10 Sources of Funding for Small and Medium-Sized Businesses

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Content

Most up-and-coming entrepreneurs have great ideas but often lack sufficient capital to start a business. Bank loans for small start-ups are not easy to get, especially without collateral. If a company is already up and running, additional funds are needed for ongoing development and growth.

This is why we've put together this guide on the different ways to raise money at every stage of a business's development. Some entrepreneurs are able to raise money from people close to them, while others apply to investment funds or use personal savings. To help you find the best way, we look at 10 different funding sources and provide you with valuable insights and tips for setting up and developing your business.

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1 Personal investment

One of the best ways to fund the establishment of a business is a personal investment. Whenever possible, it is always better to start a business by investing your own money.

It is unnecessary to fund the total amount of the business needs. Still, it is worth trying to put up between 25 and 50 per cent of the required capital. This will show potential investors and lenders that you are prepared to assume some of the risks and are convinced of the business's viability.

Putting in at least 25 per cent of the capital from your personal funds is also worthwhile because you will secure a favourable position when negotiating with potential lenders. And because you will own a sizeable chunk of the business personally, other sources will be more inclined to help with the rest because you will already have fulfilled what is often one of their conditions. This may also facilitate access to a bank loan for your business.

2 Borrowing from friends or family

One of the most common ways to fund start-ups is by using a loan from friends or family. But when relatives become your creditors, both funds and relationships can be put at risk.

To avoid any misunderstandings, you should draw up a financial agreement and a written contract for a loan. These should indicate when your relatives will get their money back, reduce the risk of any disagreements developing, and show your relatives that your approach to the loan is serious.

It is also essential to consider how the agreement will be structured: whether you will repay as much as you have borrowed or if you will offer minimum interest payments. Informing your lenders about the risks is just as important. Make sure you present a strong business plan but caution your relatives that there is always a possibility that they will lose their money.

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3 Business angels

Small and medium-sized enterprises searching for funds to launch their business often prefer business angels. These angels can be private individuals, for example, who invest at an early stage in exchange for ownership of some of the company's equity. Unlike traditional investors, business angels usually differ in that they invest smaller amounts, make rapid investment decisions, and rarely insist upon taking a controlling stake. Therefore, this funding option is very convenient for start-ups that do not need large amounts of investment and want to maintain greater business control.

The greatest challenge in obtaining funds from business angels is making your proposition sufficiently attractive. Business angels choose where to invest their money, so it is essential to know how to get their attention.

Having an appealing and well-developed idea is vital. Such an idea should be registered with dedicated, which bring together business angels and those launching start-ups. When presenting a project to business angels, you should highlight the strengths of the idea, and the presentation should convince them that all that is needed to launch it is the proper financial support.

4 Venture capital

Venture capital is one of the most attractive funding opportunities when it comes to starting a new business. Venture capital is money put into new companies that can achieve rapid growth but also come with substantial risk. Entrepreneurs often turn to venture capital funds when traditional forms of finance such as bank loans are not accessible to them because of perceived unreliability or risk. Venture capital can be obtained at any stage of business development.

Unlike other forms of funding when an entrepreneur is required to repay the capital and any interest, venture capital investments are provided in exchange for a shareholding in a company. So the venture capital fund obtains powers over corporate governance.

In exchange for venture capital, entrepreneurs expect a high return on their investment. This means that the relationship between the two parties can be long-term. Instead of repaying the loan immediately, a business owner will have to work for five or 10 years with their venture capital investors. At the end of the deal, entrepreneurs who have lent the money will sell the shares to the owners or through a public auction, expecting a return much higher than their original investment.

Differences between business angels and venture capital funds

While both investors provide capital to start-ups, there are some significant differences between venture capitalists and business angels. The biggest difference is that venture capital comes from either a company or business. In contrast, business angel investments are made by private individuals.

The second difference is related to funding capacity: companies usually invest huge sums, while business angels will usually only offer more diminutive amounts.

One more difference is that venture capitalists will typically invest in any start-up they think will generate a high return. At the same time, business angels will seek investment in companies operating in industries they are already familiar with. Besides, business angels do not always require an active role in the structure of the business in the way that venture capitalists do.

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Loan

A loan can be another source of business funding. With a loan, you get a lump sum and use it for the development of your business. Repayments are either daily, weekly or monthly, depending on the loan agreement. This source of funding allows you to easily plan the financing of your business.

Fast loans

Fast loans are granted for three to 18 months and are usually designed to help a business overcome unforeseen problems. However, these rapid sources of finance are expensive. Such loans are generally for amounts that are much smaller than traditional ones. Still, their annual interest rates can be around 14 per cent or more. Fast loans are convenient because they do not require long-term commitments, and they can be obtained by any business.

Traditional loans

Traditional loans are intended for more stable companies and businesses which are already established. The loan amounts are higher but are not so easy to obtain. While there are more commitments, the interest rate is usually lower.

These loans are granted for one to five years, and although they are not issued as quickly as a fast loan, you can expect to receive funding in fewer than 10 days.

However, only about 20 per cent of small or medium-sized businesses are eligible for traditional loans. Suppose a company does manage to obtain a traditional loan. In that case, it is considered to be a great success because it is usually the safest form of funding. Large loans by banks can be repaid over a long period. With regular payments, the company will maintain business stability and reduce the need for additional investments to a minimum.

Such loans are suitable for businesses with an idea for a specific project: a marketing campaign, development, or an experimental new product.

6 Leasing

Leasing is a way of acquiring the supplies a company needs by making partial payments for assets that can be used immediately. A business only needs to make a down payment and then pay fixed monthly amounts. Assets acquired this way can be used for business development.

Leasing is divided into two types:

1. Financial leasing. During the term of financial leasing, the client must pay the full acquisition price of an asset, interest, and VAT. When the term of the lease expires, the client owns the asset.

2. Operating lease. During this lease, the leasing company acquires the client's assets and transfers them to the client to use until the due date. During the contract period, the client makes payments. At the end of the contract, they can choose to return the asset to the leasing company, enter into a contract for new assets or extend the lease.

Leasing is a helpful way to access business funding because there is no need to pay an additional deposit. The asset itself is the guarantee the company uses while still owing money on the lease. You can choose the leasing conditions according to your financial situation and a payment schedule, the period, and the initial payment. Leasing is an effective way of maximising an asset's effectiveness because a business can profit from it while making monthly payments and then reinvesting the resulting added value in the development of the company.

As with other funding methods, leasing does not come without risk. This is related to the inadequate fulfillment of obligations. When it is late with its repayments, a business damages its credit record. When it breaches a leasing contract, the finance on the lease can be terminated. The business may become subject to debt recovery and the repossession of the asset that the lease agreement was made on.

7 Credit line / Overdraft

Credit lines work in a very similar way to credit cards: a business gets access to funds that can be used whenever needed. Interest is charged only for the money withdrawn and used. When the borrowed money is repaid, the credit available returns to the original business's total amount.

You can use a credit line in any way your business needs: wait before drawing down the money until the moment you need it or use it whenever you want.

A credit line is much more advantageous than a bank loan as there are no fixed repayment dates and schedules. This is a very convenient way to fund small seasonal businesses which need to hold some capital in reserve for emergencies. If a company is considered viable, a credit line offers low interest and large sums.

The weaknesses and risks associated with credit lines are that penalties for late payments are much higher than those for loans. Furthermore, if a business is considered a bad debtor, it will face much higher interest rates.

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Factoring

Factoring is offered by Factris and is an asset-based funding system for small businesses. How does it work?

We fund outstanding corporate accounts, which later become security for the funding. A company receives financing (up to 100 per cent) for goods or services sold, paying us a finder's fee from 0.5 per cent on the amount of the account being paid. The buyer returns the money to the financiers in the amount stated in the account.

This solves some of the common problems encountered by a young business, particularly late payments by customers, resulting in a destabilising shortage of working capital and, potentially, missed payments to suppliers and other creditors.

With the factoring service, an enterprise can obtain money for outstanding accounts right away without risking growth and development processes. In other words, a steady flow of working capital and the integrity of a company's operations are ensured.

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9 Trade finance

The trade finance service is aimed at managing trade payments with greater ease and lower risk. It includes three types of funding:

Letter of credit. This instrument is used in cases where a company is in the early stages of a relationship and does not know its business partner particularly well or has doubts about a client's solvency but wants to be sure about the delivery of goods or payment. At the request of the seller of goods or services, a bank assigns a documentary letter of credit through which it undertakes to pay the seller for the delivered goods, works, or services. The seller undertakes to provide the bank with documents on the terms and conditions.

Documentary collection. This is a method of international trade payment which allows the seller to retain control of the goods until the buyer makes a payment (or until a written commitment to pay in the future is provided). This method is recommended for business partners who have worked together in the past and have built up a degree of mutual trust. It is a simple and inexpensive way to reduce the risk of international trade: the seller is confident that the ownership of goods will pass to the buyer only after payment. The buyer does not have to make any prepayment for the goods.

Guarantee. A bank guarantee is offered to ensure that a business partner or an issuer of a call for tender will fulfill its obligations. A bank that grants a guarantee undertakes to pay the amount specified in the guarantee if the enterprise for which the guarantee is issued fails to fulfill its obligations. This service helps to reduce the risk of transactions and ensure that the parties involved in a transaction fulfill their obligations, and enhance mutual trust between business partners.

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Bond placement

Bonds are an acceptable alternative to bank credits. They are more advantageous than credits. They allow a company to obtain funds on acceptable terms drawn up, taking into account market demand and including the currency, term, interest rate, payment structure, etc. In the case of bank credits, banks can impose bans and regulations that can restrict a company's activities and, in practice, do not necessarily improve the chances that the company can actually repay the loan.

One disadvantage of bonds is that they are a more expensive source of funding than bank credits, and this is particularly true with bonds issued by companies that are not yet well known or have yet to acquire a good reputation in the market. Bonds issued by reputable companies don't usually offer higher interest rates than bank credit. Still, companies often use bonds as an alternative source of funding, particularly when bank loans are no longer available.

One more difficulty related to bonds is that there is no guarantee that they will be successful just because they have been placed. Failure may be due to any factor which results in a lack of demand for a particular company's bonds, such as limited market size or a general lack of knowledge about the issuer. Moreover, every time a bond placement fails, the image of the company can suffer.

However, bonds are one of the safest forms of investment. The redemption of bonds issued in Lithuania and interest payments are ensured through various means (by property pledge, for example). Furthermore, there are clear bond issue conditions, an option to sell them on to another investor at any time before their maturity date, and a clear means to calculate the likely return on investment. Finally, the company may no longer obtain additional borrowing conditions without bond redemption, so bonds remain very attractive to investors.

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Summary

There is no single best source of funding for every eventuality. Every business is different, and it is worth considering your particular situation.

However, now that you are familiar with 10 of the most common options, you should be better informed about obtaining funding for your business. All that remains is to choose the best funding method to meet your specific business needs.

Good luck!

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