FINANCING ALTERNATIVES FOR SMALL BUSINESSES

Whether starting up a small business or expanding an existing company, you almost certainly will need financing. But which option or combination of financing options: personal savings, friends and family, commercial or government loans, outside investors? Which options will most likely be available to you and what are their pros and cons?

Before choosing financing options, however, determine how much money you'll need. That entails developing a good business plan, which benefits not only you but will be de rigueur for most financing arrangements. Books, Web sources, software, and classes are available on how to write a good plan.

Don't be too conservative estimating the amount of financing you need. Undercapitalization leads to a third of all bankruptcy filings for small businesses, according to the federal Small Business Administration. Some experts recommend estimating a realistic amount and then adding 10 percent to it just to be sure you didn't overlook anything. Others suggest having enough funds in reserve to pay your personal living expenses for at least one year so as not to put a drag on your new business cash flow.

Personal savings. The nice thing about this option is that no one will turn you down. Of course, you may not have sufficient savings or you may not want to risk your personal savings (some financing options may compel you to, anyway).

Borrow from family or friends. This is a popular choice when you can't get standard financing. Still, it can come with great peril because of the emotional bond for both parties. Expect some strained times if things go sour, so be sure everyone thoroughly understands upfront the risks of their loan. Show them your business plan and put the loan in writing.

Put in on plastic. Credit cards are easy to get and you don't give up control or have relatives or friends peering over your shoulder. But plastic can be expensive and risky borrowing, especially if you fall behind on your payments. That's why business experts often recommend limiting the use of cards for smaller, temporary cash needs you can pay back more easily, while using other financing for larger, longer-term expenses.

Commercial loans. Bank loans are often desirable because rates can be among the lowest and a bank loan can make you look good to other lenders. The problem is that many small businesses have a tough time getting bank loans because banks are pretty conservative lenders. You'll need to show them a solid business plan, a good personal credit rating, and prospects for steady cash flow. You may be asked to guarantee the loan with personal assets—something not all entrepreneurs are willing to do.

Shop around. Banks have different lending standards and one may lend where another won't.

Personal loans. Personal loans from banks are easier to get and often don't require collateral. But interest rates are likely to be double or even triple a commercial loan rate and lenders may balk at using the loan for a small business. Some finance their business with a home-equity loan, but that puts your home at risk.

Federally-backed loans. The federal Small Business Administration (www.sba.gov) provides an array of loan options through private lenders (shop around). The main program is called 7(a), which provides funding for start-ups or existing businesses for everything from land to equipment to working capital. A micro-loan program ($35,000 or less) is available for small firms employing five or fewer, particularly firms with minority, low-income, or disabled owners.

Equity partners. Bringing in other investors is an option many small-business owners are loath to do, but may have to out of necessity. Financing options from private investors can be complicated and you'll likely want assistance from an attorney experienced in this area.

The advantage of equity partners is that with a good plan and a promising business you may be able to bring in much-needed cash for a venture that lenders might shun because of high risk or lack of stable cash flow.

The downsides are that you dilute ownership, investors are likely to offer lots of advice and criticism, and the process of lining up investors can take much longer than other forms of financing.

Each of these financing options has their pros and cons, so it's critical to develop upfront a detailed, well-conceived business plan in order to determine your best funding options.

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