Raising Cash? Aim Lower

Experts say entrepreneurs too often ignore some effective ways to fund their business—making fund-raising harder than it has to be.

EVERY YEAR HUNDREDS OF thousands of entrepreneurs try to get funding from venture capitalists. In 2009, fewer than 3,000 got any. Were the other 99-plus percent of applicants just sad sacks? Not at all; chances are, they were just shooting too high.

It's instructive to think of capital sources as a pyramid, says Dave Lavinsky, of the consulting company Growthink. The top is venture capital, prestigious but hard to attain. Further down are angel investors, who work at a smaller scale; 20 times as many companies get a check from them. Business-plan competitions, vendor financing and peer-to-peer lending are other accessible options. And at the base of the pyramid are credit cards, the easiest source and not necessarily the worst—after all, the Google guys started out with credit card debt after venture capitalists said no. (It worked out okay for them.)

Often founders go to the top of the pyramid and get rejected without considering the vast array of middle bricks. It's more logical to start with easier sources of capital and work your way up. For example, seemingly every university worth its salt—along with entities as disparate as big-box retailers and a Chinese-government TV station—are hosting business-plan contests, with as much as $200,000 up for grabs. Granted, $20,000 from the Wal-Mart Better Living Business Plan Challenge won't go very far toward helping its winners go national, but such prizes often lead to mentorship and introductions to investors.

Some start-ups have pursued "strategic financing," getting capital from their own vendors and customers. Sonoma Risk first tried going to private-equity investors with its idea—selling insurance to cover certain kinds of legal bills. The investors wanted proof of its concept, but since the concept was truly new, Sonoma Risk didn't have it. Fortunately, the company's founders had developed an underwriting relationship with a large insurer; it was a matter of asking, as president Larry Kruger recalls, whether it might have an interest in an investment role. It did. And the broker Sonoma tapped to sell its product was willing to contribute personnel and back-office operations. By obtaining equity stakes, these established companies helped Sonoma raise $2.5 million.

Credit cards can be a no-questions-asked funding source, freeing you to spend time inventing that search engine or whatever, rather than making a pretty business plan for venture firms to ignore. Unfortunately, the credit crunch has created some hitches. Peter Sobotta, CEO of RecoupIT, a computer reseller in Mechanicsburg, Pa., was doing a masterful job of cash management with a full $600,000 line of credit from American Express. But after the financial meltdown, Sobotta says, the card issuer reduced his credit limit to $13,000. Sobotta wasn't sure he had heard right. "This was the punishment for the big companies defaulting," he laments. (American Express declined to comment on Sobotta's case, but says it sometimes lowers limits as part of "prudently managing credit risk.") Eventually, Sobotta was able to build a line of $100,000 on another card, picking up some slack with a traditional bank loan. The lesson: Best to get familiar with the whole capital pyramid, because one funding brick is seldom enough. S

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Fund-Raising Shortcuts

A few creative ways to find start-up capital:

Vendor financing. Some start-ups have had luck getting firms that work with them–including suppliers and customers–to become investors.

Credit cards. They let you borrow without having to sell your business plan. But rates are high, and lenders can cut credit lines with little notice.

Peer-to-peer lending. Sites like Prosper.com and Lending Club connect individual investors with borrowers, including entrepreneurs.

Photograph by Evan Kafka