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Potential Sources of Business Fundingby Robert Skurka

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This article provides information about potential sources of business funding for organic growth and acquisitions. For more information, business owners should talk with their CPA, banker, attorney or other key business advisors. Information about potential sources of capital, mezzanine financing and commercial loans may also be obtained through various Rhode Island and southeastern Massachusetts organizations, including:

Businesses Development Company- Rhode Island www.bdcri.com 401-351-3036
SEED Venture Finance www.seedvf.com 508-219-4266
RI Office - U.S. Small Business Administration www.sba.gov/ri 401-528-4561
U.S. Small Business Administration (SBA) www.sba.gov/financing. 401-528-4561
RI Small Business Development Center www.risbdc.org 401-232-6111
Southeastern MA Small Business Dev. Center www.msbdc.org/semass 508-673-9783
Cherrystone Angel Group www.cherrystoneangelgroup.com 401-351-3036
Point Judith Capital www.pointjudithcapital.com 401-398-0260
To fund normal working capital needs, organic business growth and acquisitions, business owners utilize various sources of funding, including:
1) Equity/capital
2) Mezzanine/subordinated debt, and/or
3) Commercial bank loans/senior debt financing
This article highlights some of the similarities and differences of these sources of business funding.
1) Equity/Capital
Equity/capital is available from various sources including: friends and family, business contacts, angel investors, venture capital funds, investor groups, etc. Business owners normally contact their CPA, banker, attorney, and other business contacts to network with individuals who may provide an equity or capital contribution in exchange for partial ownership of a business.
The business owner would benefit from this equity/capital by obtaining funding now for organic growth in revenues/profitability and/or for acquisitions. An unfavorable characteristic of equity/capital is that the principal of the business needs to give up partial ownership of the company to the new investor. Some entrepreneurs have preferred to grow at a slower pace in line with their existing equity/capital, thinking that retaining 100% ownership is their most desirable option. However, some experts, including accounting and business advisors, would make a legitimate argument that by attracting additional equity/capital from new investors now, the business owner would be able to achieve a higher level of revenues and profitability sooner rather than later, thus providing significant benefits to all parties.
2) Mezzanine financing/subordinated debt
Mezzanine financing or subordinated debt is a very beneficial option for business owners seeking to retain ownership of their business without giving up partial ownership to the new equity/capital investors. Since mezzanine lenders provide a secondary security position loan, the company needs to demonstrate strong cash flow. The company will need to provide a professional business plan, reflecting capable management, good revenue/profit trends and favorable growth opportunities. Business owners normally talk with their CPA, banker, attorney and other business contacts to network their way to mezzanine financing/subordinated debt lenders.
Mezzanine financing offers significant flexibility and may be one of the few financing sources available to some leveraged, cash-strapped entrepreneurs. A significant additional benefit of mezzanine financing/subordinated debt is that it is treated by the senior debt lender as equity, thus enabling the entrepreneur to leverage the subordinated debt with additional senior debt financing from a commercial lender. Due to its higher risk, the mezzanine lender needs to earn a coupon rate in the range of 12-15% with an overall target return of 20-25%. This target return is achieved through the basic coupon interest rate, plus an upside return from future profitability/excess cash flow, or through warrants, which are intended for a relatively short term with a defined exit strategy such as a put agreement. Mezzanine funding is generally secured by a second security interest in all business assets and is normally amortized over a 5-7 year period, with some early exit opportunities or payoff of the balloon balance via refinance.
Senior debt financing or traditional commercial loan financing is available to companies with good cash flow, adequate collateral, capable management and a credible business plan. Business owners normally network with their CPA, banker, and attorney to arrange for this traditional commercial loan funding.
One of the primary benefits of senior debt financing is that banks are able to offer lower interest rates than mezzanine/subordinated debt financing entities since these commercial loans are generally well-collateralized and paid via the company’s demonstrated strong cash flow.