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Financing a Business in a Brave New Business World

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The primary way in which banks make money is through loans. But in today's economic environment, regulators are requiring banks to increase their reserves – the capital that backs loans - to support an increasing number of loans at risk of default. As banks work hard to reduce their bad loans, many are making far fewer new loans and decreasing the limits on existing lines of credit. Their problem is that they need to make more loans to make money, but they are being pressured to make fewer loans.

For business owners in need of capital to grow or stay afloat, a bank's problems can become their own. A company that once qualified for a line of credit now might only qualify for a smaller line or no line at all. This is often true for a company seeking its first round of debt financing, but even companies with long-standing relationships with commercial lenders feel the scrutiny. Banks and businesses operate in a vastly different financial world than a few years ago.

Consider the Alternatives

With commercial banks increasingly sidelined, many businesses are finding an answer to their borrowing needs in smaller loans from alternative lenders. Sometimes referred to as micro-lenders, these organizations specialize in smaller loans to help startups. But as alternative lenders such as ACCION, WESST and The Loan Fund have demonstrated in the past few years, they can also support larger loans of greater scope.

Larger businesses with an existing and predictable base of business can turn to asset-based lenders. These lenders typically take a direct security interest – or even buy – a business's assets, like its accounts receivable. A trusted commercial banker can provide the name of reputable asset-based lenders.

Equity investment is another source of capital, but it is far different from debt financing. An equity investor has a distinct expectation of potential return for the investment and truly becomes a partner.

Sources of debt financing expect repayment of their investment over time and a reasonable rate of interest. Depending on the nature of the loan and the condition of the company, interest might be tied to the prime rate paid by banks, but it is generally not more than 10 to 15 percent. In contrast, equity investors are more patient about being repaid in the future, and they don't need regularly scheduled interim payments. But they typically expect an annualized return of 40 to 60

percent, depending upon what stage the company is in. For an equity investor, the company's growth prospects must be extremely strong, or the owner can expect to give up a large equity stake to make the economics work for the investor.

Equity Means Ownership

Another important difference between debt and equity financing is the investor's level of involvement. While today's economic environment requires any source of capital to pay close attention to the business, equity investors are true partners because they own part of the company. Equity investors expect to be treated as co-owners and to reap substantial benefits at the end of their relations with the company, usually when the company is sold.

As commercial banks keep tight control of their loan portfolios and alternative lenders address specific lending needs, equity has become more important in the spectrum of funding opportunities available to companies. Equity capital is available through local venture capital firms, as well as New Mexico Angels and hybrid sources such as New Mexico Mezzanine Capital.

Before approaching any source of capital, business owners should research the expectations and areas of focus of the organizations they are considering approaching. Equity investors do not look favorably upon being asked for a term loan, and technology investors are unlikely to invest in a construction deal. Time wasted pursuing inappropriate sources means delays in acquiring the capital needed to grow a business.

A convincing plan that demonstrates strong growth potential is likely to catch equity investors' attention. And any company that has survived the recession more streamlined, more focused on customers and sales, and more savvy about how to grow rapidly in the recovering economy will find itself more attractive to equity investors than ever before.

Money is available to support growing and successful businesses. Those who find it only look a little harder. Visit the Finance New Mexico Web site (www.financenewmexico.org) for more information on financing sources in New Mexico.

Finance New Mexico is an initiative of the New Mexico Small Business Investment Corporation (NMSBIC) and its partners to assist individuals and businesses in obtaining skills and funding-resources for their business or idea. To learn more, go to www.FinanceNewMexico.org.