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Creative Uses of Friends and Family for Funding

By Dennis L. Monroe

A recent article in the Small Business section of the Wall Street Journal, "Local Investing Takes Off" (June 12, 2014), caught my attention. The tagline was, "More entrepreneurs are turning to a new source of funds: their neighbors." The article discussed various local sources of financing and how many entrepreneurs have obtained seed money.

This is particularly true for early stage investments that do not need a large amount of funding but enough to get the budding entrepreneur started. The rest of the business world may be catching up to the restaurant industry.

The restaurant industry has always used friends, family and neighbors for raising capital, most often relying on the patrons of the entrepreneur (in many cases, chefs' previous patrons are sources of funding). I am approached several times per month by young restaurateurs who have worked for larger restaurant companies and want to start their own restaurants. They seek me out to see if I can recommend any sources for their initial start up money. I always suggest they do whatever they have to do to raise the money and keep it as simple as possible. I also suggest they look at SBA loans.

Over the years, I have learned a few techniques that may be the best way to approach friends, family and other people who are known to the owner. Let's call this group the "Affinity Group."

Loan. The most common type of offering to seek from the Affinity Group is a straight loan. In nearly all cases, this is a subordinate or unsecured loan and carries an interest rate in the low teens but probably only for a period of time. Normally, in addition to the loan, the Affinity Group member will get some type of participation in the ownership. This approach makes the investor feel better and keeps things more at arms' length—particularly when friendships are involved – than a straight equity investment.

Preferential Return. Another approach is the use of preferred class of investments where there is no guarantied return but a preferential return (normally in the 6% to 8% range) and a preference as to the return of the investment plus an ongoing participation. Simply put, friends and family investors get all of their money back before the founder gets a profits distribution and after the investors get their preference (The founder does get compensation as a manager). Future profits are typically split into 70% for the founder and 30% for the investors.

Personal Guaranty. This approach is great with wealthy Affinity Group investors who do not want to take funds from other investments but do want to help. Here the Affinity Group members just lend their balance sheet as a guaranty. Often banks will take these individuals' guaranties and make the appropriate loan. The guarantor gets a guaranty fee ranging from a low of 2% of the outstanding principal in any given year to 5%. Banks are getting tougher on these types of guaranty loans but they are still available.

Common Ownership Investment. In this type of investment the Affinity Group enters into partnership with the investors. This approach is common in higher-end restaurants. A good selling point to encourage investment (particularly if it is going to be a well-known restaurant) is that the investors might receive special treatment at the restaurant, or gift cards, etc., that make them feel important. Profit distributions are normally pro-rata, with everyone having voting rights.

Equipment Leases. This is a new technique. The Affinity Group agrees to buy the equipment or some asset of the business and then lease the assets to the restaurant. The good news is that if something goes wrong, the investors have some collateral. Normally, it is not the type of collateral the banks like, but it may be a way to give the investors a better return. Again, the investors usually get certain dining privileges as well as a piece of the ongoing business after the equipment is paid off.

Crowd Funding. All of the approaches listed above form a prelude to the advent of crowd funding. Crowd funding is a way restaurants may be financed in the future. The thing about restaurants is people like to be able to feel and touch their restaurant investments. It gives them great joy to be involved as both a consumer and an investor.

For years, Wisconsin has had a fairly liberal securities law, where a company could raise up to $1.0 million with what is, in effect, crowd funding. I have been involved with several restaurant companies that have used crowd funding in their expansion. When these crowd-funding companies open a new restaurant, they normally get good publicity, and they can use this publicity to attract new investors.

If you plan to use the Affinity Group as a source of funding, I would suggest that before asking for the actual money, you should arrive at a structure that fits the company, fits the investors and does not substantially limit future funding. But in the end, the investors are investing in you and your team's talent and vision.

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