15

Small Business Finance:

Using Equity, Debt, and Gifts

Source: Entrepreneurial Small Business, Katz & Green, 2e
McGraw-Hill/Irwin

Chapter 15

Sources of Financing

- Number one source is from the owners themselves
- Major sources:
  - Family and friends
  - Credit cards
  - Trade credit
  - Banks
  - Commercial lenders

15-2

Chapter 15

- Other sources:
  - Angel investors
  - Government programs
  - Community-based financiers
  - Stock sales
  - Venture capital

15-3

Chapter 15

Example

Finance Your Franchise

- Infinite sources of financing available to help you launch the franchise of your dreams
- Never invest more than 75 percent of your cash reserves
- 40-year-old Douglas York decided to purchase a Great Clips franchise with his wife, he found his best financing bet was with a nonbank lender

http://www.entrepreneur.com/franchises/buyingafranchise/howtoguides/article36480-5.html

15-4

Chapter 15

- Financing with equity: from the entrepreneur or from others
  - Personal equity: how much you are worth
    - Often people underestimate their personal worth
    - If you plan to get investments, they may ask to see your personal financial statements

15-5

Chapter 15

- Financing with equity: cont.
  - Outside equity: money from selling part of your business
    - Outside equity investors:
      - Outside: not part of the business
      - Equity: legal ownership rights to your business
      - Investors: you are using their money
        - » Partnership, corporation, limited liability

15-6

Chapter 15

Getting Equity Investment

- Owners and investors want to make money
  - Lenders expect a return on this money
- To get money from other people, you've got to show them that your business probably can make gains for them
- Growth potential is a primary concern for equity investors

15-7

Chapter 15

- Time required to receive gains can be a deal killer for potential investors
- Financing with equity is:
  - Expensive
  - Guaranteed to create problems of control and decision making

15-8

Chapter 15

- Getting outsiders to invest:
  - Two primary reasons:
    - You will reduce your own exposure to financial loss
    - Your business will not have increased costs in the form of interest

15-9

Chapter 15

Financing with Debt

- Most common source of capital for established ongoing small businesses is borrowed funds
- Three ways:
  - Direct loans of cash
  - Guaranteeing loans made by commercial banks
  - Reducing taxes by allowing interest to be deducted

15-10

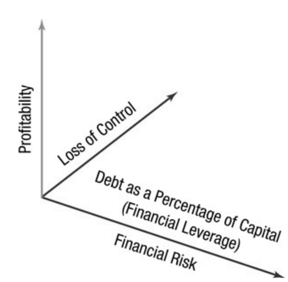
Chapter 15

- Where can a small business get loans:
  - Your current bank
  - Small Business Administration guaranteed loan programs
  - Numerous small business investment companies
    - http://www.sba.gov/INV/index.html
  - Incubators or accelerators in your area

15-11

Chapter 15

The Four C's of Borrowing



15-12

Chapter 15

Gift financing:

- Impression might be that a government or a foundation hands out money that never has to be repaid
- Costs time and money to obtain
- Often requires time and money for accounting and reporting to the granting agency
- Two general sources of gift financing:
  - Institutional
  - Personal

15-13

Chapter 15

- Sources of gift financing:
  - Institutional: most common is reduced taxes
    - Tax abatement: a legal reduction in taxes
      - Encourage specific activities to improve blighted areas
    - Tax credits: direct reductions dependent on meeting some legal criteria
      - Encouraging investment in specific assets, to increase economic activity, supporting industries

15-14

Chapter 15

- Sources of gift financing: cont.
  - Institutional:
    - Grants: require very accurate record-keeping and reporting
      - Small Business Innovation Research program
      - Small Business Technology Transfer program

15-15

Chapter 15

- Sources of gift financing: cont.
  - Personal gifts: forms are as varied as human imagination
    - Tremendously popular
    - 1/3 of small businesses report having unpaid labor contributed by family members
    - Always more than just a gift
    - Loaded with special meanings

15-16

Chapter 15

- Forms of Personal Gifts:
  - Cash
  - Picking up the tab
  - Accelerated cash-outs
  - Free use
  - Free work
  - Overpayment
  - Forgiveness
  - Piggybacking

15-17

Chapter 15

- Sources of gift financing: cont.
  - Personal gifts:
    - Giving a gift also has tax implications
    - Put your agreement into writing
    - If it is a gift, have the agreement say so
    - If it is a loan, have the agreement specify the exact interest and payment terms
    - If it is an equity investment, consider nonvoting stock

15-18

Chapter 15

Example

Choosing Between Debt and Equity Financing

- Entrepreneurs would much prefer to raise money in the form of equity rather than debt
- Why is equity so appealing?
  - it feels like you're getting "free" money during the startup stage
  - usually no repayment obligations and no interest payments due to equity investors
  - have some say in negotiating the price of your stock, any dividend payments and the position the investor will have in your company

http://www.entrepreneur.com/money/financing/startupfinancingcolumnistasheeshadvani/article159518.html

15-19

Chapter 15

What Type of Financing is Right for Your Business?

- Cost of both equity and debt capital changes as their relative percentages of total capital change
- Few, if any, small business owners even attempt to estimate the optimum capital structure of their business

15-20

Chapter 15

- Why should you borrow?
  - Borrowing enhances the potential for higher rates of return for the owners
  - Borrowing allows the owners to keep a greater level of control of the business
  - Borrowing increases potential profits by:
    - Lowering the weighted average cost of capital
    - Providing capital funds that allow the business to consider additional opportunities

15-21

Chapter 15

Financial Management

- Requires some method to measure and compare your financial position and financial results
- Financial position – expressed on balance sheet
- Financial results – expressed on income statement
- Most financial comparisons are made using ratios
  - Activity ratios
  - Profitability ratios
  - Liquidity ratios
  - Leverage ratios

15-22

Chapter 15

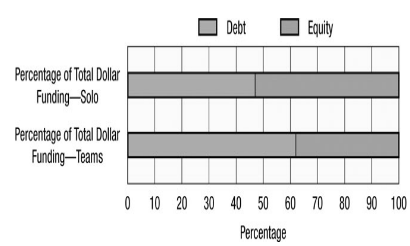
Financial Management

- Financial management for start-up:
  - Primary need is to obtain sufficient funds to pay for equipment, buildings, inventory, and other costs of starting and running a business
  - Funds for start-ups are usually obtained through founder's personal resources, personal credit worthiness, and internally generated cash flows

15-23

Chapter 15

Pecking Order of Funding Sources for New Firms



15-24

Chapter 15

- Financial management for growth: “Bad news-good news” joke
  - Bad news is that the business has greater capital needs than ever
  - Good news is that more sources of money are available to meet those needs
  - Emphasis is to obtain increasing amounts of cash inflows to pay for added inventory, productive assets, and employees

15-25

Chapter 15

- Financial management for operations
  - Emphasis of financial management is to build owner wealth, to conserve assets, to match cash inflows to outflows, and to maximize the return on capital assets by making optimum investing decisions

15-26

Chapter 15

- Financial management for business exit
  - Successfully leaving your business requires maximizing the value of your business for your successors
  - The emphasis is to create effective internal control of assets and liabilities, develop business systems to replace your specific skills and knowledge, and to ensure that the processes of the business and personal transactions of the owners are completely separate

15-27

Chapter 15

Summary

3-28