FERRAIUOLI LLC

Funding a Startup: A Brief Guide to Financing Alternatives

You have a unique business idea but do not have the capital to properly get it off the ground. Startups commonly face challenges in obtaining funding to finance their operations. Failing to raise capital and maintain adequate cash flow is the most common reason new businesses don't last. From traditional financing alternatives to emerging financing alternatives, we provide below a brief description of the most common sources of startup business financing.

Traditional Financing Alternatives:

A. *Commercial Banking*.

(i) Asset Based Financing.

A term loan or line of credit typically granted by a financial institution and secured by the assets of the debtor. These assets are commonly comprised of the inventory and the accounts (including accounts receivable) of the debtor.

(ii) Mortgage Backed Financing.

A term loan or line of credit typically granted by a financial institution and secured by a mortgage encumbering a real property of the debtor or a related third party. These loan or lines of credit may also be secured by inventory and accounts (including accounts receivable) of the debtor.

Whether asset based or mortgage backed, commercial loans are generally structured as: (i) term loans, (ii) non-revolving lines of credit, and/or (iii) revolving lines of credit.

(i) Term Loan.

A loan with a specific repayment schedule and a fixed or floating interest rate that is typically granted by a financial institution. These loans usually mature within five (5) to seven (7) years and require a fixed monthly payment of principal and interest with a final balloon payment for the remaining amount then outstanding.

(ii) Non-Revolving Line of Credit.

The debtor is allowed to withdraw funds up to a determined aggregate amount. These lines of credit usually mature within one (1) year, at which time they are either renewed or declared immediately due and payable. In addition, these lines of credit are typically granted by a financial institution and require monthly payments of interest calculated over the then current outstanding principal amount.

(iii) Revolving Line of Credit.

The debtor is allowed to withdraw funds up to a determined aggregate amount. These lines of credit usually mature within one (1) year, at which time they are either renewed or declared immediately due and payable. In addition, these lines of credit are typically granted by a financial institution and require monthly payments of interest calculated over the then current outstanding principal amount. Contrary to a non-revolving line of credit if the debtor pays down the outstanding principal, the debtor may once against withdraw funds up to the determined aggregate amount. The most common example of a revolving line of credit is a credit card.

B. *Equity Financing*.

This is the raising of funds or capital by selling ownership interests in a business. These transactions will result in the reduction of the ownership interest of the founder of the business. Equity financing may take many forms ranging from small investments made by family and friends to initial public offerings and trading of a public corporation on an exchange. The common factor is that all of them raise capital in exchange for an ownership interest in the business. Venture capital is one of the more popular forms of equity financing used to finance high-risk, high-return businesses.

C. *Factoring*.

A transaction comprised of the sale of the right to collect on an account receivable at a discount. In a factoring transaction one party sells a product or service that is payable at a later date (i.e. in thirty (30) or sixty (60) days). The seller then proceeds to sell the right to collect to the purchaser at a discount, for example at eighty percent (80%) of the value of the account receivable. The purchaser then collects one hundred percent (100%) of the value of the account receivable from the debtor. It is important to note that the purchaser will be interested in the creditworthiness of the account debtor and not of seller.

D. *Government Programs*.

(i) Government Grants.

There are currently twenty six (26) federal agencies that provide grants to eligible grantees. The funds disbursed under these grants are generally not required to be paid back to the federal government. For more information on federal government grants please visit www.grants.gov.

(ii) Government Loans.

The Small Business Administration (SBA) is the largest federal funding source for a small business. The SBA directly issues some SBA loans, but commercial lenders actually administer the large majority of SBA loans. In essence, then, an SBA loan is a commercial loan guaranteed by the federal government. For more information on SBA loans please visit www.sba.gov.

On the local front, the Economic Development Bank for Puerto Rico (EDBPR) also provides funding alternatives to emerging businesses. For more information on EDBPR loans please visit www.bdepr.org.

Emerging Financing Alternatives:

A. *Micro-Lending*.

A loan in an amount that does not exceed Fifty Thousand Dollars ($50,000.00) typically made to small or emerging businesses. These loans are available to businesses that do not have an established credit or have a poor credit score, however, these loans impose higher interest rates than traditional commercial loans (between twelve percent (12%) and eighteen percent (18%)). For more information on micro-lending you may visit the website of micro finance entities such as Accion USA (www.accionusa.org). Accion USA has issued more than One Hundred and Thirty Two Million Dollars ($132,000,000.00) in microloans since 1991.

B. *Peer-to-Peer Lending*.

A method of financing that allows individuals and entities to acquire and provide financing (typically microloans) without the need to use a financial institution as an intermediary to the transaction. This financing is commonly accomplished by means of an internet platform that enables potential debtors and lenders to come together. An example of such a platform is the Lending Club (www.lendingclub.com).

C. *Purchase Order Financing*.

This is a transaction that is quite similar to Factoring. The purchase order lender pays the debtor's supplier for the production or delivery of a product and, in turn, sells it to the customer. The purchase order lender keeps its fee and delivers the remaining funds to the debtor. A purchase order financing may make sense for a cash strapped business that has an order from a client but does not have sufficient cash to purchase the product from its supplier. The fees charged for this type of transaction typically exceed the interest rates charged under traditional financial alternatives. It is important to note that the purchaser will be interested in the creditworthiness of the customer and not of the debtor.

In sum, emerging financial alternatives are typically accessible to startups, but are more expensive than traditional financial alternatives. Nonetheless, given the scarcity of credit in today's financial markets, these may serve to temporarily fill the needs of up and coming business across the country. We hope this serves as a useful guide and provides new financing alternatives for your business while reinforcing the more traditional financing alternatives on the market.

Legal issues are complex and highly fact specific and require legal expertise that cannot be provided by any single article. In addition, laws change over time and vary by jurisdiction. The information in this article does not constitute legal advice and should not be used as a substitute for obtaining personal legal advice and consultation prior to making decisions regarding individual circumstances.

******

Authors:
José Fernando Rovira-Rullán is a Senior Member at Ferraiuoli LLC
Rafael L. Rovira-Arbona is an Associate at Ferraiuoli LLC