Show Me the Money

The Pros and Cons of Banks, Angels, VCs and Private Equity

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The lament of so many businesspeople is that if they only had enough money, they could start or grow – or just keep alive – their business. Some entrepreneurs have a brilliant idea but no cash to bring it to life. Others have companies that can't fill new orders or take on new projects because they can't pay their existing bills.

Still, others see their promising businesses shrivel and die because they have no cash reserves and they can't withstand bad times. All of these entrepreneurs want to know how to get their hands on more money.

Aside from special situations, like grants and prizes, there are two primary sources of capital for business: loans and investments. Each one has its own rules.

BANK LOANS

Often, the first inclination of an entrepreneur is to seek a bank loan. Understand, however, that banks make relatively little on their loans. Bankers slog it out for a relatively meager 5 percent to 10 percent annual return. Hence, they are looking for a great deal of certainty before they part with their money.

That's why bankers typically lend to established businesses that have both good track records and reliable, if not skyrocketing, prospects. That is also the reason banks move slowly and deliberately. They want to get to know you, both personally and financially. It would not be unusual to engage in one or more substantive meetings and also submit extensive financial information. Typically, the requested financial information takes the form of operating statements and balance sheets, as well as tax returns. Within this information lies data that reveals all kinds of metrics that are important to lenders, such as your profitability, your ability to pay current debt and the likelihood you can manage growth and pay off a new loan.

Yet one of the most important things to bankers is, surprisingly, your honesty. Banks only make money when loans are repaid. One bad loan can wipe out the potential profit from many others. And financial statements can be "massaged" so that they present an unduly rosy picture of a business' health. By the way, that is one of the reasons banks and others ask for both your financial statements and your tax returns. When it comes to the IRS, most businesses are trying to minimize the tax liability – and, hence, the income they report on their tax returns. Yet their financial statements might read more like an online dating bio. A comparison of the two documents can reveal contradictory promises about a business' profitability.

So when it comes to banks, a forthright display of your weaknesses is not only prudent, it can enhance your credibility and may advance your desirability to a lender. Still, be realistic. Don't expect a bank loan for an untested business or one that presents any significant risk that you won't be able to repay your loan. Also, be prepared to provide a personal guaranty and even put a second mortgage on your house to secure a bank loan.

INVESTORS

There are many kinds of investors, but one way to categorize them is by how much risk they are willing to take and, not surprisingly, how much reward they expect for their investment.

Angel Investors: At the high-risk, higher-reward end of the spectrum are angel investors. They lend to the prototypical "two Ph.Ds and a briefcase." That is, angels will invest in promising ideas. They also want bountiful rewards. It would not be unusual for angel investors – the plural is intentional, as they tend to travel and invest in packs – to insist on a large chunk of ownership in your company and a lot of control. If that is not enough to put you off, they also usually invest in relatively smaller amounts, such as tens or hundreds of thousands of dollars, not millions. They are often scarce, especially in hard times. Quite frankly, you don't have a lot to offer yet, and they are investing based on hunches and how they feel about your company (instead of poring over three years of audited financial statements).

On a related note, the wisdom of tapping family and friends for funds depends in no small part on how important it is to you that these folks remain your family and friends. When you ask those closest to you to dip into their savings to invest, you're risking a lot, too. Proceed with caution, and make sure that they understand that they can – and very possibly will – lose their money. Don't sugarcoat it. Sometimes, it is better to wait to start a business, keep it smaller or make other sacrifices than it is to jeopardize treasured relationships.

Venture Capitalists: Venture capitalists cover a lot of territory. But they tend to invest in early-stage, existing businesses that are operational, or soon to be, although you may not yet have any revenues, much less profits. But VCs must at least be able to see the full outline of your business. They need to know what you do, or will be doing, and need to see your product or service, even if you can't demonstrate how well it sells.

Venture capitalists also expect significant ownership in your company. Further, they'll usually insist on the ability to put in place their own management if business does not go well. Likewise, their percentage of ownership will often increase if you don't achieve expected sales and profitability – and your ownership will be reduced or "ratcheted down." But venture capitalists will write big checks. Plenty of entrepreneurs have grown quite rich with VC backing. The key is finding one, enticing the VC to invest and then negotiating a deal that leaves you with your clothes on.

Private Equity Firms: Private equity firms usually invest in established businesses that have a record of growth and profitability but need more money to expand (private equity firms also regularly buy entire businesses). This group of investors would love to invest in your company, help you grow it further and then sell your company – or possibly take it public – in three to seven years, realizing better than 20 percent annual returns (sometimes far better) on their investment. The economy will affect how intensively they inspect your business and how tight a legal noose they put around your neck with lengthy agreements. In the tech boom of the late 1990s, deals were hastily jotted on napkins. In the depths of the Great Recession, the rare deal was documented with a box-load of agreements.

But if you do pull off an investment from any of these investors, it can be more of a coup than you might imagine. It's not just about the Benjamins. Usually, you'll have enhanced your credibility in the eyes of future lenders and investors and even people that one day might want to buy your stock in a public offering. In the meantime, you may also be able to tap into your investor's wealth of contacts, knowledge, and experience.

THE FINE PRINT

But there are pitfalls. There are investors that have literally forced the founders out of the company they created. In other instances, the entrepreneur's stake in the business is drastically diluted. Or the lender sues to collect on a loan and seizes your personal assets. It's all there in the fine print. So doing a deal is more than just closing a deal and going to a celebration dinner. Successfully raising money requires assistance in responding to both extensive due diligence requests and complex legal documents. You'll need a cast of experts, including a good investment banker or similar financial advisor, as well as a lawyer and accountant. But first and foremost, design and then build a great business. That's the best way to ensure you'll be able to raise money.

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