Ask SCORE

After working in the industry for a number of years, I want to start my own catering business. Conversations with a couple of banks about financing have not been promising, so I'm considering approaching some friends and relatives about borrowing the startup money. Is this a good idea?

When seeking financing help for a small business, many entrepreneurs turn to friends and family, rather than banks or other lending sources. While this approach may avert the stresses associated with loan applications and presentations before strangers, it carries its own set of risks and potential pitfalls.

If you're considering keeping your financing sources "close to home," small business owner and writer Caron Beesley suggests considering these key factors:

Choose your financiers carefully. Select people with solid business skills who know the risks and benefits of what they are getting into. At the very least, limit your list to friends or family who have faith that you will succeed, who understand your plans and are clear about the risks.

Demonstrate passion and due diligence. Write a business plan, even if it's a mini-plan that demonstrates the steps you've taken to research your market and work out your potential profitability. Most important, it should spell out what you need the money for.

Be realistic about how much money you need. Instead of asking for the maximum, consider what you need to get you to a certain point in your business plan. Once you have shown your ability to repay that initial investment, you'll be in a better position to ask for more money as needed. Communicate your business progress along the way, even if it's correcting mistakes in your business strategy.

Decide what you want. A loan will require repayment over time, while a direct investment in your business is usually made in exchange for an active role in how the business is run. Think hard about the emotional consequences of being unable to repay the loan, but also whether you want your family or a friend involved in your business operations on a day-to-day basis.

Use a peer-to-peer lending (P2P) service. P2P firms act as an intermediary or broker between you and the people providing the loan. You and your lenders decide on the repayment terms and the P2P manages the repayment on your behalf for a fee. This eliminates the inconvenience of writing a check each month, and gives your lenders confidence of being repaid without having to chase you.

Develop an agreement with a repayment plan. Detail your business plan, how the funds will be used, how progress will be measured and how repayment will be made. If the investment is a stake in your company, clearly outline the potential risks so your family and friends are 100% sure about what they are getting into.

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