

FINANCING YOUR BUSINESS

Financing is one of the most important aspects of starting a new business. Your ability to provide and raise adequate capital will determine the fate of the business venture. Insufficient financing may cause the business to fail. Excess borrowing with easy credit at high interest rates can also put the business at risk. So, before you start, you must take a careful look at the type and amount of capital you will need. Then, you must decide how you are going to finance the capital needs of the business. Last, but not least, you have to determine a source for the capital at a favorable cost.

Types of Capital

There are two types of capital: start-up capital and working capital.

Start-up Capital

Start-up capital is the money you need to get the business ready before the grand opening. The type of start-up capital and the amount that you need depends on the type of business you are starting. In a professional service business, you may not need much capital to start. But, if you plan to start a manufacturing or retailing business, then your start-up capital may be a considerable amount. It is very important to account for all possible expenditures. These might include:

- Seed money: for research and planning.
- Real Estate: for acquiring, leasing, and improving land or building.
- Equipment: for tools of the trade.
- Inventory: for purchasing or commissioning goods you plan to sell.
- Human Resources: for hiring the staff and management to open the business.
- Legal Fees: for registering business name, trademark, etc.
- Franchise Fees: if you are buying a franchise.

Working Capital

Working capital is the money you need for the day-to-day operation of your business. This capital is especially important for a new business. How much working capital you need depends on the type of business you are starting. The rule of thumb is that you must have adequate working capital in reserve to keep the business going until your sustainable income will FULLY support the operational cash requirements of the business. Operating expenses could include:

- Taxes: for installment payments to Federal and State governments based on sales forecast.
- Payroll: for wages, benefits, and employer's contributions.
- Utilities: for gas, electricity, telephone, etc.
- Rent: for monthly rent or yearly lease.
- Advertising: for any type of sales promotion.

- Debt Services: for repayment of loans.
- Supplies: for replacing goods sold or used from inventory, including
- Office supplies.
- Maintenance: for repairs, security, janitorial services, etc.
- Insurance: for property and legal protection.
- Accounting: for bookkeeping and professional services.

Miscellaneous

If you have raised sufficient start-up capital but have failed to secure enough working capital to operate the business, then your business will not succeed. It is the working capital that keeps the business operating.

See the section "Writing a Business Plan" (page 63) for more assistance in planning your financial needs.

Financing Your Capital Needs

The amount of funds borrowed and the sources of funds will depend on the type of business involved, the legal structure, the nature of the financing, the cost of capital, etc. Three basic financing sources can be categorized as follows:

- Equity Financing
- Debt Financing
- Internal Financing

Equity Financing

Equity refers to the amount of money that private investors put into your business. This also includes the money that you have invested.

Equity investment gives you, and other investors, ownership of the business.

Equity investment may come from private sources or from venture capitalists. These two sources are discussed below in "Sources of Financing."

Debt Financing

Debt Financing is borrowing dollars that must be repaid with interest, but it does not give the lender ownership control. There are many debt financing sources available to a small business. It is very important that you carefully investigate all possible sources to make sure that your business receives the most favorable terms available.

Medium and long-term loans are loans that extend for over one year and are dependent on the cash flow generated by your business for repayment:

- Unsecured Term Loans: Granted only to firms with projected financial data to prove ability to repay. Usually they require the owner to put up 30% to 50% of the funds needed, depending on the type of business.

- **Equipment Loans:** Permits firms to purchase equipment or use owned equipment as collateral for loans when unable to qualify for unsecured loans. Loans are usually for 60% to 80% of equipment's actual cash value with terms for repayment of five years or the equipment's useful life.
- **Real Estate Financing:** Commercial or industrial mortgage up to 75% of the appraised value, usually for a term of ten to twenty years.
- **Equipment Lease:** Banks will underwrite leases with terms for a minimum of three years or up to 80% of the useful life of the equipment.

Internal Financing

Internal financing can provide only working capital for your business — it is not a source of start-up capital.

Internal financing is sometimes called "bootstrap" financing. This means your business uses internal resources such as trade credit, conversion of assets to cash, and reduction of operating expenses to generate working capital. This type of funding is the least expensive and most efficient means to finance an ongoing operation. Three common sources of internal financing are:

- **Customers:** The customers who supply raw materials for finishing or processing pay for portions of the work when completed (progress payments), or provide cash deposits, or pay cash on delivery.
- **Trade Credit:** Suppliers will often extend thirty to sixty days or even ninety days interest free credit for goods or services once you have established a satisfactory payment record. This permits you to order, obtain delivery, and sell the goods before a bill is due. In some instances, suppliers have extended loans to their best customers. The key is a good customer/supplier relationship.
- **Reduced Expenses:** The last method of reducing financing costs is tightfisted management. Examining the profit and loss statement to determine where the firm's funds are going and taking necessary action to cut costs. A reduction in expenses can reduce the need for financing.

Sources of Financing

Sources of financing can be divided into five categories:

- Private sources
- Commercial banks
- Government agencies
- Venture capitalists
- Other sources

Private Sources

A common method of financing comes from private sources such as your own savings, and from friends and relatives.

- **Your Own Savings:** The Advantage of using your own money is twofold. First, there are no finance charges and, second, it cuts down on your search for funds

which can sometimes be very time consuming. The disadvantage is that you lose the interest you could be earning on your money; you also lose the cushion for any future emergencies if you use your savings now.

- **Friends and Relatives:** The Advantages of borrowing from friends and relatives are that they are less likely to make demands on your style of management, and there is no legal limit as to how much you can borrow. A third advantage is that the terms of borrowing can be negotiated and usually are more flexible. The disadvantages center on the potential problems that may arise if the money is not paid back on an agreed- to time schedule.

Commercial Banks

Most banks are commercial banks or have a commercial banking division. Since the deregulation of the banking industry, many savings and loan associations also engage in commercial banking. Commercial banks offer both short-term and long-term loans at prevailing interest rates.

Government Agencies

There are many federal, state, and local government agencies that offer special financial assistance to small businesses. Many loan programs are available at any given time. These loan programs are administered under government guidelines and are funded or guaranteed by the government. Each program is designed to assist a special type of business.

Like any government program, new ones are sometimes introduced as needs for them arise and old ones are sometimes phased out. For an up-to-date list of loan programs available and the requirements of each program, you can contact:

U.S. Small Business Administration

Finance Division
801 R Street, Suite 201
Fresno, CA 93721
(559) 487-5791
www.sba.gov

The U.S. Small Business Administration (SBA) offers both guaranteed and direct loans programs to eligible small business entrepreneurs who cannot borrow on reasonable terms from conventional lenders without government help.

Guaranty Loans: Most of SBA business loans are made by private lenders, usually banks, and are guaranteed up to 90% by SBA. This means that SBA acts as a guarantor to the bank in case of default on the small business loan. While the SBA may guarantee your loan, you must first convince the lending party that you are a good risk and are capable of repaying the loan. Preparing a creditable Business Plan will materially assist in getting a loan.

Since the extent of participation on the part of the Small Business Administration varies from time to time, it is prudent to check with the SBA at the above address and telephone number to determine the current conditions.

Direct Loans: SBA direct loans are available only to applicants unable to secure an SBA guaranteed loan. Before applying for a direct loan an applicant must seek financing from a bank.

Direct loan funds are very limited. Interest rates on direct loans are based on the cost of money to the federal government and are calculated quarterly.

Since the "ground rules" change frequently, you should call the SBA reference above to verify the most recent values as to loan maximums and interest rates.

To apply for a business loan, you should prepare the following: current business balance sheet, profit and loss statements for the last three years, current personal financial statement, list of collateral and a detailed statement on the amount of the loan requested and the purpose of the loan. See the section "The Business Plan."

Take these materials to your bank. Should the bank be unwilling to consider a loan to you directly, you should ask them to consider your request under the SBA Loan Guaranty Program. If you are unsuccessful in obtaining either type of loan from at least three banks you may then apply under the SBA Direct Loan Program.

As a new business start-up, having no business track record, you must be prepared to present a detailed business plan that emphasizes management experience, amount of equity capital you will bring to the business, and believable pro forma financial anticipated performance of your business.

In addition, SBA has a number of special loan programs for specific business needs:

- **Small general contractor loans** to assist small construction firms needing short-term financing.
- **Seasonal lines of credit guarantees** to provide short-term financing for small firms having a seasonal loan requirement.
- **Energy loans** to firms engaged in manufacturing, selling, installing, servicing or developing specific energy measures.
- **Handicapped assistance loans** to small business owners who are physically handicapped and private nonprofit organizations that employ handicapped persons and operate in their interest.
- **International trade loan guarantees** for the acquisition, construction, renovation, modernization, improvement or expansion of productive facilities or equipment to be used in the United States in the production of goods and services involved in the international trade.
- **Export revolving line of credit guarantees** to provide short-term financing for export firms that have been existence for a year or more.
- **Pollution control financing loan program** to assist those small business needing long-term financing for planning, design and installation of pollution control facilities or equipment

Economic Vitality Corporation Revolving Loan Fund

The Economic Vitality Corporation has state and federal funds to create a Revolving Loan Fund (RLF). The funds are intended to create private sector jobs or to provide services or goods for low and moderate income persons and to diversify and strengthen the economic base. RLF loans are used to fill gaps in financing to businesses that are unable to obtain suitable private sector lending. A letter of denial from a conventional lender is required.

Eligible applicants include private, for-profit firms, including corporations, partnerships and sole proprietorships, as well as cooperatives organized for the conduct of business. A borrower is eligible only when credit is not otherwise available on terms and conditions which would permit completion of the project to be financed. The majority of the jobs created or retained by borrowers must be for individuals whose incomes meet the low to moderate income levels per federal/state guidelines.

For further information and/or a loan application packet, please contact:

The Economic Vitality Corporation
4111 Broad Street
San Luis Obispo CA 93403-5257
(805) 788-2012
Fax (805) 781-6193
www.sloevc.org

Venture Capitalists

Venture capitalists invest in a new firm in the expectation that by growth, the investment will be multiplied. Many venture capitalist firms are controlled by banks, financial institutions, insurance companies, large corporations, private groups, or individuals. Investment minimums are usually \$500,000 and up. Most have a preference in locations, industry and size of investment. While their preference is to purchase common stock or convertible preferred stock (often sitting on the board with ownerships near or above 50%) they are usually not interested in running the business, but will help with advice.

Venture capital groups usually charge both a fee and interest. The advantage is that venture capital groups sometimes are willing to take risks not acceptable to public lending institutions. The disadvantages lie in the higher rate of interest they charge, the restrictions they place on the lending terms and the degree of control they may demand over your business.

Other Sources

Credit Unions and life insurance companies also can be a source of funds.

Credit unions offer personal loans to members usually at interest rates lower than those offered by commercial banks. Insurance companies often lend money against the cash value of your life insurance policy for up to 95% of the policy cash value. Interest rates charged by insurance companies are generally lower than those charged by commercial

banks. Interest payment also may be deferred as long as premium payments are made. However, until the loan is repaid, your coverage will be reduced by the amount of the loan. This is a very common method of raising capital.

Your telephone directory is another excellent source for locating the help you need. Many private lenders are listed under Financial Planners, Financing, and Financial Consultants sections of the Yellow Pages.

Credit Considerations

Whether your business is considering debt or equity financing, it is most important to understand those factors which will affect a credit decision. These factors include:

- Experience of Management
- Collateral (banks will discount value based on quick sale estimate)
- Type of Business
- Type of Industry
- Ability to Repay
- Amount of Funds Required

The Federal Equal Credit Opportunity Act prohibits discrimination against credit applicants. If for some reason your loan application is turned down by a bank, do not give up. Try another bank. However, if two or more banks have turned you down and you think that it was done unjustly, you can file for a grievance hearing with:

The Comptroller of the Currency
Consumer Affairs Division
Washington D.C. 20219
(800) 613-6713

Financial Consulting Firms

Financial consulting firms do not lend you money directly, but they are a valuable source for locating the lenders and discovering what is currently available. Many of the financial consulting firms are contractors for government agencies. Financial consulting firms are professionals in the world of business financing, offering financial advice, and helping you determine your needs. Moreover, most financial consulting firms will also help you prepare a loan package to present to the potential lender. There are several in this county. Refer to the Yellow Pages for their names and locations. It is suggested that you request references and/or referrals before engaging their service.