Types of Capital: Pros and Cons

Depending on the stage a business is in, it will use different types of financing that each have their own unique set of "Pros" and "Cons".

FINANCING MECHANISM	DEFINITION	PROS	CONS
Seed Capital	• Very early financing given to the entrepreneur that is meant to support the business until it can generate cash flow.	• The entrepreneur personally knows who they are borrowing from.	• May need to give up part of ownership/decision-making power in exchange for cash.
Personal Savings	• Money that the entrepreneur has saved over time.	• Demonstrates commitment. • Used at the descretion of the entrepreneur.	• Not always sufficient. • Increases the risk of the entrepreneur.
Startup Loan	• Financial support given to the entrepreneur at the beginning of her business with the expectation that the money will be paid back, and often with interest.	• Do not need to give up equity or decision making power in exchange for financial resources.	• Can be difficult to obtain through formal financial institutions during startup phase. • Interest rates may be high.
Friends and Family Funding	• Financial support given to the entrepreneur by family members or close friends. Can be as a loan, equity or a gift.	• Typically more supportive and understanding of the entrepreneur's vision. • Requires less rigorous process than financial institutions for funding.	• Miscommunication is common - expectations are not commonly outlined before money is exchanged. Be sure to draft a contract that outlines the agreement!
Equity Crowd Funding	• People, typically over the [illegible], invest in an unlisted company in exchange for shares or ownership in that company.	• Avoids complicated processes of formal financial institutions - typically a speedy process. • Gives entrepreneur more exposure to a large number of potential investors.	• Gives up part ownership/decision-making power in exchange for funding. • Commonly gain only financing, as opposed to expertise and network that is provided in traditional equity deals.

FINANCING MECHANISM	DEFINITION	PROS	CONS
Angel Investor	• A person that provides capital to a startup or a small entrepreneur. Angel inverstors usually invest because they believe in the person behind the business.	• Funds are typically provided by someone aligned with the entrepreneur's vision. • Minimal need for "proof of concept" or successful track record. Investment often based on belief in the entrepreneur.	• May cause the entrepreneur to give up equity at an early stage in their business. • Investor may want to heavily influence the decisions or direction of the business.
Overdraft Loan	• Allows an entrepreneur to continue drawing money from an account, even when the account has reached zero. This is typically a fixed amount allowed by the institution.	• A very convenient and hassle-free way to borrow money when needed. • Handles timing mismatch of flow of funds.	• Interest rates can be very high. • There is a very strict limit to the amount that can be overdrafted, and this can be reduced.
Peer-to-Peer Lending	• The practice of lending money to unrelated individuals without using a traditional financial intermediary such as a bank.	• Avoids the bureaucracy of traditional financial institutions, making the borrowing process faster. • Typically a lower cost of borrowing.	• Entrepreneur may not get the whole amount of the loan she is seeking. • May not be good option for entrepreneurs who value their privacy.
Asset-based Lending	• A loan to a business that is secured by collateral, or an asset of the entrepreneur.	• Typically lower interest rates (depending on the quality of the asset lent).	• Must have assets such as inventory, accounts receivables, and other balance sheet assets to secure a loan.
Leasing	• An agreement where the entrepreneur agrees to rent property from another party for a fixed amount of time. The owner typically pays for the right to use this property on a monthly basis.	• Allows entrepreneur to pay small amount on a monthly basis to use someone else's property - no large initial capital outlay! • Often avoids long-term cost of owning equipment, such as repairs or replacement.	• The property used can never be considered an asset to an entrepreneur's company, only a cost. • Over the long run, this may be more expensive than owning the property.

FINANCING MECHANISM	DEFINITION	PROS	CONS
Trade Financing	• Typically includes activities such as lending, issuing letters of credit, factoring and export credit and insurance.	• Encompasses various financing options so that the entrepreneur can determine which is best for her situatton.	• Many options only provided through tranditional financial institutions. • Many of these options may take a lot of time to materialize due to bueracracy.
Mezzanine	• This is debt capital that gives the lender the right to conver to an ownership or equity interest if the loan is not paid back on time and in full.	• Often offers flexibility on terms (coupon structure, amortizatton, covenants, etc.) to business owner.	• Carries a lot of risk, since the debt can be converted in to equity which is very expensive for the entrepreneur.
Private Equity (PE) Investor	• A formal investment organizatton that finances larger, more mature companies throughg big investment.	• Brings a lot of capital and expertise in to the business.	• Entrepreneur typically loses a lot of control of the business, and new management is brought in.
Initial Public Offering (IPO)	• The first sale of stock by a private company to the public. Typically a long, expensive and rigorous legal and regulatory process.	• Brings in a lot of capital to the business.	• Business is subject to a new host of regulattons and financial reporting. • Stockholders are now the priority of the business, not the owner's will.
Venture Capitalist (VC)	• A person who invests in high potential startups for the sole purpose of achieving a big future payoff.	• Typically brings in capital and expertise.	• Entrepreneur's will is second to reaching profitability and growth goals of VC, which are typically extremely high.