

## **LOANS, LEASES, GRANTS AND OTHER FINANCIAL RESOURCES**

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While equity is the most frequently used form of financing for start-up and early-stage companies, it is only one option. The following are additional sources of money or resources that companies should consider: loans (including government-guaranteed loans), leases, and free resources, including grants.

### **LOANS**

The most common form of financing for many start-up companies, after founder's equity, is debt financing. Companies must make sure they understand their obligations when incurring debt. First, the company must eventually repay the money received, called the principal, to the lender. Whether the principal must be repaid in installments or in one large payment at the end of the loan term varies. Second, the company generally must make interest payments at regular intervals during the loan term. These payments are in addition to the principal borrowed; they are payment to the lender for use of the principal. Interest is paid as a percentage of the principal, and the percentage, or interest rate, varies with the characteristics of the loan. Third, the lender may impose requirements on the company as a condition to making the loan. For example, the company may have to maintain a certain amount of equity, or net worth, for each dollar of debt, the lender may require that it be given copies of all non-confidential materials provided by the company to its board of directors or be invited to attend the company's board of directors meetings in a non-voting capacity, or the lender may require the company's owners to invest a certain amount of their own money in the company before the loan will be funded.

As with equity financing, there are advantages and disadvantages to debt financing that companies should consider when seeking start-up capital. Debt has two important benefits. Unlike the case with equity, lenders do not obtain an ownership interest in the company when a loan is made; instead, the company will likely owe the lender regular interest payments. Such interest payments may be tax deductible, while dividends paid to investors with ownership interests are not. Moreover, similar to proceeds received from the sale of equity interests, the principal received as loan proceeds is not included in the company's taxable income when the loan is made (although neither is repayment of such principal deductible from income).

Debt also has some drawbacks. First, debt payments must be paid on a fixed date or upon the occurrence of a predetermined event regardless of the availability of the company's cash. In contrast, dividends are generally paid only when the company can afford it, if at all. If debt payments are not made, the company is in default on the loan. When the company defaults, a secured lender may be entitled to seize some or all of the company's assets, which may force the company into bankruptcy. Second, taking on current debt may restrict a company's ability to obtain debt financing in the future—even for a compelling purpose. Lenders are hesitant to make loans to companies, especially start-ups, if such companies already have significant debt, due to the higher risk of the investment. Third, and perhaps most significant, loans may be unavailable for start-up companies without positive cash flow. While venture-stage financing may not be readily available either, venture capitalists and angel investors generally seek to invest in moderate to high-risk companies. That is the nature of their business. Most lenders are interested in lower risk investments. Finally, venture capitalists and angel investors that lend money to companies commonly require that such companies agree to an "equity kicker," which often take the form of payments to the lender after the loan principal has been repaid and which often resemble contractual dividends. Such

“equity kickers” can make debt financing quite a bit more expensive, especially for high risk companies, where “equity kickers” are most often required by lenders.

## **Types of Debt**

There are several types of debt. Probably the most important distinction among types of debt is whether or not the debt is “secured.” When debt is secured, the lender has obtained a consensual lien on some or all of the company’s property including, in some cases, anticipated future property. A lien allows the lender to seize certain property if the company defaults on the loan. A default may consist of a missed or late payment, or a violation of another condition in the loan agreement.

In most loans to start-up companies, the lender may require that all of the company’s assets be given as collateral, for two reasons. First, start-up companies present the significant risk that they will fail and the lender will lose its money. The lender seeks to minimize its risk by creating a method—the use of a lien—through which it can seize and sell the company’s assets if a default occurs. This sale allows the lender to recoup some of its money. Second, many start-up companies do not own many assets. In such cases, the lender will need to use all of the company’s assets as “collateral,” or assets it may seize in case of default. Loans may, however, be unsecured, meaning the lender cannot seize and sell any of the company’s property if a default occurs. Instead, the lender must sue the company for the loan amount and then seek to obtain a non-consensual lien on the assets of the borrower resulting from a judgment against the company. Such unsecured loans are rare for start-up companies, due to the lending risk involved.

Typical types of collateral include the following:

- Real estate
- Equipment
- Inventory
- Accounts receivable
- Intellectual property

In some cases, lenders may require only specific assets of the company as collateral. For example, if a company is seeking a loan to finance a piece of equipment, the lender may require only the purchased equipment as collateral.

A company agreeing to provide collateral to a lender is said to pledge, or grant a security interest in, those of its assets comprising the collateral. There are several consequences to obtaining a secured loan which should be considered. First, the procedure required to obtain a secured loan is somewhat different than that for an unsecured loan. Because the lien involved in a secured loan is a legal interest in the company's property, the Uniform Commercial Code ("UCC") requires a filing to alert others to the lender's interest in the pledged personal property (i.e., generally, property other than real estate). Thus, a secured loan requires a security agreement between the lender and the company, which describes the collateral, as well as a UCC filing in the state where the company is organized. Other filings may be required depending on the type of collateral pledged to the lender (for example, if the collateral consists of real estate or fixtures, a filing must be made in the state where the real estate or fixtures are located). Second, the default procedure for a secured loan will be different than that for an unsecured loan. In a secured loan, the lender has the right to seize and sell the property described in the security agreement and the UCC or other filing. In addition,

unless the lender has failed to make the necessary filings, it can seize and sell such property without court approval. Finally, whether a loan is secured affects the lender's rights if the company should file for bankruptcy. Secured loans take priority over unsecured loans, meaning secured loans are paid first.

- **Term Loans.** One of the most common forms of debt is a term loan. A term loan is for a fixed amount of time and the loan payments will cease when the term expires (assuming all payments have been timely made). These loans are almost always secured. The length of the term varies, but generally extends to the useful life of the assets securing it. Thus, loans secured by real estate may have a term of 20 years or more, while equipment loans usually last five to ten years.

There are many payment options on term loans. One option, similar to that used with home mortgages, is to make regular payments that include interest and a portion of the principal. The payments at the beginning of the term generally include more interest and less principal, and the payments at the end of the term are mostly principal, though it may be possible to negotiate equal principal payments for the life of the loan. Another option is what is called a balloon loan. The company will only make interest payments for the life of the loan, and repay the entire principal upon expiration of the term. Third, in certain rare circumstances, it may be possible to negotiate a balloon loan on which no interest payments are paid currently; instead, the interest is added to the principal to be repaid at the expiration of the term. The company should consult a tax adviser in this instance, as this option has immediate tax consequences, even though no current payments are made. Finally, in very rare situations, a company may be able to make loan payments that vary with the company's ability to pay. This option will likely not be available unless the company is established, in a particularly strong financial position, in an obviously fluctuating or seasonal industry, or a combination of all three.

When considering a term loan, companies should consider the issue of prepayment. Prepayment is when a company pays all or part of its loan off early. Upon prepayment in full, the company's loan obligations cease, including interest payments. Lenders generally dislike prepayment, as it deprives them of future interest payments. Often, lenders will build prepayment premiums into their loan conditions, which means that the company will have to pay a premium if it prepays its loan. These premiums are usually structured as a percentage of the outstanding principal that decreases the longer the loan is held.

- **Demand Loans.** Another type of loan is a demand loan. Its characteristics are generally similar to those of a term loan, except that a lender can force ("demand") the company to repay the loan in full at any time. Obviously, this type of loan is not beneficial to the company unless it is the only form of financing available or the company is certain it will have adequate funds to repay the loan at any time that the loan might be called. A company should carefully consider the possible effects of accepting a demand loan. The lender could demand repayment of the loan at a time when the company has very little cash. In fact, it may be more likely that the lender will demand repayment at such a time, as that is when the lender will perceive the company to pose the greatest financial risk.
- **Revolving Loans.** A third type of loan is a revolving loan, or a line-of-credit. These loans are similar to consumer credit cards. The lender extends a revolving loan to a company in a certain amount and the company can then borrow up to that amount. The loan is called a revolving loan because the company borrows money periodically as it needs it and makes payments on the loan when it can. The company can then continue to reborrow under the loan, up to the pre-set maximum. These loans are not intended to be long-term loans, though the line-of-credit itself may be outstanding for a long time. Similar to the procedure with credit cards, the company is expected to make

payments on the loan regularly. The interest rate on revolving loans is usually higher than that on term loans. These loans are generally used to provide working capital, rather than to purchase assets. Revolving loans are usually unsecured, meaning that the lender cannot seize the company's assets without going to court.

- **Factoring.** Next, there are two types of asset sales that strongly resemble loans. The first is factoring. In factoring, a company sells its accounts receivable to a third party. The third party pays a set percentage of the value of the accounts, based on how old or creditworthy the accounts are. Usually current accounts will typically net roughly 90% of the outstanding balances of such accounts. The third party will then collect the accounts receivable from the company's customers. Factoring differs from a loan in that it is based on the credit-worthiness of a company's customers. Therefore, the credit-worthiness of the company itself is largely irrelevant, and a factoring arrangement is often easier to obtain than a traditional loan. This ease in obtaining factoring is one of its major advantages. The other significant advantage provided by factoring is that it provides money for the company immediately; there is no delay in realizing most of the accounts receivable, as the third party is fronting the money. Finally, a factoring arrangement means that companies do not have to deal with collecting their accounts receivable; the third party collects them for the company.

In contrast, there are several negative aspects to factoring which should be carefully considered. Factoring is expensive, as the percentage charged by the third party in the form of a discount on the value of the receivable(s) generally exceeds interest rates charged in traditional loan transactions. Also, the third party collection agent's interests are not the same as those of the company. While the company may be interested in retaining its customers, and may occasionally let a bill go unpaid or issue a payment extension to do so, the third party has no such concern.

Its sole interest is in collecting the accounts receivable, and the tactics it may use to do so may cause the company's customers to refuse to buy from the company out of reluctance to deal with the third party collection agent.

- **Royalty Financing.** A second type of asset sale resembling a loan is royalty financing. In royalty financing the company receives an advance on its future sales; it actually sells a right to a percentage of the company's receipts. This type of financing is also much easier to obtain than a traditional loan, as it depends on the strength of a company's product rather than the company's credit-worthiness. In a royalty financing arrangement, the lender gives the company money. In return, when the company receives payments for sales, it sends a percentage of its income to the lender. This arrangement continues until the lender has been paid back, usually up to five times the amount of its initial investment. In negotiating royalty financing, the company should make sure to put a time limit on the arrangement. If the company is unsuccessful with future sales, it will not want to owe the lender money indefinitely. Companies should consider negotiating for an end to the arrangement a few years after the investment is expected to be recouped. One tremendous advantage to royalty financing is that the payment terms automatically adjust to the company's ability to pay; the company only has to make payments when it receives cash. Also, the lender does not obtain an interest in the company in exchange for its investment. On the downside, however, lenders will not give money to a company for non-sale-related activities such as research and development. Additionally, the company is depriving itself of a significant portion of its income (usually 5% to 15% or more). If a company has a low profit margin, royalty financing is not really an option.

## **General Considerations in Determining Credit-Worthiness**

Lenders look at a multitude of factors in determining whether to make a loan to a company. The importance of the factors differs

according to the type of loan involved. For example, the value of the company's assets may be less important when negotiating an unsecured line of credit than in trying to obtain a secured term loan. Moreover, strength in some areas may compensate for weakness in others. A company with a strong business plan may be able to obtain a loan despite its lack of operating history. The following is a list of general elements a lender will look to in determining a company's credit-worthiness:

- **Availability of Other Funding.** If a start-up company has not yet tapped the owners, their families and friends, and angel investors or venture capitalists for start-up capital, lenders are likely to refuse the loan. In particular, commercial lenders are often reluctant to make a loan to a company in which its owners have invested little money. Lenders see owner investment as a concrete sign that the owners believe in the company. Moreover, such investment indicates to lenders that the owners will work harder to make the company successful, so as to retain the value of their investment. If owners are reluctant to invest in their company, lenders see this as a sign of weakness in the company, its products or services, or its management. This raises the risk assessed by the lender, and decreases a company's chances to obtain a loan, on favorable terms, or at all. For this reason, loans are sometimes conditioned on owners' existing investment in an amount equal to a certain percentage of the loan value.
- **Availability of Collateral.** Certain types of lenders, such as banks and other financial institutions, strongly prefer to make secured loans. If a company has no assets available to pledge as collateral, a lender is likely to refuse this type of loan.
- **Past Business Performance.** Lenders prefer companies with successful track records, as it gives them a more accurate assessment of the risk of the investment. While lack of past business performance may not defeat a company's request for a loan by itself, the other factors considered will have to be significantly stronger, to assure the lender that it will be paid back.

- **Financial Statements.** Lenders prefer to review the financial documents of prospective borrowers, for much the same reason they review past business performance. Financial statements give the lender a way to quantify its risk in making the loan and, the stronger the company's financial position, the more risk a lender will generally take. Regardless of the financial position reported, clear, standardized financial statements are more likely to convince a lender to make a loan than confusing or incomplete statements.
- **Management.** The management of a company is often determinative in lending decisions. Lenders know that management is key to the future success of a business, and a good management team may be able to overcome the lack of past performance in obtaining a start-up loan. If a company's management abilities are questionable, however, lenders may be more likely to discount past performance and financial data.
- **Business Plan.** Companies should be very careful in drafting their business plans. They are important not only to lenders' funding decisions, but to other potential investors' decisions as well. Comprehensiveness and clarity are vital to a business plan. In addition, when applying for a loan, companies should include in the business plan a section that shows the prospective lender how they intend to repay the loan. Such a repayment plan shows the lender that the company has carefully considered its financing options and is prepared to undertake the commitment a loan requires.
- **Relationship with Lender.** If a company has no past performance, weak management and a confusing, incomplete business plan, simply having a relationship with the lender will not generally result in a loan being made. In situations in which the lender has an interest in keeping the relationship, however, the existence of such a relationship may convince the lender to make the loan. This is why companies often start, when seeking a loan, with the lender (usually a bank) where they maintain accounts. Moreover,

companies should consider creating a relationship with a lender before they need a loan, in case such a relationship later becomes the decisive factor.

## Sources of Debt

There are many possible sources for getting a loan. Owners, family and friends, and lenders are the traditional sources for start-up companies. Many niche industries are springing up, however, in addition to these traditional sources. Companies now are specializing in factoring, or royalty financing, or small business loans. Credit card companies are another source of credit for small businesses. Finally, many government agencies assist companies in obtaining loans through various guaranteed loan programs.

- **Owners.** The first place a company should look when seeking debt financing is its owners. Loans from owners to the company are common, though they have additional considerations that lender loans do not. First, a company should consult a legal and/or tax expert. If certain loan formalities are not observed (i.e., proper loan documentation, application of market interest rates, provision for regular payments, etc.), the loan may be treated as equity by the IRS; such a determination may have unintended tax consequences. Second, even if certain formalities are observed, a loan from a company's owners may be subordinated to other debt and perhaps even equity if the company goes bankrupt. This means that the loan might be paid off, if at all, only after the company repays all other debt it has incurred, and perhaps even after redemption of any preferred stock.
- **Family and Friends.** The second source of loans is the owners' family and friends. Often, small loans from family members and friends will be enough to get the business started. Owners generally like this source of loan financing because they think there may be less repayment pressure. While this may be true, owners should seriously consider the effect such a loan will have on their personal relationships. If the owners do choose to

borrow from family and friends, they should think about signing formal documents with the lender(s) no matter how close the relationship, and about making regular payments on the loan.

- **Banks.** Third, many commercial entities may be a source for a small business loan; however, banks are the most common. Companies should look for banks that make a significant number of small business loans every year. The Small Business Administration (“SBA”) compiles annual statistics by state on which banks make small business loans, how many loans are made, and in roughly what amount. For example, see the list of Minnesota SBA participating lenders compiled by the SBA at [www.sba.gov/mn/](http://www.sba.gov/mn/) under the link “[SBA Lender List](#)” and the lending statistics compiled by the SBA’s Office of Advocacy at [www.sba.gov/advo/research/lending.html](http://www.sba.gov/advo/research/lending.html). Companies should also look for banks that engage in small business lending in their particular industry. Such banks are more likely to understand the needs of the company and the company will be able to spend less time explaining its industry, as well as its business, to the bank. If a company cannot find a bank that make loans to businesses in its industry, a bank that is willing and eager to learn about the industry is the next best option. Finally, small business shouldn’t look only to large, national banks. Many community banks are actively seeking to expand their small business lending, and may be more likely to support local businesses through such loans.
- **Commercial Finance Companies.** Another type of commercial lender is a commercial finance company. These companies are not banks and do not engage in the wide variety of activities that banks do. Commercial finance companies specialize in lending—particularly asset-based lending—and are also the source for most factoring arrangements. The interest rates charged by these companies tend to be higher than those charged by banks.

- **Credit Card Companies.** Credit card companies can also be a source of financing for small business, either through the personal credit cards of the owners or through a business credit card. Care should be taken to ensure that personal and business charges can be easily tracked as such and are not intermixed. Clearly, credit cards are not an ideal solution, as debt tends to run up quickly and the interest rates are extremely high. If a company is unable to find financing from another source, however, credit cards may keep the business afloat.
- **Specialists.** Another commercial financing source is specialists, such as companies that provide royalty financing arrangements. There historically have been few of these companies, but the industry is growing in both size and importance, especially in the technology industry. Companies should consider looking into this option when seeking financing.
- **Insurance Companies.** Insurance companies may also provide loans to small businesses or their owners. If an insurance policy contains a substantial cash surrender value (meaning the policy is currently worth a significant amount and allows the policyholder to borrow against it), it may provide a source of cash. When a policy-holder borrows against his, her or its insurance policy, the policy is reduced in value by the amount of the borrowing. As a result, the principal does not have to be repaid; instead, the value of the policy is permanently decreased. The policyholder will have to make interest payments on the amount borrowed, however. Insurance companies may also in rare situations make loans not based on current policies. Usually the insurance company requires that the borrowing business be well-established, or that the loan be secured by a significant amount of assets. Thus, non-policy-based loans from insurance companies are generally unavailable to start-up companies.

- **Suppliers.** Suppliers, and others in a company's chain of production, may be a source of funding. A company can gain informal funding from its supplier simply by delaying the company's payments to its suppliers, thereby gaining additional days of cash on hand. Most suppliers have a set number of days in which they would like to be paid; then they generally have another period after the current payment period in which payment is due but not yet delinquent. A company in desperate need of cash can generally delay its payments to its suppliers for several weeks or longer without being charged interest or late fees.

Suppliers may also be willing to supply loans or resources to a company in several, more formal, ways. A supplier may be willing to make a small loan to a company, either to keep the company in business or because of an established relationship. Suppliers may also extend their payment terms voluntarily to certain companies, usually because of an established relationship. Finally, suppliers may be willing to share or lease office space, and resources such as computers and telephones to a related company if they have extra resources though such an arrangement will not result in increased cash on hand. While such supplier arrangements are not always common, companies should consider such solutions if they have good relationships with their suppliers or others in their production chain.

## **GUARANTEES**

If a company, or its owners, cannot obtain a loan on its or their own credit, it may be possible to obtain a loan when a guarantee is used. A guarantee is a promise by a third party to pay the loan, or a part of the loan, if the borrower cannot. If a guarantee is made, and the borrower defaults, the lender can seek to recover the principal both from the borrower and the person making the guarantee (the guarantor). The lender can choose to seize and sell assets, if the loan was secured, or to sue the borrower and/or the guarantor for

repayment. If the guarantor is called upon to repay the loan, or a part of it, the guarantor can subsequently seek repayment from the borrower unless some other arrangement has been negotiated between them.

### **Personal Guarantees**

There are several types of guarantees. The first, and most common, is a personal guarantee by the owners of a business covering loans made directly to the business. In this case, by signing the personal guarantee, the owners are promising to repay the loan if the company doesn't. Owners should carefully consider the effects of making such a guarantee, though loans to start-up companies generally require them. If owners make a guarantee and the company defaults, the lender can sue the owners for repayment. If the owners cannot pay cash, the court can force a sale of the owners' personal assets. Lenders may also be willing to place a limit on the total amount of obligations guaranteed by a particular guarantor or build in an automatic phase-out or decrease in the amount of obligations guaranteed, with decreases based on the passage of time or the company's achievement of certain negotiated performance milestones.

### **Third Party Guarantees**

If a personal guarantee from the owners (with or without their spouses) is insufficient to obtain a bank loan, additional parties can offer to guarantee the loan. These parties may include family, friends, or even entities related to the start-up company, such as a parent or a sister corporation.

### **Federal Government Guarantees**

Finally, different branches of federal, state and local government have loan guarantee programs to help start-up companies obtain loans. The largest program is the federal government's Small

Business Administration (“SBA”) guarantee program, which works with banks. The purpose of the SBA is to assist small business owners, and the main method for doing so is by providing loan guarantees. Under the SBA guarantee program, a bank makes the loan to the small business, and the SBA guarantees all or part of the loan, depending on which program is used. This provides the bank with assurance that the loan will be repaid—if not by the borrower, then by the federal government—such that the bank may be willing to make a loan it would otherwise be unwilling to make. The SBA has no funds for direct lending or grants, with the exception of disaster relief loans; it generally only guarantees loans.

Most banks will support SBA-guaranteed loans, but since some will not, a start-up company should select a bank that has a history of making SBA-guaranteed loans. If the bank determines an SBA guarantee is necessary, it requires that the borrower fill out the SBA application, and the bank sends the materials to the SBA. The SBA then determines whether it will guarantee the loan.

The SBA has several different loan guarantee programs. The most common is the 7(a) Loan Guaranty Program. Under this program, the maximum loan amount is \$2 million. The SBA maximum guarantee is 85% of the loan, if the loan is considered “small” (\$150,000 or less). If the loan exceeds \$150,000, the SBA can guarantee up to 75% of the loan. The maximum amount of the SBA’s guarantee is \$1.5 million, regardless of loan size. All owners of 20% or more of the company must provide personal guarantees for all SBA-guaranteed loans.

Another SBA loan guarantee is the Section 504 Loan Program. The 504 Program is designed to guarantee long-term, fixed-rate financing for investment in fixed assets. The program also includes a job creation requirement designed to increase local employment opportunities. As this program is limited to fixed-asset financing, it is generally used by established businesses seeking to expand, rather than start, companies. Start-up companies such as manufacturers, however, may find the 504 Program helpful if they wish to buy assets

rather than lease them. A list of Certified Development Companies for the 504 Program in Minnesota can be found at [www.sba.gov/localresources/district/mn/financing/mn\\_cdc.html](http://www.sba.gov/localresources/district/mn/financing/mn_cdc.html).

The following types of borrowers have special features associated with them with regard to SBA-guaranteed loans and should check with the SBA to determine eligibility:

- Franchises
- Recreational facilities and clubs
- Farms and agricultural businesses
- Fishing vessels
- Medical facilities
- Eligible Passive Companies (small companies that do not engage in regular and continuous business activities)
- Borrowers undergoing a change of ownership
- Residents that are not U.S. citizens
- Borrowers on probation or parole
- Academic institutions

No businesses seeking SBA loan guarantees may be engaged in illegal activities, loan packaging, speculation, multi-sales distribution, gambling, investment or lending. Additionally, non-profit organizations are ineligible for SBA guarantees.

The SBA offers a number of additional guarantee programs, including SBAExpress, which guarantees up to 50% of revolving or term loans with outstanding advances not exceeding \$350,000 at

any one time, and SBA CommunityExpress, which guarantees up to 85% of revolving loans or term with loan amounts not exceeding \$250,000. Unlike other SBA loans, which review and approval take weeks or months, SBAExpress loan applications can be approved within 36 hours from the time the application was submitted. The SBA Community Express loan program is designed for small businesses located in economically disadvantaged communities, and the maximum principal amount is limited to \$25,000 or less if the business is not located in such a community. Both SBA Express and SBA CommunityExpress cover revolving loans with terms of up to seven (7) years, and term loans of up to ten (10) years for fixed assets and twenty-five (25) years for real estate, with maturity extensions permitted in some cases if negotiated at the outset.

The SBA also offers a Microloan Program, through which small businesses can obtain up to \$35,000. The average loan size is roughly \$13,000 for such loans. These loans are issued not through banks but through non-profit groups approved by the SBA, generally local and state governments or local economic development organizations. The SBA loans the money to the non-profit agency that then pools the money with local funds, and then issues the loan to the small business. Microloans may be used for almost any purpose, but they may not be used to pay existing debt or purchase real estate. For a list of SBA Participating Microloan Lenders see [www.sba.gov/localresources/district/mn/financing/mn\\_microparticipants.html](http://www.sba.gov/localresources/district/mn/financing/mn_microparticipants.html).

Another SBA opportunity available to small companies regardless of their industry or product grows out of Small Business Investment Companies (SBICs) and Specialized Small Business Investment Companies (SSBICs). The SBA's website, at [www.sba.gov](http://www.sba.gov), is a good source for further information about the various SBA programs, their eligibility requirements, restrictions and other features.

Federal government programs other than the SBA should also be investigated, because a company's owners, industry or project may qualify it for special loans or guarantees. Businesses owned

by minorities or women, veterans, those operating in rural, inner-city, or low-income areas, and those creating projects such as new pollution control systems, are examples of businesses which may be eligible for additional programs.

Many state and local government agencies also exist that are designed to provide loan guarantees or other resources to small businesses. The State of Minnesota, for example, has several small business loan guarantee programs. Its Small Business Development Loan Program is the most widely available and guarantees loans for a variety of industrial, commercial and manufacturing purposes. Further information about this program may be found on-line at [www.deed.state.mn.us](http://www.deed.state.mn.us) . In addition, the City of Minneapolis has a Community Planning and Economic Development Department (CPED) that provides loans and other services to start-up and small, more established businesses. Its website is located at [www.ci.minneapolis.mn.us/cped/index.asp](http://www.ci.minneapolis.mn.us/cped/index.asp).

## LEASES

While leases are not, strictly speaking, a method of raising capital, they can be useful to small companies that are short on cash. Purchasing, rather than leasing, assets is generally cheaper in the long run, as the useful life of the asset is often longer than the payments, except, perhaps, with respect to computer and other high-technology equipment that quickly becomes obsolete. Start-up companies that are short on cash, however, should look into leasing certain assets, including office space, equipment, and computers. While leases don't result in the purchase of the asset, they can be significantly cheaper than loan payments that finance the purchase of an asset.

There are several advantages to leasing beyond saving the company's current cash flow:

- leases are generally easier to acquire than loans to purchase assets;
- leases generally only require six months to a year of credit history;
- leasing may help companies keep current technology in their workplace; and
- leasing may have a beneficial effect on a company's balance sheet, by reducing debt.

Companies should consult a tax expert regarding the tax benefits of leasing versus the depreciation deduction allowed to owners.

An additional option for companies that are truly in a bind financially is a "sale and leaseback." Under this arrangement, the company sells an asset and the buyer leases the asset back to the company. The only real advantage to this arrangement is that it provides the company with immediate cash. Additionally, companies will receive a tax deduction for the rental expense, but this may be offset by the loss of the depreciation deduction a company receives from owning an asset. The downside is, of course, that the company no longer owns the asset.

## **OTHER RESOURCES**

### **Tax Incentives**

Some government entities may offer tax incentives to small businesses. The most common tax incentive is from the state government and rewards companies that have created jobs in that state. Businesses should always ask their tax expert if there are tax incentives available to small businesses that they may be able to

claim, or that they may be able to claim with a small change to the business (such as addition of another employee). For a discussion of potential tax incentives available to start-up businesses in Minnesota see the discussion in the Department of Employment & Economic Development's [A Guide to Starting a Business in Minnesota](#).

## **Business Plan and Innovation Competitions**

Companies seeking small amounts of cash may want to consider entering a competition that awards cash or resource prizes (such as computers). For example, a company may enter its business plan in a competition. Such competitions may require analysis of hypothetical problems and preparation of a business plan for an imaginary company. These competitions present a less practical option to businesses with little free employee time. Another possibility is an innovation competition, in which the company can enter its technology or product. Prizes in these competitions vary, though a typical first-place award is roughly \$50,000. Nonetheless, these competitions probably are not worth the time required unless a company can enter an existing product or business plan with little alteration or employee involvement.

## **Incubators**

Both profit and non-profit companies now use incubators as a way to get their businesses off the ground. For example, the SBA sponsors a program called Business Information Center ("BIC") which provides, in conjunction with state agencies, existing and prospective small business owners with access to computers, internet resources and business information and advice. The address of the BIC in Minnesota is 2324 University Avenue West, St. Paul, Minnesota 55114 (telephone: 651-209-1884.). While the incubator concept is still relatively new, it is worth looking into for companies seeking start-up capital. Incubators generally offer not only monetary assistance and investments to companies, but can provide other forms of free resources, such as consultation, training, and accounting. Incubators

are usually very hands-on, so companies seeking to exercise greater control over their own activities should seek money elsewhere. Moreover, incubators usually limit themselves by industry; companies looking to use an incubator should seek one designed for their type of business.

### **Bartering**

Companies seeking basic supplies can always try to barter. This system works particularly well with other businesses in the start-up company's production chain. For example, a start-up could offer a discount on its products in exchange for office space in its buyer's offices. This option is generally used on a more informal basis, and between companies that have an established relationship. Bartering will not provide a company with a great deal of money, but may provide small advantages and benefits.

## **CONCLUSION**

Clearly, start-up companies have many financing alternatives to equity financing. Companies should spend some time researching their financing options before proceeding. Not all lenders are alike, and companies should seek one that meets their needs. Similarly, government and investment programs differ a great deal; companies need to investigate the programs for which they qualify and which programs are a good fit. Companies then need to consider what their needs and preferences are before settling on a financing option and choose an option or options accordingly. Companies should also think about getting help from a lawyer, an accountant, tax expert, or all of these professionals before proceeding with many of these options, as some involve detailed legal requirements and some may have unintended economic and tax consequences.