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Funding Your Business

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Introduction

Funding is the lifeblood of every business. Specific funding needs and sources will vary depending on the general age of a business (the business life cycle) and whether the financing is for long-term (plant and equipment) or short-term (cash flow or operating expenses) needs. Raising capital can often be a difficult, time-consuming frustrating and undertaking. As Richard Harroch points out in the Small Business Kit for Dummies, raising money is always harder than you expect and will take longer than you anticipate. Traditionally, there are three ways to finance your company: 1) use your own money, 2) borrow the money or 3) give investor equity in your company in return for using their money. There are also some non-traditional ways to fund your business. This white paper is divided into two parts. The first section looks at these various traditional and non-traditional types of funding. The second section correlates them to the business life cycle, describing which funding alternatives are most typically used at the various stages of a business's life cycle.

Types of Funding – An Overview

For the entrepreneur, available financing needs to be considered from the perspective of debt versus equity and using internal versus external funds as the funding source as well as the prevailing economic conditions (i.e., interest rates, consumer confidence, etc.). Taking these factors into account, funding alternatives can be categorized into four types: debt, asset based (a special form of debt), equity, and internal.

Debt

Debt financing is a financing method involving an interest-bearing instrument, usually a loan, the payment of which is only indirectly related to sales and profits. Typically, debt financing (or asset-based financing) requires that some asset (e.g., car, house, plant, machinery or land) be used as collateral. Debt financing requires the entrepreneur to pay back the amount of funds borrowed plus a fee expressed in terms of the interest rate and sometimes points for using or being able to use the money. Business owners need to be careful that the debt is not so large that regular payments become difficult if not impossible to make, inhibiting growth and development or even resulting in bankruptcy

Generally a loan proposal/application from a small business owner should include a comprehensive business plan, detailed company financials, and personal financial statements. The lender will then evaluate the loan request by considering a variety of factors. For example, the lender will examine the small business's credit rating and look for evidence of its ability to repay the loan, specifically focusing on past earnings and income projections. The lender will also inquire into the amount of equity in the business, as well as whether management has sufficient experience and competence to run the business effectively. Finally, the lender will try to ascertain whether the small business can provide a reasonable amount of collateral to secure the loan. The entrepreneur should determine what types of financing are available to the company, considering its stage of development and capital needs and then compare the costs and requirements of the different financing options[i]. The entrepreneur should ascertain whether or not the company is in a position to make set monthly payments on the loan.

Long Term

Long-term debt is frequently used to purchase some asset such as a piece of machinery, land or a building, with part of the value of the asset (typically 50 to 80 percent) being used as collateral. Financing through a mortgage is used to purchase real estate is secured by the asset and generally runs between ten and forty years. Such loans are classified as long-term. In addition to these types of loans, corporations and government entities issue bonds in a form attractive to both public and private investors. A bond is a contract held in trust with the obligation of repayment. It usually matures in a long-term timeframe. A debenture bond is unsecured, while a mortgage bond holds specific property in lien.

Intermediate Sources

Loans whose maturity generally runs more than one year but less than five are termed intermediate-term loans. These loans, sometimes called term loans can be used to finance the purchase of furniture, fixtures, vehicles, and plant and office equipment Consumer loans for autos, boats, and home repairs and remodeling are also of an intermediate term.

Short Term Sources

A single-purpose loan with a maturity of less than one year is considered a short-term loan. If the financing is short-term (i.e., less than one year), the money is usually used to provide working capital to finance inventory, accounts receivable or the operation of the business. Short-term borrowing is usually repaid from the results of sales and profits during that year. This type of loan is usually obtained for interim financing, special inventory purchase or to cover any cash shortages resulting from a one-time increase in current assets. Trade credit is an example of short-term financing. It is extended by a vendor who allows the purchaser up to three months to settle a bill. It is also a practice for vendors to discount trade bills by one or two percentage points as an incentive for quick payment.

Related Concepts

Debt to Equity Ratio

The debt-to-equity ratio is a measure of total debt to total assets (or total capital). The ratio indicates the percentage of the business' assets that have been financed by creditors and the percentage financed by owners. The ratio is used by lenders to assess a business's ability to carry additional debt. While the ratio does vary from industry to industry and where in the Business Life Cycle your business is, as a general rule of thumb the debt ratio should be at least 1:2 – meaning there are two dollars in equity (your assets or those of your partners or investors) for every dollar you borrowed.

Leveraging

Leverage is the advantage gained from using borrowed money to acquire income or cash-producing property. A highly leveraged company has a high debt to equity ratio, meaning it has a relatively large amount of debt (borrowed funds) in relation to its equity (invested funds). The effect of leveraging is to maximize the return on equity funds by earning a return on borrowed funds.

Personal Guarantees

In smaller businesses, personal guarantees are likely to be required on most debt instruments; commercial debt financing thereby becomes synonymous with personal debt financing. A personal guarantee is a pledge, by someone other than the named borrower that he or she promises to pay any deficiencies on a specific loan. Most guarantee forms require joint and several liabilities, meaning that each individual who signs a guarantee can be held responsible for the whole amount of the loan. Consequently, even if someone is only a 10 percent owner in the business, that person is personally liable for 100 percent of the amount being guaranteed. The guarantors can be sued individually or all together. There is no requirement that, before the guarantor can be held responsible, the lender must show that the borrower actually named in the loan document, e.g., the business, is unable to pay the loan. In effect, when you sign a personal guarantee, you become personally liable for the loan, even if your business is incorporated.

Today, with many lenders, the name of this game is "take it or leave it" and everyone they want to sign a guarantee must sign one or there's no deal. However, depending upon collateral and the creditworthiness of the business, room for negotiation may exist, particularly when dealing with smaller, community banks. Naturally, the banker is unlikely to tell you this. You won't know until you test the bank's degree of dependence on this point.

Asset Based

Asset based financing is a special form of debt financing. It uses specific assets to generate liquidity by using these assets as the basis for a debt based funding source.

Three types of asset based financing options are most typical: receivable based, inventory based, and capital asset based.

Receivable Financing

Receivables are an asset considered to be fairly liquid in the intermediate future, but represent a loss of liquidity in the immediate future. That is, the money tied up in accounts receivable is not available for paying bills, paying back loans, or expanding your business. The payoff from an investment in accounts receivable doesn't occur until your customers pay their bills. Collecting from customers in a timely fashion enables the business owner to reinvest those monies in the business. Customers who pay slow force the business owner to effectively borrow funds to cover costs that should be paid by receipts. In addition, there is a cost of doing business to monitor and address potential uncollectibles. The national average age of Accounts Receivable is about 45 days. Any improvement is a businesses A/R aging represents internal funding by the generation of cash. Receivables can be used as collateral in a short term funding arrangement. Although there is a cost associated with this, it removes the liquidity burden of rapid collection from the business owner.

Inventory Financing

Much like accounts receivable, inventory represents an investment of a business's cash — cash that cannot be used for other cash outflow purposes. Typically, a business purchases inventory and either pays for it at the time of the purchase, or within 30 days. Depending on the nature of your business, it may be days or weeks before the inventory is resold; or used in the manufacturing of a final product, and then sold. Therefore, your business's investment in inventory has a significant impact on your cash flow. An over-investment in inventory reduces the amount of cash that could be available for other outflow purposes. Good inventory management is another way to generate internal cash. In addition, like receivables, inventory can be used as the collateral basis for short term funding.

Sale and Lease Back

Capital assets tie up a great deal of cash. These assets can be converted into cash by selling them and then leasing them back. Under these arrangements, the capital assets are still available for use by the business but the value of the asset is converted into immediate cash.

Equity

Equity financing does not require collateral but requires that the business owner sell an ownership interest in the business in exchange for capital. The investor shares in the profits of the venture, as well as any disposition of its assets, on a pro rata basis. The challenge associated with equity financing is finding investors who are willing to buy into the business in light of the amount of control of the business the owner is willing to give up. By selling equity interests in a business, you sacrifice some of your autonomy and management rights. In addition, unlike debt financing, the way your business is organized will, to some extent, determine the types of equity financing available. While your choice of legal structure or "entity" for your small business involves many considerations (e.g., degree of personal risk, tax considerations, and the need to attract good business managers), the following discussion highlights some of the financing considerations associated with different forms of business entities.

Sole Proprietorships

Sole proprietorships are the simplest businesses to form, but equity financing is limited to the owner's assets.

Partnerships

General partnerships require at least two owners; so equity-financing possibilities are greater than in proprietorships but still limited to the number of partners. A limited partnership is a partnership that requires only one partner to assume personal liability for the business's liabilities (the general partner). There may be more than one general partner. However, there may also be other partners (limited partners) who are passive investors and do not incur personal liability. A limited partner is merely an investor; s/he supplies the capital but is not involved in the day-to-day management of the business. In fact, limited partners are prohibited from becoming actively involved in the on-going management of the business or they forfeit their limited liability. Limited Partnerships must have at least one general partner who is responsible for overseeing operations and for making day-to-day management decisions.

Corporations

Corporations provide the most flexible possibilities for investors. For many small businesses, incorporation provides the easiest method for raising capital from multiple investors, particularly those investors who are not necessarily interested in actively participating in the business. In some instances, it may be easier to persuade 25 people to invest $5,000 than to convince one person to contribute $125,000, and a corporation permits this kind of widespread ownership. Several alternative types of corporations may be available for small businesses, including S corporations, closed corporations, and C corporations. Each of these types of corporations have different requirements but they all permit equity financing through the sale of stock in exchange for a capital contribution of money or property.

Internal Sources

Financing is also available from internal funds. Internally generated funds can come from several sources within a company: profits, sale assets, reduction in working capital, extended payment terms, and accounts receivable. For new businesses, the start-up years involve putting profits back into the business; even outside equity investors do not expect payback in these early years. Sometimes, the needed funds can be obtained by selling little-used assets. Assets, whenever possible, should be on a rental basis (preferably on a lease with an option to buy), not on ownership basis, as long as there is not a high level of inflation and the rental terms are favorable. This will help the entrepreneur conserve cash, which is particularly critical during the start-up phase of a company's life.

Profits

Assuming a business is running successfully, the profits generated by operating on an on-going basis are available as an on-going source of funds to the business.

Payables

Suppliers make good financiers. If a supplier offers 30 days to pay, take 30 days and think about asking for 45. The slower you are to pay bills – without placing the relationship in jeopardy, the more cash you have in your pocket to run YOUR business. Also, set up a process to take advantage of early payment discounts. Again, if you can keep the funds, it's like printing cash to help grow your business and meet customer needs.

Expense Control

Make every dollar count. If you do not need it, don't buy it! Do you really need to rent that expensive postage meter or can you just buy self-stick stamps for a while? Does your company van need to be washed at the fancy place down the block or can you spare a little time to do it yourself on the weekend? Smart purchasing applies to fixed assets as well. Will a used computer do the job you were going to buy that Pentium 4 screamer for? Every dollar saved is a dollar available to fund your business.

Cash Flow

A healthy cash flow is an essential part of any successful business. Some business people claim that a healthy cash flow is even more important than your business's ability to deliver its goods or services! That may be placing a bit too much importance on your cash flow, but consider this — if you fail to satisfy a customer and lose that customer's business, you can always work harder to please the next customer. But if you fail to have enough cash to pay your suppliers, creditors, or your employees, you're out of business! No doubt about it, proper management of your cash flow is a very important step in making your business successful. In its simplest form, cash flow is the movement of money in and out of your business. It could be described as the process in which your business uses cash to generate goods or services for the sale to your customers, collects the cash from the sales, and then completes this cycle all over again.

Cash outflows and inflows occur at different times, and never actually occur together. More often than not, cash inflows lag behind your cash outflows, leaving your business short of money. Think of this money shortage as your cash flow gap. The cash flow gap represents an excessive outflow of cash that may not be covered by a cash inflow for weeks, months, or even years. Managing your cash flow allows you to narrow or completely close your cash flow gap. It does this by examining the different items that affect the cash flow of your business. Examining your cash inflows and outflows, and looking at the different components that have a direct effect on your cash flow, allows you to better balance these flows. This balancing may significantly reduce the need for other funds.

Business Life Cycle and Funding

The general life cycle of a business is classified into four stages of development, specifically: start-up, growth, maturity, and transfer. It is very similar in concept with the theory of product life cycle that was first introduced in the 1950s to explain the expected life cycle of a typical product from design to obsolescence. Business life-cycle theory is an extension of this product life-cycle concept originally developed in the fields of marketing and microeconomics.[ii] Individual products (goods or services) move through four more or less identifiable phases: start-up, growth, maturity, and decline. Similarly, firms can be described in terms of life-cycle stages that depend on the portfolios of products. The goal is to maximize the value of business and profitability at each stage. During each stage the business has specific goals that need to be addressed with the right financing strategies.

Correlating Needs and Sources

Startup Needs and Funding Sources

In the start-up phase a firm generally has few assets in place. There are little or no positive operating cash flows or earnings. A large portion of a start-up firm's value consists of the value of its growth opportunities. The firm may need financing in this stage to be able to invest in positive net present value growth opportunities. Assets in place may be very different from the assets the firm will need in the future. For example, a high-tech research firm will currently be involved in research and development activities, but will later invest in production and sales facilities for the marketing of viable products. Early in the business life cycle with no proven market or customers the business will rely on cash from owners, friends and family. Other potential sources include suppliers, customers and government grants.

Growth Needs and Funding Sources

In the growth phase, investment in growth opportunities has begun, and some financing has been obtained. The ratio of the value of assets in place to the value of the firm is higher in the growth stage than in the start-up stage. The assets in place are more representative of the growth opportunities available to the firm and are now generating income and cash flows. Growth opportunities, however, are still a major component of the overall value of the firm. Financing needs at this stage are evaluated with the funds available for growth factors. Banks provide a variety of loans for supporting companies at this stage. Other potential means during this phase are profits, partnerships, grants and leasing options.

Maturity Needs and Funding Sources

In the mature phase, the value of growth opportunities compared to the value of assets in place is less than in the start-up and growth phases. The firm is in a stage of moderate or low growth (in percentage terms), with many of its cash flow needs internally generated. The assets in place are representative of the growth opportunities of the firm, that is they are likely to be involved in scaled expansion: for example, building similar manufacturing facilities in different locations. Joint ventures, banks, licensing, new investors and partners are potential sources during this phase.

Transfer Needs and Funding Sources

In a firm's transfer (or stagnant) phase, the value of assets in place is, to a large extent, still the value of future cash flows generated from the operation of these assets. Growth opportunities in this case are likely to be limited: Competition is likely to be greater, potential markets smaller, and scaled expansion less profitable. These declining firms are not necessarily going to fail. Firms can regenerate by investing in new product lines and technology, and go back into the growth or mature stage or forestall failure for many years. If a business transfer of ownership is considered for several reasons such as retirement, buyout even before a firm reaches a decline stage. There are several mechanisms that lead to transfer such as buying and selling of whole or parts of business.

This paper will concentrate on the first three stages of a business's life cycle. Since the optimum alternatives for businesses in the growth and mature stages are similar, these stages are grouped under one heading. Furthermore, since transferring or selling a business has its own unique financial requirements and needs, this stage is not specifically addressed in this paper.

Funding a Startup

Private Sources

The short-term needs of many start-up businesses are met using personal and private sources such as borrowing from friends and relatives. The main advantage of this type of arrangement is that friends and relatives are likely to provide more flexible terms of repayment than banks or other lenders. In addition, these investors may be more willing to invest in an unproven business idea, based upon their personal knowledge and relationship with the entrepreneur, than other lenders. A related disadvantage, however, is that friends and relatives who loan money to help establish a small business may try to become involved in its management. Experts recommend that small business owners create a formal agreement with such investors to help avoid future misunderstandings. Personal financing sources are used both for long-term and short-term needs.

Credit Cards

Increasing numbers of entrepreneurs have turned to credit cards to finance their business ventures in recent years. Credit cards are one of the most overlooked resources for obtaining start-up capital and are an excellent means of short-term financing needs. It is a way to get several thousand dollars quickly without the hassle of dealing with paperwork. The disadvantage of credit cards maybe their high interest rates. Because many companies are competing in credit card financing, an entrepreneur may find bargains or deals. An entrepreneur who pours money into his/her business via credit cards, only to have the business fail, will be left with a very poor personal credit history. On the other hand, a small business owner who successfully uses credit cards to finance a start up or expansion, can impress a bank with his/her financial management of the cards and earn a more attractive credit line.

Credit Unions

A credit union is a co-operative financial institution that is owned and controlled by its members, where a member may deposit money or borrow money from it. The character of a borrower is often deemed to be the most important factor in deciding whether or not to make a loan. A credit union differs from a traditional bank in that the members who have accounts in the credit union are its owners. Since a credit union is a co-operative institution, its policies governing interest rates and other matters are set to benefit the interests of the membership as a whole; for example, credit unions often pay higher interest on deposits and charge lower interest on loans. Credit union revenues (from loans and investments) do, however, need to exceed operating expenses and dividends (interest paid on deposits) in order to remain in business. Credit unions offer many of the same financial services as banks, including share accounts (savings accounts), share draft (checking) accounts, credit cards, and certificates of deposit. Credit unions are good a source for both long-term and short-term financing for a startup business.

Trade Credit

Trade credit exists when one provides goods or services to a customer with an agreement to bill them later, or receive a shipment or service from a supplier under an agreement to pay them later. It can be viewed as an essential element of capitalization in an operating business because it can reduce the required capital investment to operate the business if it is managed properly. Vendors and suppliers are often willing to sell on credit and this source of working capital financing is very common, especially for startup businesses. Suppliers know that most small businesses rely primarily upon a limited number of suppliers and that small businesses typically represent relatively small order risks.

Banks

Banks are the sources that most people immediately think of for debt financing. There are many different types of banks, although in general they exist to accept deposits and make loans. Most banks tend to be fairly risk averse and proceed cautiously when making loans. As a result, it may be difficult for a young business to obtain this sort of financing, unless the owner has personal collateral to pledge. Commercial banks usually have more experience in making business loans than do regular savings banks. It may be helpful to review the differences among banks before choosing one as the target of a loan request.

SBA Loans

A major source of financing for small businesses in the United States is the U.S. Small Business Administration (SBA). Thousands of small enterprises who were unable to secure loans from lending institutions on their own were supported by the SBA's various loan programs. Businesses cannot solicit loans from the SBA unless they are unable to get funding independently. The main component of the SBA loan system is its 7(a) programs that annually accounts for the vast majority of the loan guarantees distributed to small businesses. Loan guarantees made through the 7(a) programs totaled $10.5 billion in FY 2000, accounting for approximately 91 percent of the total of all SBA loans made during that time.

Under the 7(a) Loan Program is the most popular of the agency's programs. Under this program, the SBA does not actually make direct loans to small businesses. Instead, it assures the institution that is making the business loan—usually a bank—that it will make payment on the loan if the business defaults on it. Since the SBA is taking responsibility for the loan, it is usually the final arbiter of whether a loan application will be approved or not.

The 7(a) Loan Program was formed to meet the **long-term financing needs** of small businesses. The primary advantage of 7(a) loans is that business enterprises are able to repay the loan over a very long period of time. Ten-year maturities are available for loans for equipment and working capital (though seven-year terms are more commonplace), and loans for real estate and major equipment purchases can be paid back over as long as 25 years. The SBA can guarantee 75 percent of loans up to $750,000, and 80 percent of loans of less than $100,000. The interest rate of 7(a) loans can not exceed 2.75% over the prime-lending rate. The SBA maintains several individual loan programs under the 7(a) umbrella. These include CAPLines, LowDoc, SBAExpress, EWCP, DELTA, and an assortment of other lending initiatives targeted at specific sectors of the small business world.

- **CAPLINES** Limited to $750,000, CAPLines loans are given to small businesses with short-term working capital needs. "Under CAPLines," notes the SBA, "there are five distinct short-term working capital loans: the Seasonal, Contract, Builder's, Standard Asset-Based, and Small Asset-Based lines. For the most part, the SBA regulations governing the 7(a) Program also govern this program."
- **LOWDOC** The Low Documentation Loan (LowDoc) Program is a simplified version of the 7(a) loan for businesses with strong credit histories seeking less than $150,000. It combines a streamlined application process (for many loan requests, the application is only one page long) with the elimination of several bureaucratic steps to improve response time to requests. Any small business that

posted average annual sales over the previous three years of $5 million or less and employs 100 or few individuals (including all owners, partners, and principals) is eligible to apply for a Low Documentation Loan. Since its inception, the LowDoc Program has proven enormously popular with small business owners and entrepreneurs.

- **SBAEXPRESS** This relatively new pilot program is only available through selected lending institutions. It makes loans of up to $150,000 to qualified businesses.
- **EWCP** The Export Working Capital Program (EWCP) guarantees loans for qualified small businesses engaged in export transactions. It replaced another SBA program known as the Export Revolving Line of Credit Program. Most of the SBA regulations governing the 7(a) Program also govern this program. Loan maturities, however, may be for up to three years, with an option for annual renewals. EWCP loans can be extended for either single or multiple export sales.
- **DELTA** The Defense Loan and Technical Assistance (DELTA) Program was implemented to help ease the impact of national defense cuts on defense-dependent small businesses. According to the SBA, DELTA loans of up to $1.25 million must be used to retain jobs of defense workers, create new jobs in impacted communities, or to make operating changes with the aim of remaining in the "national technical and industrial base." While listed under the 7(a) umbrella of loan programs, DELTA actually uses the 504 CDC program as well.

The SBA also offers several other types of loan programs, these include:

- **MICROLOANS** SBA MicroLoans are short-term loans of up to $25,000. Disseminated through non-profit groups, MicroLoans are intended for the purchase of machinery and other equipment, office furniture, inventory, supplies, and working capital.
- **INTERNATIONAL TRADE LOAN (ITL)** The ITL provides long-term financing assistance to small businesses who are involved in international trade or who have been hurt by imports. Under this program, the SBA guarantees loans for up to $1.25 million for a combination of fixed-asset financing and working capital needs (though the working capital portion of the guarantee is limited to $750,000).
- **POLLUTION CONTROL PROGRAM** This program extends loans to small businesses engaged in the planning, design, or installation of pollution control facilities.

The interest rates on SBA-guaranteed loans are negotiated between the borrowing business and the lending institution, but they are subject to SBA-imposed rate ceilings, which are linked to the prime rate. Interest rates on SBA loans can be either fixed or variable. The Small Business Administration defines businesses eligible for SBA loans as those that: operate for profit; are engaged in, or propose to do business in, the United States or its possessions; have reasonable owner equity to invest; and use alternative financial resources (such as personal assets) first. In addition, to secure SBA assistance, a company must qualify as a "small business" under the terms of the Small Business Act.

That legislation defined an eligible small business as one that is independently owned and operated and not dominant in its industry.

Angel Investors

Angel investors are wealthy individuals who provide capital to help entrepreneurs and small businesses succeed. They are known as "angels" because they often invest in risky, unproven business ventures for which other sources of funds such as bank loans and formal venture capital are not available. These individuals want to invest in up-and-coming new companies not only to earn money but also to provide a resource that would have been helpful to them in the early stages of their own businesses. In many cases, the investors sit on the boards of the companies they fund and provide valuable, firsthand management advice.

Like other providers of venture capital, angel investors generally tend to invest in private startup companies with a high profit potential. In exchange for their funds, they usually require a percentage of equity ownership of the company and some measure of control over its strategic planning. Due to the highly speculative nature of their investments, angels eventually hope to achieve a high rate of return. Some entrepreneurs gain access to angel investors through venture capital networks—informal organizations that exist specifically to help small businesses connect with potential investors, and visa versa.

Although an angel can seem like the answer for an entrepreneur who is desperate for capital, it is important to evaluate the person's motives for investing and need for involvement in the day-to-day operations of the business before entering into a deal. Regardless of the type of angel a small business owner is able to recruit, there are a number of methods available to help avoid potential problems in the relationship. Entrepreneurs should, for example, be very frank and honest when describing their business idea to a potential investor. Entrepreneurs should also interview potential investors to be sure that their goals, needs, and styles are a good fit with the small business. It is important to ask questions of potential investors and listen to their answers in order to gauge their needs and interests. Ideally, the angels' investment approach will be compatible with the entrepreneur's needs. Entrepreneurs need to keep in mind that partnerships between angels and entrepreneurs are like marriages, involving issues of compatibility and cash.

Franchising and Licensing

Financing for growth and expansion through franchising or licensing involves selling the rights to a unique business or product to other companies. Other small business owners are able to form alliances or partnerships with other firms that have a vested interest in their success, such as customers, suppliers, or distributors. These business owners may obtain funds from their partners through cooperative work agreements, barter arrangements, or trade credit.

Non-Traditional Sources

Some of the more common nontraditional financing sources include selling assets, borrowing against the cash value of a life insurance policy, and taking out a second mortgage on a home or other property. Some entrepreneurs choose to sell some of their personal or business assets in order to finance the opening or continued existence of their enterprise. Borrowing against the cash value of your life insurance can be an effective means of securing capital provided that the owner has held the policy for several years, thus giving it some cash value. Insurers may let policyholders borrow as much as 90 percent of the value of the policy. As long as the policyholder continues to meet his or her premium payment obligations, the policy will remain intact. Interest rates on such loans are generally not outrageous, but if the policyholder dies during the period in which he or she has a loan on the policy, benefits are usually dramatically reduced. Some entrepreneurs secure financing by taking out a second mortgage on their home. This risky alternative does provide the homeowner with a couple of advantages: interest on the mortgage is tax deductible and is usually lower than what he or she would pay with a credit card or an unsecured loan.

Funding a Business in the Growth/Mature Stage

A growing or mature business usually has sufficient stability in its operations so that cash flow problems are not a constant crisis. If the business is successful, internally generated funds from sales and investments can fund many of the business's needs. Businesses in these stages have available to them all the sources a startup business has. However, typically, growing and mature businesses have more financing options available to them because of their operating history, established value, credit history, and availability of inventory and accounts receivable financing. In addition, the advantages of having established customers and suppliers, efficient internal operating procedures, more sophisticated marketing and advertising, realistic long-term business plans, and the company's emerging goodwill help improve the creditworthiness and investor appeal of the business.

The primary sources of short-term financing for a business in the growth or mature stage is debt and asset based financing, bank lending, *trade credit*, *factoring* and *commercial finance companies*.

Factoring

Factoring is the sale of accounts receivable. By selling your invoices for future payment, you generate cash much sooner than if you collected the money on your own. The factor company that purchases your receivables takes title to the invoices and collects them when they are due. The factor also assumes responsibility for all of the costs, as well as the hard work and hassle that comes with customer debt collection.

Commercial Financing

Commercial finance companies provide business loans rather than consumer loans. A small business's primary use of a commercial finance company is to borrow money for the purchase of inventory and equipment. These financiers can be a useful resource, particularly if your business has adequate collateral available to support a loan. Commercial finance companies usually do a great deal of accounts receivable and inventory financing. Small businesses involved in manufacturing or wholesaling may be most interested because they tend to need to be highly collateralized.

Debt financing and bank lending can also be primary sources of long-term financing. In addition, *Leasing*, *Business Alliances*, *Venture Capital*, *Limited Private Offerings* and *SBA Section 7(a) loans* can also be good sources for long-term financing for the growing or mature business.

The main advantage of *leasing* is that your initial outlay of cash to gain the use of an asset is generally less for leasing than it is for purchasing. This is especially important to a growing business trying to maximize it use of cash. However, the major disadvantage of leasing is that you usually end up paying out more over the asset's life than you would have paid if you purchased the asset. Depending on interest rates, leasing terms and useful life of the equipment, this might be a wise choice.

Business Alliances

For small businesses, *business alliances* often consist of simple "bartering" with customers, suppliers, and even competitors. If you own a manufacturing business, for example, you might be able to get a better price for component parts if you propose using a label on your final product that includes the supplier's trademark. Alliances for research and development efforts are also quite common as a means of minimizing these long-term costs. Cooperative buying and mutual assistance agreements are another way to leverage the power of group buying. Also important to consider is that although partnering arrangements are often with other businesses, you may also find that trade associations, nonprofit groups, local community organizations, may offer great opportunities for financing some advertising and distribution expenses.

Venture Capital

Venture Capital is another source of funds for growing or mature businesses. Venture capital companies or VCs, supply funding from private sources for investing in select companies that have a high, rapid growth potential and a need for large amounts of capital. VC firms speculate on certain high-risk businesses producing a very high rate of return in a very short time. Firms typically invest for periods of three to seven years and expect at least a 20 percent to 40 percent annual return on their investment. Venture capital financing may not be available, nor a good choice of financing, for many small businesses. Usually, venture capital firms favor existing businesses that have a minimal operating history of several years; financing of startups is limited to situations where the high risk is tempered by special circumstances, such as a company with extremely experienced management and a very marketable product or service.

While many small businesses sell interests in their companies that are "securities," as defined by federal or state laws, the transactions are often exempt from registration regulations because the offerings are sufficiently small in dollar amount, and they are restricted to a limited number and/or type of investors. These exempt offers of securities are called *limited private offerings* and they can avoid much of the cost and delay of a public offering. Unfortunately, to qualify for any of the exemptions, you must fit the criteria for *both* federal and state security laws.

Limited Private Offerings

Limited private offerings can be either debt or equity instruments, or a hybrid of both. These alternative offerings allow the business to tailor the amount of immediate equity (ownership and control) that it relinquishes, and the amount of debt (cash outflow) that it can safely assume. It's strongly advised that you consult with a legal expert as part of considering a LPO financing strategy.

Conclusions

A variety of sources for financing is available for businesses. Depending on how the business is organized and its overall financial condition the best available sources can be sought. In the different phases of the business cycle where a business exist a classification of financing with the different maturity periods is shown in the chart below.

Business Life Cycle	Short-Term	Long-Term
Start-Up	• Personal Finance • Credit Card • Credit Union • Trade credit • Caplines • SBAExpress • Microloan • DELTA loans	• Licensing • Credit Union • 7a loan program • EWCP • International Trade Loans • Asset based financing • Franchising • Angel investor
Growth/Mature	• Factoring • Trade credit •	• Bank lending • Debt financing • Leasing • Business Alliances • Venture Capital • Limited Private Offerings • SBA Section 7(a) loans

[i] Taken from *Financing for the Small Business,* Brian Hamilton, 1990, Small Business Administration..
ii Rink, David and J.E. Swan (1979), Product life cycle research: A literature review, *Journal of Business Research* 7,219-242

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