BUSINESS FINANCE

An Introduction to Small Business Financing

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When and how you should finance your business

Acquiring a small business loan or angel investor sounds fantastic, doesn't it? Until you're face-to-face with an overwhelming number of options, terms, minute details—or even, perhaps, huge bills.

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Financing doesn't have to be complicated. Before you start down that road, know where you're going. We'll help you discover the right times to consider raising external capital and the wide range of options available to small businesses, including term loans offered by lenders like Bond Street.

By the end of this guide, you'll know the answer to these key questions:

1. Is financing right now a good idea for your small business?
2. What's the difference between debt and equity financing?
3. Which type of debt or equity financing is best for your business?

Let's start with an inconvenient truth.

Acquiring a small business loan or raising equity may not be the right next step for your company's current needs. It's possible to grow your business slowly and with less risk by bootstrapping. Paying back lenders and dealing with investors are serious responsibilities that can cripple your small business if done carelessly. But when done right, raising external financing is the key to growth for many businesses.

The difference between good and bad reasons to look for external capital comes down to **return on investment (ROI)**. Evaluating ROI is critical. If you deploy the funds you raise toward an expense that will generate growth or revenue, the investment will have a positive return on investment. If you deploy the funds you raise toward an expense that will not generate revenue—such as for repainting your office walls—you will have a negative return on investment.

Understanding check: ROI measures the return on a specific investment compared to the cost of that investment.

This simple rule applies to raising either equity or debt. Whether you're asking for investments from family and friends or applying for a small business loan, you should have a clear idea of exactly how the expenditure of that capital will grow your business. In addition to helping you test whether small business financing is a good route for your own business, articulating this plan will also help you convince investors or lenders to trust you with their money.

Expenditures you can expect a positive ROI from include hiring employees, opening new retail or office space, buying important equipment or inventory, refinancing debt, and smoothing out short-term fluctuations in cash flow.

Before seeking financing, ask yourself: "Would this expenditure have a positive ROI and help grow my business?"

If you've decided that raising outside financing is the right next step, it's time to determine whether to seek equity financing (money from investors) or debt financing (various forms of small business loans).

Equity financing involves raising money from a 3rd-party investor who buys a percentage of your business. You get capital now; the investor gets a share in the company's profits later and, often, a say in decision-making.

Pros and cons of equity

One advantage of equity financing is that companies can raise it at an early stage without much operating history, even when they are not yet profitable or when the industry or business model is very risky. (By comparison, most small business loans require companies to be profitable and have two years of operating history.) Because there are no immediate payments on the equity raised, the business does not need to maintain a steady or sufficient cash flow. This temporary reprieve frees business owners to focus on longer-term strategies that may only generate income down the line.

Of course, raising 3rd-party capital means giving up ownership of part of the company. You are giving up a portion of your future profits, which means you don't know the amount you will ultimately be paying out for that initial capital. Often you are also diluting your decision-making power to investors who have their own preferences and ideas to consider. Another disadvantage of equity financing is that the process of raising equity tends to be time-consuming and challenging. The complex, irregular process involves intricate contracts and legal considerations.

Types of equity according to stages of business growth

Equity is a suitable option for a business at a very early stage all the way through to a late-stage company. High-risk startups and companies in very cyclical industries tend to rely on equity financing more than companies in traditional sectors.

While most small business loans are appropriate for businesses with some operating history, equity financing can be raised before a company has any revenue at all. Friends and family are often the first source of capital. Once a startup is up ambitious, well-prepared startups in innovation and technology.) Finally, profitable businesses with some years of operating history may also raise private equity to keep growing.

Takeaways on equity

- Raising equity means trading a piece of your business for capital.
- Equity financing is available to early-stage companies and requires no immediate payments, but it is difficult to raise and requires giving up a percentage of future profits and immediate decision-making power.
- The four sources of equity, according to business stage, are friends & family, angel investors, venture capital firms, and private equity.

Small Business Loans 101

Debt is the counterpart to equity in the financing world. Debt financing, which includes small business loans and credit cards, means borrowing money from a lender to pay back in the future.

Pros and cons of debt financing

With debt financing, you receive capital to grow your business with no strings attached except a clearly specified repayment plan. Taking out a small business loan—whether in the form of a small credit card purchase or 10-year term loan—does not affect your ownership of the company. Unlike equity financing, which works according to percentages, debt financing is clear about the amount you will pay your lender.

avoid defaulting on payments. There is always the risk that something unexpected happens within a business that affects its ability to repay. Because lenders often require operating history and profitability of a company, debt is also not appropriate or possible for pre-launch or pre-revenue businesses.

What type of debt is right for my small business?

There are a variety of types of debt, which serve different use cases. Debts with lower interest rates are often asset-backed, which means that the business puts up assets like equipment or invoices receivable as collateral. Unsecured debts, such as many credit cards, are more expensive but do not require collateral.

Understanding check: Assets are anything of value a business owns. They can be tangible (like cash or equipment) or intangible (like trademarks or patents).

Depending on your business' type, growth stage, and needs, the following types of debt financing are available:

- Lines of credit
- Small business credit cards
- Merchant cash advance (MCA)
- Invoice financing
- Term loans

Lines of credit for short-term flexibility

You draw down from a line of credit to make cash available in your business bank account. Lines of credit are limited by a certain maximum and must be paid back quickly or you will incur interest costs. They are usually secured by collateral and therefore have lower rates than business credit cards. To qualify, a business must usually have at least two years of operating history, one year of profitability, and a

Small business credit card for small fluctuations in expenses

Small business credit cards are much like personal credit cards. They offer a revolving line of credit useful to a huge range of businesses for small and emergency purchases. They help simplify accounting, separate your business and personal finances, and come with rewards. While very convenient, you are personally liable for business credit cards, which often have interest rates topping 15%.

Merchant cash advance for short-term working capital

A merchant cash advance is upfront cash that you repay, along with a fee, through a % of daily sales. The loan has no fixed time period; it continues for as long as it is not repaid. MCAs are appropriate for short-term working capital needs and tend to be the most expensive type of debt, especially among unethical lenders in the relatively unregulated industry.

Invoice financing for smoother cash flow

Invoice financing is when you exchange your invoices for upfront cash equivalent to a percentage of the invoices' value. If your business struggles with gaps between invoices and payment, this is a good option to smooth cash flow. Invoice factoring and invoice discounting are two types of invoice financing; technically, only invoice discounting is debt financing. But the two methods are very similar.

Term loans for growth investments

A term loan is a fixed amount of capital repaid over a set time period. Besides lines of credit, it is the most popular form of financing found at banks. Lines of credit such as:

- Hiring employees
- Purchasing inventory or equipment
- Opening a new office or retail space
- Refinancing credit card debt

Businesses often look to a bank for small business loans. Unfortunately, banks require a manual and time-consuming application, after which it often takes weeks (even months) to return a loan decision. And, 80% of the time, the decision is No. Most banks prefer lending upward of $1 million and do not have the technology or infrastructure to assess small business risk. Business owners looking for quick capital often look to expensive alternative lenders such as MCAs, not realizing that there is a way to get small business loans in a fast and affordable way.

At Bond Street, intermediate-term small business loans are our specialty. We seek to fill the gap between banks and alternative lenders by providing loans of up to $1 million over 1-3 year terms to businesses with at least 2 years operating history and $200K in annual revenue.

Takeaways on debt

- Debt (i.e. a small business loan) involves borrowing money from a lender that you will repay.
- With debt financing, you retain full ownership of your business but are responsible for paying back the loan according to its terms, no matter how well your business is doing.
- Types of debt financing include lines of credit, credit cards, merchant cash advance, invoice financing, and term loans.

Congratulations on becoming an expert in the basics of small business loans! You are well on your way toward responsible business growth. Before applying for financing, consider these steps:

1. Take stock of your business history and current needs. Is financing right for you?
2. Decide which debt or equity financing options fits your business best. Consult with an advisor and do a little more research on that type of financing to confirm your hunch.
3. Choose 2-4 lenders/investors who offer the appropriate kind of funding to compare. Don't hesitate to call them up and get all your questions answered. Evaluate the terms, fees, and long-term consequences of your 2-4 options.
4. Finance your business!

Louis DeNicola

Louis DeNicola is the president of LD Money Media LLC and an experienced finance writer who specializes in credit, personal finance, and small business finance. Within the small business sphere, he helps business owners understand their financing options, cash flow management, business credit, and taxes. In addition to Funding Circle, you can find his work on BlueVine, Credit Karma, Experian, Wirecutter, and Lending Tree.

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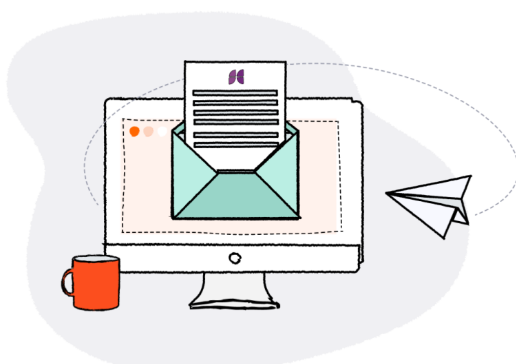

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