A Definitive Guide:

DEMYSTIFYING SMALL BUSINESS FINANCING

KAPITUS

Introduction

The road to owning a successful business is paved with self-belief, perseverance and significant effort. All small business owners must face multiple challenges - long hours, cash crunches, unforeseen situations, fluctuating market conditions. However, with smart planning a small business owner can overcome these challenges and thrive.

The New York Fed's latest report says that small businesses in the US are expecting to see stronger revenues and witness escalated employment throughout this year. In its national survey spanning "nearly 16,000 firms with fewer than 500 employees, more than 60 percent said they expect more revenue in 2017 than last year. Around 40 percent anticipated expanding their workforce."[1]

When businesses are thriving, owners may not think they need quick access to capital. If they feel that the business is running smoothly, why would they need to be thinking about access to extra capital to sustain or grow their business? Due to this mentality, most small to mid-size businesses (like manufacturers, retailers, franchises, restaurants, service providers and e-commerce ventures) do not consider it a top priority to have an alternative source of funding as a backup for unforeseen expenses.

What many don't realize is that the best time to investigate additional funding is when a business is doing well. If you wait to apply for financing only when the business is struggling, you risk not being approved. With a decade of expertise helping thousands of small businesses every day, we have compiled a guide to the fundamentals of small business financing. From understanding the pros and cons of financing to dealing with sudden emergencies, we will help you expand your business horizons for a brighter tomorrow. With a little planning and the right financing at the right time, you can accomplish anything.

Fundamentals Of Small Business Financing

Every business needs capital to sustain and grow. Acquiring inventory, renovating, purchasing top-of-the-line equipment or strengthening operations all require capital. Loans through traditional lenders are usually where businesses first seek capital. However, traditional lenders can often be very slow and have complex qualification requirements. When capital is needed quickly, they are often not a viable option. This is where alternative financing options come in. Unlike banks, small business alternative financing partners are fast sources of capital, usually requiring very little paperwork. They are willing to take greater risks by betting on the future success of established businesses.

Alternative financing isn't always cheap. However, used wisely it can be the catalyst that ensures continued growth and health. Here are some of the top reasons businesses choose alternative financing options when looking for capital.

1. Fast access to capital.

Having fast access to capital allows you to take advantage of opportunities that arise, like when an ideal property for expansion with an enviable location comes onto the market, or when a manufacturer or distributor is having a huge sale on items that you know your customer base will love. In order to take advantage of these opportunities, you need cash and you need it fast. Having a relationship with an alternative financing provider can ensure that you won't lose out on opportunities like these. They can get you the cash you need in a very short amount of time.

Fast access to capital can also address unforeseen challenges. For instance, your restaurant may be registering good profits and solid growth. But if your refrigerator suddenly stops working, where do you get the cash to fix the problem? Or, worst case scenario, replace the equipment? Similarly, when the building landlord can't fix your air conditioner for a couple of weeks, you may have no choice but to fix the problem yourself. In situations like these, a quick supply of cash through an alternative financing partner becomes a necessity. It immediately gets you access to the capital you need to fix the problem and get your business back on track.

Also, many situations will require investment upfront. You may need equipment for a big contracting job, or inventory to service a large order, or a sudden unforeseen expense may be required to expand physical space in your office for new or existing employees. In these scenarios, an alternative source for small business loans is a solid safeguard for your business.

2. No collateral or little collateral required.

It is an irony of business that banks only lend you money when you don't need it. Banks must ensure that a small business has enough collateral to repay a loan (e.g. assets, property, stock). If your company is looking to take off, or you want to make some changes on the operations side, then approaching a bank for a loan may not always work out. This is because you may not fit their meticulous collateral criteria.

In situations like these, it may be easier to choose a form of alternative financing that focuses on the future success of your business. Some financing options available through alternative lenders have very low collateral requirements and sometimes none at all. As with any loan, it is important for the business owner to carefully understand and match the financing option to their business's needs.

3. Short-term cash injections.

Not everyone needs business financing for the long term. You may have a small emergency, or your business is facing a seasonal slump, both of which would be solved by a quick capital injection. Alternative financing is a great option for a quick cash injection for a relatively short period (3–18 months). This extra capital helps you sustain your business. Be wary – if you find yourself always in need of short-term alternative financing, you may want to revisit your business structure and confirm that it is still the best option for you.

4. Flexible payment terms.

A great advantage of alternative financing is that you can choose the mechanism and timing of your payments, meaning you have the freedom to choose a payment schedule that suits your business the best. Some financing options allow you to pay back on a daily basis, with the daily payment amount determined by how your business performed on that day (on successful days you pay more, while on slower days you pay less).

Some options allow you to repay directly from your bank via ACH or as a portion of every credit card swipe used to pay your business. The flexibility of the payment mechanism and type gives small businesses a great advantage in managing their cash flow. The beauty of this arrangement is that the success of the alternative financing provider is tied directly to the success of your business. The same cannot be said for traditional lenders.

5. Better cash flow management.

Cash flow is the lifeblood of a successful small business, and perhaps the most important barometer of financial health. If you have good cash flow management in your business, then nothing can stop you. Poor cash management can lead to operational nightmares and financial hardship. Late payments on equipment or rent agreements or even miscalculated inventory can adversely impact your business.

You could find yourself up against numerous challenges, like the inability to make payroll, fulfill tax liabilities or buy inventory to serve your customers. In a scenario where no traditional loans are available to counteract a temporary decline in cash flow, alternative financing comes in handy.

Small Business Loans and Alternative Financing Options

Every business is unique. What works for one may not work for another. With a range of choices, each with its own unique requirements and mechanisms, how do you identify which type of financing is best for your business and your needs? The best place to start is with the basics: having a full understanding of your situation and being clear about what you want/need versus what your business can take on. Whether you want capital immediately or sometime later, in a lump sum or phased over time, take stock of your situation and then consider your financing options.

Here we explain the most frequently used business financing options available to small businesses.

A. Small Business Loans through SBA

The government-backed Small Business Administration (SBA) extends aid to small businesses via loans that not only help them to start up their business but also help to sustain and grow that business. While the agency itself does not provide financing, it makes affordable loans available through SBA-approved lenders like banks. These loans are designed to meet very specific business purposes, so it is important to understand each before applying for an SBA loan. Though cheaper than other loan options, it may be difficult to qualify for an SBA loan due to factors such as insufficient collateral, low credit scores or being in an industry or sector that is not qualified to receive an SBA-backed loan.

SBA loan programs are designed to meet the major financial requirements of varied small businesses. These include microloans, real estate loans, equipment loans, and basic loans under the 7(a) program.

The loans provided through the 7(a) program can be used for a variety of purposes: setting up a new business, acquiring a business, purchasing equipment and machinery, or as an influx of working capital.

The general small business loans from the 7(a) program are the most popular of all SBA loans. Since these loans are guaranteed by federal agencies, lenders can offer businesses very lucrative and flexible terms. It is no secret that the 7(a) loans through the SBA are by far the best way for any small business to get financing if they can qualify.

To be eligible for 7(a) loans, a business must satisfy the following criteria:

A. Be a for-profit company.
B. Operate within the United States.
C. Demonstrate a business need for the funds.
D. Show proof that you've exhausted all other avenues and financial resources before applying.

In order to show that you have exhausted all other options, you will need to have used your own personal assets, reached out to family and friends in addition to having applied for and been declined by a traditional lender. Due to this strict criteria, most small businesses find these loans out of their reach. In fact, a 2016 Forbes report points out that, "The head of the U.S. Small Business Administration has cited industry estimates that 80 percent of small business loan applications are rejected."[2]

Key points to remember about SBA loans:

- Lowest cost option for small businesses looking for financing to start up or grow a business.
- Offered by traditional and alternative lenders and backed by government guarantee.
- Multiple types of loans and grants depending on business type and need.
- Businesses applying for a loan must first use other resources including personal assets.
- Personal guarantee required by business owners or top management of the company.
- Long application and funding process compared to alternate financing options.

SBA loans may be a good option when:

- Working capital is needed to expand the business over the next few years.
- Consolidating loans from multiple lenders.
- Hiring new employees or opening a new location.
- Recovering from declared disasters.
- Your business is impacted by NAFTA.

SBA loans may not be an option when:

- Working capital is needed immediately for a very short term.
- Consolidating loans will require the company to take a loss.
- Business owner cannot provide a personal guarantee.

Besides the general 7(a) loans, the SBA provides 7(a) loans to cover special situations like companies conducting business in underserved communities or companies looking to expand export activities. There are also microloans up to $50,000, and special programs to help businesses recover from declared disasters. To learn more about SBA loans, visit: https://www.sba.gov/loans-grants. Many traditional and alternative lenders will also help businesses navigate through the process of applying for SBA loans.

B. Revenue-Based Financing

The most frequently used option for small business financing, revenue-based financing allows small businesses to take financing against their continued business success. The oldest form of revenue-based financing is the popular merchant cash advance. Given that the financing partner only gets paid if the small business continues to be viable and successful, this option truly aligns the interests of both parties. This is proven as merchant cash advances continue to see a healthy increase. A 2016 report on Merchant Cash Advance/Small Business Financing Industry by Bryant Park Capital notes that "The volume of merchant cash advances provided to U.S. SMEs has steadily increased over the last couple years, projected to reach $15.3 billion in 2017, up from an estimated $8.6 billion in 2014.[3]

Typically, revenue-based financing provides a lump sum of cash to a small business with the understanding that it will dip into a fixed percentage of future sales. It's a great option for any small business owner who is looking at short-term financing (less than two years), cash flow and working capital.

Previously, merchant cash advances were limited to those businesses that received customer payments via credit or debit cards, like bars, nail salons, restaurants, retailers, and other forms of B2C companies. Nowadays, with advancements in the system, merchant cash advances can work for almost any type of small business.

While a merchant cash advance gives your business financial backup, it's also important to know that it directly impacts your daily and weekly cash flow. Good lenders ensure that the funds they advance to merchants guarantee healthy growth in the business even when daily and weekly remittances are being taken from the business's revenue stream. Uninformed merchants can easily fall prey to unscrupulous lenders who can overburden a business's cash flow. Therefore, small businesses applying for a merchant cash advance should first make an objective analysis of whether this service is best suited for their business.

Key points to remember about revenue-based financing:

- Quick access and faster approval of the application.
- Much lower credit score requirement compared to a traditional loan.
- Qualification does not require secure assets.
- A fraction of the company's daily and weekly sales goes toward its outstanding financing amount.
- Supports payments to be processed against both credit card and cash payments (ACH).
- Instead of fixed monthly payments regardless of the business performance, the remittances re tied to the success of the business.
- Flexibility of daily and weekly payments with the ability to true-up payments against the actual performance of your business provides peace of mind and extra cushion when times are lean.
- There is an immediate impact on your business cash flow.

Revenue-based financing may be a good option when:

- The business does not meet SBA loan requirements.
- Funds are needed immediately.
- The company does not have enough collateral for traditional long-term loans.

Revenue-based financing may not be a good option when:

- The funds will provide only temporary reprieve but cause irreparable harm to cash flow.
- The business already has several outstanding loans or advances.
- Your credit score is below 550. In this case, alternate options like Factoring may be more appropriate.

It is important to note that unlike other traditional loan options, which are usually backed by a collateral or federal guarantee, this financing type presents a great risk to the alternative lender. That is why it is a more expensive financing option compared to traditional loans. Businesses should therefore thoughtfully consider whether this option makes sense for them and carefully vet the alternative lender.

91.7 billion USD

Size of factoring market in the United States in 2016

- Source: Commercial Finance Association

C. Factoring

A clever way to unlock some of the cash latent in your business is by selling receivables that your business is owed by third parties. Factoring, or sale of receivables at a discount, is a great way to finance unforeseen cash flow shortages. With factoring, an alternative lender will instantly give you capital by purchasing the invoices of your company at a defined percentage. Factoring gives you two advantages – immediate cash in hand to solve your cash flow needs, and time and resources freed up from chasing invoice payments. This is an especially good route for companies that are owed large sums from vendors or customers.

Among other reasons, factoring is most suited for your business when you want to expand or renovate, purchase equipment, upgrade inventory, or ensure timely payroll.

What you should know about Factoring

- Factoring can be a cheaper financing option compared to revenue-based financing. This is especially true if you have slow paying customers or long-term remittances.
- A factoring fee may be assessed based on the cost of the entire invoice or even the amount you've taken as an advance. In fact, most factors give an advance between 70% to 90 % of the invoice and your factor rate may increase on a weekly, bi-weekly or a monthly basis. Typically, a small business may pay 2% to 6% in factoring fees. Therefore, it is advisable to determine ahead of time that your company's profits can cover the cost of financing via factoring.
- The alternative lender providing factoring services will inform your clients of the business relationship between your company and the factoring company. This is done to ensure that your invoices are correct and that the clients are satisfied with you.
- Your company is not required to provide collateral.
- Factoring is available to businesses based on their receivables, so credit history is not considered for this type of financing.

Factoring may be a good option when:

- You have large receivable invoices from one or two vendors or customers.
- Your credit history will not allow other financing options.
- You have already taken one or more merchant cash advances.

Factoring may not be a good option when:

- Your relationship with the vendor/customer that owes you funds is in danger of being negatively impacted due to sale of the receivable.
- The receivables are through multiple vendors or customers.

Remember, it is advisable to use factoring for an emergency cash injection. When you've chosen a company to be your financing provider, ensure you read the fine print to avoid surprises later. For instance, your factoring agreement may be subject to additional fees like a service fee, lockbox fee, credit check fee and more.

D. Equipment Financing

Every small business owner will agree that starting a business is very exciting and challenging. From setting up an office with computers and staff cafeteria to on-the-ground supplies for transportation services or construction, every piece of equipment matters. To keep your business operating seamlessly, everything must be planned. However, new opportunities seldom present themselves with no obstacles. Many businesses often find themselves in need of new equipment to make the most of a new lucrative opportunity. Equipment financing eases these worries and bolsters your growth by catering to the needs of your business without any down-payment. Equipment financing is ideal for companies like towing businesses, construction contractors, medical practices, those that have a large warehouse, or those that have vehicle fleets.

What you should know about Equipment Financing

- It's a great way to get ahead of your competition. With equipment financing, you can have the most advanced equipment in your sector without adversely impacting the financial health of your small business.
- Do your homework. Ensuring the right quality of equipment financing is a top priority for any small business owner. Carefully consider some basic parameters before entering into an agreement for equipment financing, including the amount of cash required, fees and alternate equipment upgrade options.
- Consider these questions before pursuing new equipment: How will the new equipment add revenue or reduce costs for your business? How essential is it to supplement the growth of your business, cash flow, and profits? Once you have the answers, choose a lender whose terms suit your requirements.
- While the approval process for equipment financing is fast and hassle-free, things can get tricky if you don't balance your cost and cash flow. For example, cash flow is impacted if you repay over a short term. If you select a long-term repayment, then you end up paying a lot of money on the lure of low payments. Therefore, choose a repayment term that is in sync with your cash flow and that you can easily manage on a monthly basis.
- Be aware of associated costs like insurance and maintenance. Many businesses forget to factor in these costs when looking for equipment financing.

Equipment Financing may be a good option when:

- The cost of purchasing the equipment is too high to sustain on current cash flow.
- You want to maintain the option of changing the equipment in the future to keep up with the latest technology.
- The new equipment will give you an edge on the competition.
- The new equipment will give you access to a new market or new line of business.

Equipment Financing may not be a good option when:

- The total cost of ownership of the equipment, along with the associated fees, maintenance and insurance costs will introduce too much risk in the business.
- There are cheaper options for used or re-traded equipment that would provide the same benefit to the business.

With careful planning, equipment financing not only saves money but also helps small businesses to pursue other business goals. Used wisely, it is a great way to fuel growth in your business.

E. Term Loans

Are you looking to make some big inventory purchases? Are you planning a huge expansion of your operations? To finance these projects, you could consider a term loan. Simply put, term loans are traditional loans which give capital for a specific business requirement. They come with a set framework which includes monthly payments with fixed interest rates and they can extend anywhere between one and five years. They are best suited for businesses that indicate robust growth potential and are well entrenched in the marke

These loans can be used by all types of businesses. Funds can be available through some lenders within days. Though lower monthly payments are an attractive incentive, repayment terms are longer. Term loans consider a variety of aspects of your payment history, financial health, cash flow and creditworthiness. t.

Did you know...

Lines of credit have a relatively lower rate of interest, making it a smart option

F. Line of Credit (LOC)

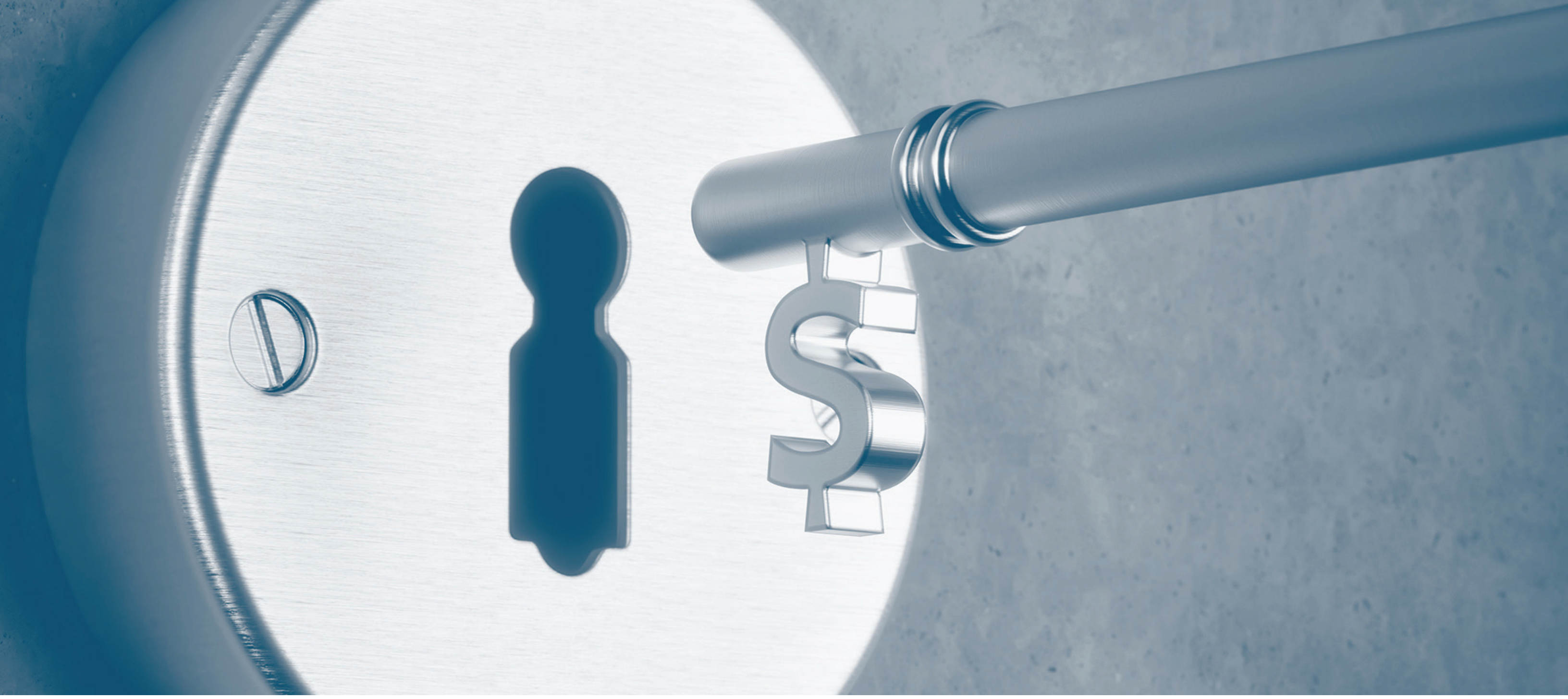
Consider this: you own a party supplies business and most of your inventory has been sold much more quickly than you had anticipated. The challenge here is that these sales may not reflect in your company's account until the month's end. In the meantime, you need more capital to restock your store with new supplies. Where do you source that extra capital? You may want to consider a line of credit as an alternative option for your small business.

An LOC gives your business defined capital when required, which you can repay within a specified time span or on an immediate basis. This type of financing takes care of different business requirements, like helping with a strategic investment, plugging financial gaps, addressing daily business or operating expenses, buying inventory or dealing with liquidity issues. A business line of credit is akin to saving money for a rainy day because you can dip into reserves without upsetting your existing finances.

Remember, the line of credit is a costly option. This is because the interest rate and fee are activated as soon as you borrow the money. The good news here is that, unlike a credit card, lines of credit have a relatively lower rate of interest, making it a smart option too.

Key points to remember about a Line of Credit:

- Documentation is required when you apply for a line of credit.
- Some alternative lenders insist on collateral.
- Your company must have a good credit score. Some alternative financing lenders tend to give credit to those businesses who have a credit score of at least 650.
- In case you have used only a portion of the money you applied for, you won't be charged interest for the unused portion.
- Your small business will improve its credit score with regular payments.



Applying For Small Business Loans And Alternative Financing

The underlying premise of an alternative financing provider is that the small business borrowing money is healthy and growing. To make this determination quickly, the lenders look for indicators of good business health. By managing those indicators of health, you can not only ensure that your own business remains healthy, but you can also be sure to get the best financing terms should you need to get alternative financing.

Maintaining strong financial health

I. Keep your business in order.
Securing a small business loan can increase your potential and help you achieve your goals. In order to avoid possible delays, be smart and ensure all required documentation is organized, up-to-date and easily accessible. This includes updated financial records, income statements, balance sheets, personal and business credit score, and invoices.

II. A robust credit score will help.
If your credit score is in good shape, that's good news for your company. You can get a free copy of your credit report from annualcreditreport.com. If you find any incorrect information on your credit report, contact each credit reporting agency (Experian, Transunion and Equifax) immediately to resolve any issue. Remember, while small delinquencies are understandable, lenders are uncomfortable with statements that show delinquencies on child support or recently dismissed (not discharged) bankruptcies.

III. A sound Cash Flow Analysis will reap benefits.

If your company is in good health, you've won half the battle. Showing 3 to 6 months of positive cash flow can get you approved faster. It can even get you better financing terms for your small business loan.

IV. Have an airtight plan and factor in hidden costs.

A plan that reflects your current and projected financial standing, business potential and growth strategy will certainly propel your application faster. Ensure that you've done your homework and market research properly. Also, be prepared to handle hidden costs in the business.

V. Bank statements will be a big help.

A company's bank statements can provide a good picture of its financial health. Therefore, it's a good idea to furnish at least three months of bank statements when going for alternative financing. Additionally, if you can maintain a positive daily balance on your bank account, it always works in your favor.

VI. Don't let large deposits to your account slow your application.

Financial windfalls are great. But large deposits are viewed suspiciously by wary lenders. They want to be sure that it isn't money suddenly deposited to your account to help show that your business is healthy, or worse yet, is part of a scheme to defraud lenders or launder money. If you have your paperwork in order and can explain these large deposits, then you should be fine. Here's an example: if you are in manufacturing, you may have large deposits daily or at frequent intervals. In this situation, ensure that you provide copies of your account receivables and future contracts. This will help expedite your loan application.

VII. Manage and finish off payments for other outstanding loans.

There could be times when you need capital for various purposes and have elicited the services of multiple lenders. In this situation, you may want to manage and finish your loan obligations before choosing an alternative financing option for raising more capital.

Tip

Use this list as a checklist before applying for a business loan

How To Choose The Right Business Loan

It's not easy to decide which alternative financing option is best for you when there are so many choices. Quick approvals and immediate access to capital can be so lucrative that in your hurry to get the best deal you may not fully appreciate the net impact on your business. This is one of the many insights that small business owners have shared with us.

Here we provide considerations to better determine your best alternative financing option.

I. Figure out how much capital is required for your business.
This fundamental question can sometimes be overlooked in the hurry to get the best deal with a lender. This can be a costly mistake. Good lenders will try to assess how much financing you truly need. The bigger the loan, the more you repay, so it may not be worthwhile to go for the largest loan you can take. Therefore, evaluate how much capital is required and apply for a financing option which is the closest to that number.

II. Choose your lender wisely.
Before you select your alternative lender, research several companies to ascertain the perks, interest rates, and other deals provided by each. Then choose the lender that is best for you. Also, if you want to minimize total cost of borrowed capital, some lenders will give incentives to make faster repayments. Always read the reviews and track the ratings of your chosen lender.

III. Consider the term for which you require capital.

Set a timeline within which you will take advantage of the extra capital and when you can repay it to the lender. That way, you can focus on the other financial aspects of your business, like cash flow, handling profits and running seamless operations.

Alternative financing has evolved significantly from the early days of merchant cash advances. It is now more than just an emergency back-up for capital and is truly a catalyst for transforming the small business ecosystem. In this context, market experts report that 2017 trends indicate small businesses have embraced automation and marketing with the help of alternative financing.

While continuing to be more technology-driven, small business owners are now enhancing and growing their businesses with features for customer engagement like business websites, Twitter, Facebook and more personalized marketing e-mails. As in previous years, automation continues to top the favorites list for small businesses. New tools for data management, payment processing, and customer loyalty have made a mark in small business workplaces to trim expenses and grow revenues. More than ever, small businesses are leveraging smart financing to accelerate smoother business functioning. The pace of change in our society is accelerating. Alternative financing is helping small businesses to make the most of these changes to realize their goals. After all, empowered business owners can do anything: create rock-solid businesses, generate employment, and most significantly, make a lasting difference to their communities.

LINKS:

1. https://www.reuters.com/article/us-usa-fed-credit-idUSKBN17D25E?il=0

2. https://www.forbes.com/sites/sageworks/2016/07/17/5-tips-for-small-business-owners-looking-to-get-a-bank-loan/#7c4b736f7033

3. https://www.zoclaw.com/future-merchant-cash-advances/

About the Author

Aman Devgan

Aman Devgan is the Chief Marketing Officer at Kapitus where his team helps small businesses connect with smart financing options. He has over a decade of experience working with small businesses building digital marketing platforms and services to help them grow. Prior to joining Kapitus, Aman served in executive leadership positions at Propel Marketing, 1&1 Internet US/UK, and Web.com. Aman holds a Masters in Computer Science from the University of Nebraska and an MBA from the University of Michigan's Ross School of Business. He lives outside of Boston with his wife and two children.

You might also like!

Essential Checklist For Small Business Loans and Alternate Financing

How to Prepare Your Small Business for Cash Flow Needs

Follow us for more!

KAPITUS

Founded in 2006 and headquartered in NYC, Kapitus is one of the most reliable and respected names in small business financing. As both a direct lender and a marketplace built with a trusted network of lending partners, Kapitus is able to provide small businesses the financing they need, when and how it is needed. With one application business owners can save time and money, while eliminating the stress that comes with applying to different lenders. At Kapitus, we believe that business owners should be able to focus on running their business, while we take care of the financing. To learn more, visit **www.kapitus.com.**

120 West 45th Street, New York, NY 10036
1-800-780-7133 | www.kapitus.com | info@kapitus.com