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FastTrac® GrowthVenture™

TAKE CHARGE OF YOUR BUSINESS®
A program of the Kauffman Foundation

Cash Flow: External Sources

When external sources of cash flow are from debt, the amounts received must be repaid according to a specific set of terms and conditions. The money to pay back these loans generally comes from sales. So, in effect, you are taking an advance against future earnings to grow the business. Other cash flow sources, such as equity investments, may not have a specific payback schedule, but these will typically cost you quite a bit more in the long run.

Traditional Funding Sources
Evaluate traditional funding sources as they may provide you with the best option to cover your cash flow needs. These include bank loans, angel investors, venture capital investors, private placements, and initial public offerings.

Bank Loans
Banks are a traditional source of funding to small business owners. Their principal role has been as a lender offering short- and long-term loans and lines of credit. The SBA-guaranteed lending program encourages banks and non-bank lenders to make long-term loans to small businesses by sharing in the lenders' risk. This practice allows lenders to make loans that they usually wouldn't make.

Bank financing is attractive to business owners because they maintain control at a reasonably low cost. Payback timing and other terms are usually not flexible; however, you can sometimes negotiate them. Finding a lender with expertise in your industry will help ensure that you receive the right type of financing at the right time. Banks generally offer lines of credit, short- and long-term loans, and some offer SBA-backed loans.

Lines of Credit – When a line of credit is awarded to your business, you can draw upon the funds, to a maximum level, whenever you need them. This type of funding is appropriate to cover seasonal fluctuations in sales or regular cash shortages. You determine the amount and terms of the line of credit in advance based on the needs of your business and the policies of the lending institution.

In most cases, you will pay lines of credit within a year. The bank may impose other policies such as not using the line of credit for two months after you pay the balance. The rate on a line of credit will vary based on the institution and your business. In general, the rate is often 1–2 percentage points over prime for established companies and slightly higher for new businesses.

Short-Term Loans – A short-term note is your written promise to pay a stated sum on or by a specific date, usually in one year or less. Depending upon the deal you negotiate, these loans are either *secured* (collateralized) or *unsecured* (signature loan). For a secured loan, you pledge collateral to offset the loss to the lender should you default on the loan. If you fail to meet the terms of a secured note, the lender asks the court to take possession of whatever asset you pledged as collateral and sell it.

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The proceeds of the sale are then applied to the amount due on the note. The loss of collateral will not release you from all liability on the debt if the collateral sale proceeds are not enough to pay off the loan.

Long-Term Loans – Depending on the purpose of the loan, a long-term loan will have a payback period between two and fifteen years. For loans obtained to purchase equipment and vehicles, the payback period will vary between two and seven years. If the loan is used to purchase real estate, the payback will be significantly longer. Be aware of any balloon payment provisions within your loan agreement and the impact that they can have on your cash flow. If included, these provisions will stipulate that the loan be paid off prior to the end of the loan period. For example, a twenty-five year note for the purchase of a building could have balloon provision in year five. So although the amount of each monthly payment is based on a twenty-five-year amortization schedule, which keeps the payments lower, the loan must be refinanced at the end of five years. By allowing the bank the ability to re-assess the business's financial condition and adjust the interest rate accordingly, this process reduces the amount of risk the bank incurs during the loan period.

You will find that the interest rates, loan origination fees, and terms on long-term loans vary greatly based on the lending institution's policies and your business's age and financial status. Although the amount or type of collateral may be negotiable, these loans are never unsecured.

SBA-Backed Loans – The Small Business Administration is not a lender, so it does not provide direct loans to businesses. Instead it has several programs that may help you secure loans from lenders with reasonable terms. The primary programs are the 7(A) and 504 Loan Guaranty Programs. Through these programs you can receive small business loans through participating lending institutions, which are then guaranteed by the SBA. There are exceptions to the SBA working only through lending institutions. For example the SBA offers direct loans to businesses to recover from government declared disasters such as a hurricane.

Lending institutions approved to participate in SBA loan programs can help provide information and assistance throughout the SBA loan application process. The main advantages of this program go to the bank. Think of the SBA as a sort of underwriter for the loan. They have a guarantee from the SBA that if the loan recipient is unable to repay the loan, the SBA will repay a portion of the debt to the bank. The lender incurs very little risk. The main advantage for you is that you may be able to get a loan through this program when you couldn't get a loan traditionally.

All commercial lenders, as well as the SBA, evaluate loan applications by reviewing the following elements:

- **Cash flow of the business** – In today's lending environment, most lenders are primarily cash flow lenders, which means that your business has to show that your business can repay the loan.
- **Character of the management team** – From a banker's perspective, the character of the management team reflects your willingness to pay. A record of non-payment or a prior personal bankruptcy, for example, might cause a banker to view a borrower's character as too risky.
- **Collateral available** – By putting up collateral, you show that you are committed to the success of your business. Bankers really don't want to seize your collateral because they have no desire to be secondhand equipment dealers or sell out your stocks and bonds. But they like to have some recourse just in case your business fails.

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- **Owner's equity contribution** – You have to have at least as much at risk as the bank or other investors. This doesn't mean that your borrowing capacity is limited to what you can put in personally, but it does mean that you have to have some of your own cash in the deal (plus, in some cases, the cash investment from other investors).
- **Condition** – If your area's economy is struggling, the risk of your deal will be magnified. Economic factors may be beyond your control but, once again, will affect your banker's decision. A banker may be doing you a favor by not accepting your growth strategy today because of conditions in the economy. Tomorrow, when conditions have changed, a loan may be more appropriate.
- **Credit** –Your credit history is a key piece of the puzzle for your banker. How have you handled credit in the past? If you have paid your debts more or less on time, you don't have a history of bankruptcy or creditor lawsuits, and you have proven that you can use credit effectively, your banker's concerns will be somewhat eased.

Angel Investors
Private investors, called angels, are typically high net worth business owners and entrepreneurs who have successfully exited their businesses and seek to invest both time and money in other ventures, often in the early stages. Funding early stage companies is high risk (with 10 to 15 percent of invested companies providing most of the return on investment to angels); consequently, these investors seek high-growth opportunities to invest both their cash and their time. Typically, they seek companies with the potential to grow between 10 to 30 times their value in five years.

Angels typically invest in rounds of $250,000 to $1 million with several angels investing $25,000 to $100,000 each. Frequently angels are drawn to ventures because they have an interest in that particular industry or in the entrepreneur.

Venture Capital Investors
Venture capital investors seek later stage companies with phenomenal growth potential —those who need several million dollars to achieve success. Like all equity investment, venture capital money is an expensive funding option, requiring the selling of equity in the business in return for the investment of capital. For a high-technology company with a very aggressive growth strategy and an expectation of extraordinary growth, venture capital may be appropriate. Very few companies, however, (fewer than 2,000 in the United States) are successful in attracting first-time venture investment each year.

Venture capitalists are full-time, professional investors of risk capital. They invest funds solicited from state and corporate pension dollars, trusts and endowments, corporate resources, and wealthy families. A good venture capitalist becomes a part of the venture building team, with the CEO and other executives. Venture capitalists have a responsibility to their own investors to maximize the return on investment. Because of these expectations, venture capitalists will want to cash out of the business in five to seven years for a return of at least five times their investment and often much more, through the sale or merger of the company or, more rarely, through an Initial Public Offering (IPO).

When thinking about contacting venture capital firms, entrepreneurs should consider the following characteristics:

- **Size of market** – Venture capitalists are looking for high-growth potential, which usually translates into a $1 billion market, and a new company that can capture at least $100 million in revenue over five years.

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- **Types of investments** – Venture capitalists are looking for new markets, new technologies, or radically different ways to do old things. For the most part, today's venture capital investments are predominantly in technology and life sciences.
- **Minimum investments** – The average round of venture capital investment is $7–$8 million, but a few venture capitalists will invest as little as $500,000 in highly promising companies with an overall need for $3–$5 million in financing.
- **Management team** – Venture capitalists look for a management team with experience in the market in which they operate. They also value prior experience in start-up companies. You should be able to clearly show how key positions—chief executive officer, chief operating officer, chief financial officer, vice president of sales, and chief technology officer—will be handled in your venture.
- **Venture capitalist's participation** – Most venture capitalists play active roles in the firms in which they invest. In a very real sense, when you take equity capital, your investor becomes a partner in the operations of your business. They usually place representatives on the board of directors and will take steps to ensure the CEO has the experience necessary to grow your company as planned.

Private Placements

A private placement is the sale of securities not involving a public offering. This type of financing may take the form of debt, equity, or a combination of the two. Private placements are exempt from scrutiny by the Securities and Exchange Commission (SEC) so long as companies meet certain guidelines.

Preparing a private placement memorandum may cost anywhere from $3,000 to $20,000 or more, depending on the complexity of the venture. Wealthy passive investors often are attracted to fund private companies.

You can make a private placement directly, but more commonly investment bankers, broker/dealers, and financial consultants handle these matters much as they would handle other types of financing. Consult a knowledgeable investment lawyer or accountant before attempting a private placement offer.

Paying for the preparation of a private placement memorandum does not guarantee your company is fundable or that any investor may be interested in funding the company. Carefully study possible sources of capital prior to paying for the preparation of a private placement memorandum.

Initial Public Offerings

An initial public offering (IPO), also referred to as *going public*, results from a privately held company electing to sell a portion of its common shares of stock through public markets. Going public is very expensive and also involves significant regulations and restrictions. While a very unlikely option for successful start-up ventures (fewer than 200 companies go public annually in the United States), public markets are excellent sources of large amounts of money to fund an existing company's growth. IPOs can provide an opportunity for early angels and venture capitalists to eventually liquidate their investment as their shares later become eligible for public trading. While IPOs are often described as an exit strategy, they are primarily opportunities for promising companies to raise significant amounts of capital to fuel the continued growth of the business.

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