Types of Investments
Options & Ideas for Entrepreneurs

What's a Local Investment?
At its simplest, an investment in a small business is an exchange of resources: entrepreneurs need funds (and sometimes advice, support, or other non-monetary items) to start their businesses. In exchange, they offer a return on those resources (interest, profit, or repayment) to their investors in the future.

As simple as its sounds, there are as many ways to structure investment relationships as there are entrepreneurs and investors. Choosing one that's right for your business may depend on many factors such as risk, potential for growth, personal needs of the entrepreneur, long-term exit strategies, and more. The example structures below introduce some common terms when considering what local investment strategy is best for you.

Loans

Loans are an agreement between an entrepreneur and an investor to accept a defined amount of funding, with the promise to repay it in full to the investor in the future. Generally, the parties agree in advance on several important points, including when and how the loan will be repaid and how much interest (or return) the investor will receive on top of the basic loan repayment. Loan agreements often also stipulate what might occur if the borrower makes late payments or is unable to repay the loan.

Choosing Your Interest Rate
0% Interest Loans are becoming more common in local investing communities, for several reasons. Because they do not offer a monetary return to the investor, there are fewer restrictions on entrepreneurs seeking them. Kiva Zip and Community Sourced Capital are both example platforms that help entrepreneurs aggregate small, 0% interest loans from their community. In general, **interest rates** are determined by the investor and the borrower in such a way they are mutually beneficial – not exploitative! There might be some income tax implications to a below-market interest rate loan, so investors and entrepreneurs should consult their tax advisors when choosing an interest rate.

Scheduling Your Loan Repayment
A next step is often choosing the **term** of your loan, or how many months or years it will take to repay. **Straight-line amortization** assumes a set number of years for repayment and a set interest rate, and then calculates monthly loan payments so they are equal throughout the repayment period. (This makes it easy for both entrepreneurs and investors to predict and plan for regular loan payments). Conversely, **royalty payments** allow entrepreneurs to make larger repayments when business is booming and lower payments in slower months, easing cash flow for seasonal or start-up business. Loans that are for new businesses often have an **interest-only period**, where the business makes payments that are much lower, covering only the interest on the outstanding loan, until new revenues from the business's launch or expansion are sufficient to cover larger payments.

Creative Forms of Repayment

Most loans are repaid in cash – dollars are borrowed, and dollars are returned. But many local businesses and investors are rethinking this model, particularly when it allows for advantageous terms for the investor and an easier form of repayment for the business. For example, **Credibles.co** allows food-based businesses to accept interest-bearing loans and investors to receive their repayment in the form of a "tab" at the local food establishment.

Other Terms, Ideas & Questions to Consider

Choosing to move forward with a local investment is the beginning of a potentially long-term relationship between an entrepreneur and investor. Other important questions to consider include (but definitely aren't limited to!) some of the following:

- Is this a loan to the entrepreneur or the business (such as an LLC or S-corp)? If it is a loan to the business, is the entrepreneur providing a **personal guarantee** of its repayment?
- What happens in the event of a **late payment** or **default**?
- Is any business **collateral** being pledged as part of the loan agreement?
- What other contingencies might be in place if the business doesn't grow quite as expected?
- Are there clear lines of communication between the entrepreneur and the investor? Do you feel like you can speak honestly and clearly about expectations and the future performance of the business?

Equity

While loans are often designed to provide predictable, steady returns (called interest) equity investments focus on the opportunities of partnership: sharing the risk as well as the return (or profit) of a business. As a result, they can be considered riskier – if the business doesn't succeed, there's generally no promise of repayment. On the other hand, if a business does well, that success can be passed onto its equity investors.

How risk, return, and ownership are shared in a business depends on many factors and can be customized for the individual circumstances of the entrepreneur and his or her investors.

Choosing Your Business Structure

The legal structure of your business will help determine what type and structure of equity investments it can receive. For example, in a **Limited Liability Company** (or LLC), a company can accept new members as investors. Those members can be general managers (who manage the day-to-day operations of the business) or limited members (who don't). An **Operating Agreement** between the members determines who invests what and how decision making power, profits, and tax liability are distributed. LLCs are commonly used for businesses that have a limited number of investors, for "Main Street scale" businesses, and for real estate projects.

In a **corporation**, investors can purchase stock, or an ownership share, directly in the company. **Common Stock** owners can generally vote in shareholder meetings, receiving as many "votes" as they have shares, while **Preferred Stock** owners generally can't vote but do receive priority for a certain portion of the dividends or distribution of a corporation's profits. In the case of **cooperatives**, a special type of corporation, each member-owner receives one vote, regardless of the dollar value of funds invested, making them a unique structure for community-based, democratic corporate structures. Overall, corporations are more common structures for larger businesses, for businesses with many equity investors, and for businesses that project very strong long-term growth potential.

Voting, Owning, and Business Decision Making

Regardless of the business structure an entrepreneur chooses, an important point to consider is how much influence or control of his or her business he or she is willing to share in exchange for equity investments. While that partnership may be expressed in different terms (members, stockholders, member-owners, etc) in different legal structures, the same general principle applies: the more an entrepreneur is reliant on outside equity investors to fund their business, often the more ownership and decision making power he or she may be expected to share. Different models for sharing decision making might include (but aren't limited to):

- The entrepreneur retaining full control, or majority voting rights.
- Investors having the right to "veto" certain governance decisions.
- Investors have full decision making power through shareholder voting, based on their percentage of ownership in the business.
- Democratic member voting, generally used in cooperatives, whereby every member-owner receives one vote, regardless of total dollars they have invested.

Salaries versus Profits

When determining how "profits" are shared with equity investors, entrepreneurs should have clear discussions about their own expectations of return from a business. In many cases, entrepreneurs or owners working full-time for the business receive either a salary or a preferred profit distribution prior to the remaining profits being distributed to other investors. In other cases, their take-home pay depends directly on the performance of the business, much like any other investor.

Weighing Risk and Return

For many investors, the scale of the return they are seeking may depend on the risk of the business venture. **Venture Capitalists**, for example, are often willing to accept very larger risks in exchange for large potential returns and long-term ownership control. **Local investors** may be motivated by social and community returns in addition to monetary returns. Risk tolerance varies by investor, and clear communication about expectations, risk, market research, and potential returns are necessary and important for building long-term investor-entrepreneur relationships.

Types of Investments

Getting Started Checklist

As you consider potential investment options for your business and discuss those options with investors, your legal counsel, and financial advisors, here are a few important questions to keep in mind:

In General

- ☐ Do you have legally-compliant strategy for identifying, cultivating, and approaching investors?
- ☐ Do you have a good relationship, trust, and great communication with your investors?
- ☐ Do you and your investors have a shared set of expectations for your business's potential growth? Have you jointly reviewed or developed your business plan?
- ☐ Have you and your investors discussed "worst case scenarios"? Is there a shared understanding for strategies and outcomes if the business doesn't perform as expected?
- ☐ Are you and your investors *both* excited? Do you feel positive about your relationship and the alignment of your goals?

For Loans

- ☐ What is the term of your loan – how long will it take to repay it in full?
- ☐ What interest rate works for both your business and your investors? Is it fixed, or does it change based on certain variables (e.g. the performance of your business or the market)?
- ☐ What is your rate and form of repayment?
  - o Is there be an interest-only period?
  - o Will you make equal payments on a regular basis (monthly, quarterly, etc)?
  - o Or will your payments vary based on the performance of the business?
  - o Are your repayments in cash, goods, services, or some combination thereof?
  - o Is there any penalty for paying your loan back earlier than anticipated?
- ☐ Is this a loan to your business, or a personal loan? If it is a loan to your business, are you personally guaranteeing its repayment?
- ☐ Are you using collateral to secure your loan? If so, have you identified what collateral and how it will be pledged (for example, business assets might be secured with a UCC-1 form, vehicles are subject to title liens, and real estate has a deed of trust)?

For Equity

- How will profits from your business be distributed? For example,
  - Are you using a “Common Stock” model where all profits are subject to distribution to investors based on their share of ownership? If so, are these profits calculated before or after your salary and certain other expenses?
  - Or are you using more of a “Preferred Stock” model where investors’ returns are calculated based on their amount of investment (for example, a goal of 3% of their investment returned as a dividend each year)?
- What is your governance agreement? How is decision making shared between investors and the entrepreneur? For example:
  - Does the entrepreneur retain all decision making power?
  - Do investors have veto power over certain major business decisions?
  - Do investors and business owners vote on governance decisions based on percent share of ownership? Or do all member-owners (as in a co-op) have equal voting rights?
- What is your dissolution or exit strategy? What happens when investors and/or the entrepreneur want to exit the business?
- Is your business’s legal structure appropriate for the type and form of equity investments you have chosen?

In Closing

- Do you have good legal counsel and accounting assistance to help you create and/or review the appropriate documents (loan agreements, legal structures, operating agreements, etc.) for your chosen type of investment?
- Do you and your investors have a clear understanding of the tax implications of your investment strategy?
- With many details considered and addressed, do you and your investors still feel positive, motivated, and excited to move forward with your investment strategy?

Want More Info?

Invest Local is a project of the Staunton Creative Community Fund. We serve small businesses and entrepreneurs in the Shenandoah Valley, providing funding, consulting services, and mentoring opportunities. We’d love to hear from you:

Staunton Creative Community Fund * 10 Byers Street * Staunton, VA * (540) 213-0333 * Invest-Local.org

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