



Fueling Your Business: A Guide to Financing Your Small Business



**Identify different financing sources
and choose the best for you**

Learning Objectives

At the end of this module, you will be able to:

- Identify the types of financing available.
- Identify the difference between debt and equity financing.
- Consider important factors when determining which financing program is right for you.

About FDIC Supplier Diversity Effort

The Federal Deposit Insurance Corporation (“FDIC”) recognizes the important contributions made by small, veteran, and minority and women-owned businesses to our economy. For that reason, we strive to provide small businesses with opportunities to contract with the FDIC. In furtherance of this goal, the FDIC has initiated the FDIC Small Business Resource Effort to assist the small vendors that provide products, services, and solutions to the FDIC.

The objective of the Small Business Resource Effort is to provide information and the tools small vendors need to become better positioned to compete for contracts and subcontracts at the FDIC. To achieve this objective, the Small Business Resource Effort references outside resources critical for qualified vendors, leverages technology to provide education according to perceived needs, and offers connectivity through resourcing, accessibility, counseling, coaching, and guidance where applicable.

This product was developed by the FDIC Office of Minority and Women Inclusion (OMWI). OMWI has responsibility for oversight of the Small Business Resource Effort.

Executive Summary

A successful business needs a committed owner, a strong business concept and strategy, and financing to help the business grow and thrive. Using your own money to start and finance a business is the easiest approach, but may not be an option. Instead, you may need to obtain financing or capital from friends and family, a bank, or other sources. Regardless of the source, financing can be categorized into two options: debt and equity financing. This module explains the rules and requirements of financing options to help save you time as you begin applying for funding.

Determining Your Financing Needs

You’ve decided to turn your passion into reality by opening a small business. Now what? One of the first steps is determining how much money you will need to start this business regardless of the source. Some businesses can be started with minimal upfront capital, while others require a large initial

investment to purchase inventory or equipment. You will also need money to maintain your household, and you should keep that separate from any money you use for starting your business. To decide how much you need:

- **Determine Your Start Up Costs:** When determining your start-up costs, think about:
 - **One-time charges:** Include one-time items like building signage, business name registration, incorporation fees.
 - **Recurring costs:** Include fixed costs (rent, utilities, insurance, payroll) and variable costs (inventory, shipping, sales commissions).
 - **Hidden costs:** As a start-up, you'll find hidden costs you didn't include in your plan. You should have at least 10% in contingency money for these costs.
- **Determine Your Personal Equity:** One of the first questions any financial institution will ask is how much personal equity you will bring to the table. The amount of personal equity most lending institutions require is 20% to 40% of the total loan request.
- **Estimate Your Monthly Expenses:** It's important to estimate your expenses as closely as possible through month-to-month cash flow projections. Asking for more money than you actually need may jeopardize your ability to secure a loan and will make your loan payment higher.

If your business is already established and you want to expand, you will need to be able to show your business is profitable to be eligible for financing. If you are applying for funds due to financial difficulties, you will most likely need collateral to secure any type of loan.

Types of Financing

You have several options when considering financing:

- **Your Own Assets:** Starting or growing a business with your own money puts you in the best financial position. Using your own money keeps you from taking on additional debt, and you don't give up equity in the business. You also don't have to repay anything and no interest will accrue. If you use jointly-owned accounts, make sure you have the other owner's consent.
- **Sales/Income:** If you already own a business or have clients lined up before you open your business, the best way to grow your business is to use customer sales revenue. You get the same benefits of using your personal funds without depleting your savings account. You don't take on additional debt or give up equity, and you won't have to pay back a loan or accrue interest. Your growth may be slower, but you will have greater peace of mind without a loan repayment schedule.

- **Credit Cards:** Financial experts warn against using credit cards because of high interest rates and the risk of damaging your personal credit. In some instances, using a credit card might be an easier solution than getting a traditional loan. An example would be using a credit card to cover short-term cash flow problems when you are guaranteed income soon. If you use a credit card, only do so if you can pay it off each month. If you can't pay off the credit card monthly, you will incur even more charges in interest and late fees. If your payments are late, you may also incur even higher interest rates.
- **Friends and Family:** Borrowing money from friends or family may seem like a good idea initially, but you need to weigh the odds. Ultimately, the question becomes, "At what expense am I receiving this money?" If the money is given as a gift, it does not need to be repaid. But if the money is given to buy interest/ownership, then you need to determine how that arrangement will work. Will they have input in the decision-making process? Or, will they be board members? Regardless of their role, you should be cautious. In any situation, make sure you have loan or investment papers drawn up with clearly defined investment, ownership, and repayment terms.
- **Banks:** If you have had an existing business for one or two years, you have a better chance of receiving a loan from a bank. If you are starting a business, banks typically require a guaranty and personal collateral for business loans. The Small Business Administration (SBA) provides loan guarantees to banks to encourage them to make small business loans. If you default on the loan, SBA will repay the bank. However, the business owner is still responsible for repayment of the full loan. As an existing business, you should establish a line of credit with a bank as your business grows to help manage your cash flow.
- **Angel Investors:** Angel investors are typically wealthy individuals who want to invest in up-and-coming businesses. They are similar to venture capitalist firms but are usually individuals. If you use angel investors, know that they will expect to see some return in the form of stock or stock-buyback when the business purchases outstanding stock within seven years. Business owners looking for angel investors should network with lawyers or accountants who work with small businesses; they may have investors to whom they can refer you.
- **Peer-to-Peer Lending:** Businesses use this method of lending (also called online lending or person-to-person lending) because it's cheaper and easier than getting a loan through banks. These loans are considered individual loans or personal debt and will show up on your personal credit report, lowering your credit score. You need a good personal credit score to qualify for a peer-to-peer loan, usually 640 or more, and loans are usually capped around \$25,000.
- **Unsecured Business Loans:** This type of loan does not require collateral and is also called a line of credit loan. These loans are riskier for lenders due to no collateral as a repayment guarantee. Due to this risk, the loan amounts are smaller, and the interest rates are higher.
- **Small Business Loans:** These types of loans are for businesses with relatively few assets which generate modest annual revenue. You must be qualified as a small business to be eligible for small business loans. Small businesses are generally measured by various factors such as

amount, value and type of assets owned, revenue and income generated, number of employees, and years in operation. Most lending institutions require a guarantee and collateral for small business loans. The SBA does not lend money, but does offer guarantees for small businesses that qualify for loans through commercial banks, finance companies, and government entities.

- **Minority Business Loans:** Businesses eligible for minority loans must be owned exclusively or predominantly by individuals of a minority background. These loans are not just for small businesses, and the applicant must comply with the requirements of the lender. Requirements may be based on minority ownership or being located in a predominantly minority occupied neighborhood. Certain non-profit entities that advance and support certain minority groups may have small business loan programs available.
- **Federal Grants for Small Business:** Small business loans and small business grants may be awarded to businesses that meet the size standards that the SBA has established for most industries in the economy. The most common size and revenue standards are as follows:
 - 500 employees for most manufacturing and mining industries
 - 100 employees for all wholesale trade industries
 - \$6 million for most retail and service industries
 - \$28.5 million for most general & heavy construction industries
 - \$12 million for all special trade contractors
 - \$0.75 million for most agricultural industries

With some exceptions, all federal agencies, and many state and local governments, use the size and revenue standards established by SBA. You can search for further information and for loan opportunities by visiting the Small Business Administration (<http://www.sba.gov/>).

- **State Grants:** When searching for small business grants, start by looking at the state where your business is located. Many states have agencies designed to offer grants and other types of business assistance in order to encourage small business growth and development in their area.

Most states have a Small Business Development Center (SBDC). SBDC's are a nationwide network of sites, typically housed at colleges and universities, which provide training and advice to small businesses on all aspects of starting, financing, and managing a business. You can also visit the Association of Small Business Development Centers (ASBDC) (<http://www.asbdc-us.org/>) and search by your zip code.

- **Vendor Finance:** If you have established a good relationship with a vendor, the vendor may be willing to finance part of your business by extending their terms of payment for a predetermined length of time. You can approach vendors and show them your business plan and the orders you've already 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. Establishing supplier exclusivity for a documented amount of time may also be

exchanged for longer credit terms. Your business may be required to pay a higher price for this arrangement.

- **Prepay Financing:** If you have successfully demonstrated to your customers that you deliver your merchandise on time and as ordered, you may be able to persuade one or more of them to put a deposit on their future orders, perhaps as much as 50%. You can add an incentive by decreasing your price a bit in exchange for the deposit. Or, you can offer a bonus: if they've ordered 100 items, they get 10 at no charge. New customers can also be asked for a deposit, especially if it's a large or custom order.

Debt and Equity Financing Explained

Financing can be categorized into two options – debt financing and equity financing. Review the table below to determine which option will best suit your needs.

	DEBT FINANCING	EQUITY FINANCING
DEFINITION	Debt financing refers to any borrowed money which the entrepreneur must pay back to the lending institution. It can come in the form of a loan, line of credit, bond, or even an IOU. An interest rate and other terms apply.	Equity financing is money lent in exchange for ownership in a business. New businesses can use equity financing for their startups or when they need to raise additional equity capital to offset existing debt.
WHO DEPENDS ON THIS TYPE OF CAPITAL?	<ul style="list-style-type: none"> • Well-established businesses that have demonstrated steady sales, solid collateral, and profitable growth often rely on debt capital for financing their businesses. 	<ul style="list-style-type: none"> • Businesses with a more conventional approach to management, high profitability, and/or poor credit ratings often rely on equity capital for their funding needs. • Small business startups and newly launched businesses that have not established a solid track record of success and face uncertainty in their early stages of development.
WHERE CAN I OBTAIN THIS TYPE OF FUNDING?	<ul style="list-style-type: none"> • Commercial banks • Loans through the Small Business Administration (SBA) 	<ul style="list-style-type: none"> • Personal funds from savings, credit cards, retirement accounts, property equity, etc. • Friends and family can lend money for a stake in the business. • Angel investors and venture capitalists can provide a new business owner with desired capital in exchange for a board seat, a stake in the business, and large return on investment. • Investment banking firms • Insurance companies

	DEBT FINANCING	EQUITY FINANCING
		<ul style="list-style-type: none"> • Large corporations • Government-backed Small Business Investment Corporations (SBICs)
DEBT-TO-EQUITY RATIO	High (ideally, 1:2 or 1:1, depends on industry)	Low
REQUIREMENTS	<ul style="list-style-type: none"> • Exceptional credit history of borrower. • Borrowers must show potential lenders they are willing to invest money in the business by using their own money. 	<ul style="list-style-type: none"> • Good-standing credit history. • Borrowers must demonstrate their business is in a high-growth industry and the potential to produce a large return on investment. • Well-detailed business plan and clear exit strategy.
ADVANTAGES	<ul style="list-style-type: none"> • Lender does not gain ownership, so the business owner is able to maintain maximum control over his/her business. • The borrower has no obligation to the lender other than the repayment of the loan; the relationship ends once the entire amount is paid back. • The interest on debt financing is tax deductible. • Depending on the terms of the loan, repayment of the loan is often a fixed, monthly expense. • The business will not have all of its cash flow available to do business. 	<ul style="list-style-type: none"> • Allows the business owner to obtain funds without incurring debt which equates to more cash flow. • Allows business owners to focus their attention on making their product(s) profitable rather than paying back the investors. • Enables the investor(s) and business owner the opportunity to develop a long term relationship throughout their joint business endeavor. • The cash flow generated can be used for follow-on investments rather than towards the loan debt. • Capital borrowed from family and friends is a quick way to raise capital with no overbearing interest rates.
DISADVANTAGES	<ul style="list-style-type: none"> • Requires regular monthly payments with steadily accrued interest which equates to limited cash flow. • Tarnished credit ratings can result from the inability to pay back any borrowed capital, limiting the chances of raising additional capital. • Often limited to established businesses with a solid track record of success. 	<ul style="list-style-type: none"> • Dilution of ownership can easily occur; the more investors involved the more loss of control. • Angel investors or venture capitalists may feel inclined to have a say in every business decision. • If capital was obtained from personal finances, credit cards may be maxed out. • If money was borrowed from family and friends, then relationship strains may occur. • Too much equity can suggest that entrepreneurs are not making use of their borrowed funds; whereas too little may demonstrate non-

	DEBT FINANCING	EQUITY FINANCING
		commitment on the business owners' part. <ul style="list-style-type: none"> • Complex reporting is often required by investors.
APPLICATION PROCESS	<ul style="list-style-type: none"> • A formal application must be filled out either in person at the lending institution of choice or online. 	<ul style="list-style-type: none"> • An application and other pertinent materials are required for angel investors and venture capitalists. Family and friends usually do not require an application process.
CREDIT CHECK	<ul style="list-style-type: none"> • Yes. The higher the credit score of the business owner(s), the better the chance in obtaining a loan. 	<ul style="list-style-type: none"> • Angel investors and venture capitalists will usually conduct a credit check of the business owners during the due diligence process but may rely more on the potential of return on investment. • Family and friends usually do not conduct a credit check.
TERM OPTIONS	<ul style="list-style-type: none"> • Short-term debt financing: total repayment of borrowed capital in less than one year. • Long-term debt financing: total repayment of borrowed capital in over one year. 	<ul style="list-style-type: none"> • Usually, both angel investors and venture capitalists are involved in an investment for an average of 3-7 years.
OTHER	<ul style="list-style-type: none"> • A type of long-term debt financing payment is a balloon payment; at the end of the term, the lender and borrower negotiate a new loan amount for the residual amount left. • Variable rates usually occur with long-term debt financing, with the interest rates adjustable by the lender according to market performance. 	<ul style="list-style-type: none"> • Businesses can also opt to obtain equity financing by selling business stock to employees, Employee Stock Ownership Plan (ESOP), sharing control of the business with them rather than with outside investors.

Factors to Consider

Consider the following factors as you gain and maintain financing for your business:

- **Credit and financial history.** Your credit and financial history are important to potential lenders. If you can't show your ability to manage your personal finances, it will be difficult to secure financing from third parties.
- **Experience and expertise.** Lenders also look at the management experience and education you have that can be directly applied to the business you are opening. If you have key managers, lenders will

look at their experience as well. Strengthen your position by taking small business management courses and ensuring that your managers are equally trained.

- **Ability to repay the loan.** Consider how well you can pay back what you borrow. The interest rate you receive will be directly related to your ability to repay the loan. If you are a higher risk, meaning your credit history or personal finances are not stable, you could pay a higher interest rate.
- **Trigger points.** Develop trigger points in your business plan that will alert you to certain situations that could be signs of trouble. If you put these alerts in place early enough, you may be able to turn your business around before having to close your doors.
- **Diversification of customers.** Make sure you are not depending on only one customer for all your profits. What happens if that customer no longer uses your product or service? You need to have a diverse array of customers to be successful.
- **Insurance.** Protect yourself from catastrophic situations. In case you are no longer able to work because of injury or even death, you should make sure you have enough disability and life insurance to pay off your debts to protect yourself and your family.
- **Incorporation.** If you don't incorporate your business when you first open, consider doing this at some point. Talk to your accountant and seek legal advice when you are ready to incorporate.
- **Contingency Plans.** Should your business not get to a profitable state and closure is inevitable, talk to your investors and lenders. It may be possible for you to continue making loan payments by selling your business assets. Your investors and lenders may be able to help you develop plans to pay your debts.

Key Takeaways from This Module

- A range of possible financing options exists; be aware of the differences so that you can make educated decisions for your growing business.
- Determine your expenses and costs before seeking funding so that you know exactly how much you need to finance.
- Options for financing range from bank loans to angel investors, but each has costs and benefits that you should consider.
- Understand debt and equity financing to better prepare yourself for the requirements of different types of funding.
- Consider other factors (such as insurance and contingency plans) that are important when obtaining and maintaining adequate financing for your business.

Sources and Citations

- Small Business Administration, *Understanding the Basics*
- Shirleen Glasin, ProSidian Consulting, *Fueling Your Business - A Guide to Financing Your Small Business*
- Articles Base, *Small Business Financing Success with Realistic Choices*
- Go 4 Funding. *Small Business Funding*
- USA Today, *Funding Sources for Small Business*
- About.com, *Peer to Peer Lending – A Source of Small Business Financing*
- The Houston Chronicle. *Sources of Finance for Small Business Startups*
- Q and As, *What is an Unsecured Small Business Loan?*
- Grants.gov, *Who Is Eligible for a Grant?*
- Merchant Services, *Small Business Grant Availability*