Jump Start Micro-Enterprise Credential:
Funding Sources for Small Businesses: Small Business Capital and Credit

(Update: July 2016)

Small businesses need cash to start-up, operate and grow. This document provides you with an overview of where these funds can come from and how expensive they may be.

Capital (or Equity) vs. Credit

Funds contributed by investors to a business is called "equity" or "capital." Investors that contribute capital to a business expect to get a significant return on their investment when the business succeeds. Businesses reward owners through cash dividends (which are optional), sometimes through discounts on the goods or services the business provides, and by a substantial payment for their share of the business if the business is sold.

Funds that is lent to businesses with an agreement to get repaid with interest is called "debt" or "credit." Small businesses use credit when they want to expand, to purchase new products to sell (called inventory) and new equipment, and/or to help them keep their business operating during a period when sales are down. Businesses repay their debt (or loan) in regular monthly payments that include both an interest payment and a repayment of the amount borrowed. (Definition: the amount borrowed is called the "principal.")

The Cost of Capital and Credit

Different types of credit cost different amounts of money:

- Secured Bank Debt (least expensive debt) – credit is *least* expensive when credit-worthy owners of a company give a personal guarantee that if the business fails they will personally be responsible for paying back the debt. This is called guaranteed or "secured" debt. This gives the bank, company or individual loaning the funds a second option for collecting the money owed them if the business fails.

  If the company uses the credit to purchase equipment – like a truck – the bank may ask for the debt to be secured by the equipment in addition to a personal guarantee by the owner. That means the bank gets to repossess the equipment if the business fails. In this worst case scenario the bank hopes that the money they get from selling the equipment they repossess will help pay back at least some of the unpaid loan;

- Unsecured Bank Debt (expensive) – credit is *more* expensive when the owners of a company provide lots of information to the lender but do *not* provide personal guarantees. Banks (and credit card companies) charge more because they don't have any other way of getting their money back if the business fails.

  Some small business use unsecured debt because their owners' personal financial situation is such that the lender does not offer secured debt – the bank believes that the small business owner would *not* be able to repay the money owed if the business failed; and

- Unsecured Debt (most expensive) – credit is *most* expensive when companies provide little information and do *not* provide a personal guarantee. Credit cards are a good example of unsecured debt. Most small businesses can get a credit card relatively easily with a short application. No personal guarantee is necessary. But the interest rate on the money borrowed using the credit card is very, very high.

  These days there are many new websites that offer credit to small businesses on very convenient terms – simple applications, quick decisions, flexible terms, interest rates that start high but come down the longer the debt is outstanding. (Definition: a debt is outstanding if it's not yet paid back.)

The table below provides a summary of the cost of different types of capital and credit, *including new types of online credit and "special" types of capital that might be particularly affordable for small businesses.*

Type of Capital / Credit		Description	Affordability
Credit (or Debt)	Secured Bank Loan (also called: Secured Line of Credit)	The small business owner submits an extensive application plus: a) past tax returns; b) personal and company financial statements; and c) company banking contacts; the bank responds within days or weeks; approval rates can be low and the loan may charge an upfront "origination" fee.	Lowest Cost Debt
	Unsecured Line of Credit (or Credit Card)	The owner submits a short application without supporting documents; fast credit card company response with high approval rates; annual card fees.	High Cost Debt
	Online Credit	The owner completes a short online application without supporting documentation; decisions are almost immediate with high approval rates; owners can access the cash in convenient ways and only when they need the funds but interest rates are very high.	Highest Cost Debt
Capital (or Equity)	"Sweat Equity"	The hard work a small business owner puts into forming, founding and operating his/her business – small business owners typically work *very* long hours. Sweat equity is as important as any capital but it's not a cash investment.	
	Investor Equity	Investors provide capital for a small business because they expect a return - future cash dividends, sometimes discounts on what the business provides and then their share of the proceeds if / when the company gets purchased.	High Cost Equity
	"Angel Investors" or "Crowdfunding"	Small investments by lots of different individuals who want to see the small business owner succeed. Angel Investors are typically "friends and family," individuals who know the business owner and want the owner to succeed. Angel Investors typically provide small amounts of equity with no expectation of a large return. Crowdfunding is an Internet phenomenon, where strangers learn about your business online and then decide whether or not to make an investment. Crowdfunding investors are typically "fans" of the owner, but they *do* expect a return on investment. (The company pays a percentage of the capital raised to the online Crowdfunding website.)	Low Cost Equity

To better understand the cost of different types of credit, please review the Credit Application Definitions and complete the Cost of Credit Worksheet.