not look for VC if they are only seeking a one time cash infusion into the business. The time horizon from introduction to funding is typically at least 12 weeks and often can take 6 months or even a year and companies interested in VC should be realistic about this. The VC firm wants to get to know the management, learn the product, understand the management team's personalities and abilities, as well as the companies "feel" before they are ready to make an investment. VC firms see these types of deals as a marriage, not as a transaction.

VC's are not interested in investing in companies for the sake of maintaining a current level of operation. VC's want to invest money in companies that can realistically expect high rates of growth, 20% or more, for at least several years. Financing receivables and paying off existing debt therefore are not things that VC's would be interested in funding. VC's look for a long-term relationship in their investments, typically three to seven years. They take partial ownership in the business, and therefore expect to have a say in how the business is operated.

VC firms rarely invest in deals that come to them "off the street". That is to say, they usually look more seriously at deals that are referred to them by people they know and whose opinions they trust. If a company is seeking VC, they are best off looking for an introduction from someone whose opinion the VC firm would hold in high regard (Business consultants, attorneys, CPA's, etc).

Small Business Investment Companies (SBIC)s are venture capital firms that receive loans from the Small Business Administration to make equity investments in small businesses. Venture Capital firms do not have to be regulated, but must submit to regulation if they want to be an SBIC.

To find SBIC's in your area and for more information on the subject go to:
<http://www.sba.gov/INV/forentre.html>