Critical basics

Financing your new or existing business

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The first step in financing your business is to decide how much you need.

- If you are starting a new business, you should look to your calculations on business startup expenses to help determine how much you need.
- If you have an existing business, you may have either short- or long-term borrowing needs. Your monthly cash flow projection should provide a good picture of your short-term needs. The price of a major item, such as a fixed asset or the purchase of another company, will dictate your long-term borrowing needs.

You may wish to add a comfortable cushion to your estimate of cash needed, just to be safe. It is easier to raise all the necessary funds at once than to have to go back to lenders or investors at a later date and ask for more. However, it's best not to overestimate your needs by very much if it means you have to give up ownership or pay interest for these funds.

Sources of funds

Most small business owners suggest that you search close to home for funds during the early stages of your business. Personal savings, consumer loans from banks and credit unions, and either investments or personal loans from friends and relatives are common sources of startup capital. After you have established a profitable track record, you will have more options available for raising capital.

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Equity funding

Equity funding consists of equity from your personal contribution to the company or equity you have raised from outside sources, or both. When you raise equity from outside sources, you sell a partial interest in your company. Equity funding can be obtained from private investors, venture capital firms, friends and relatives. You should be very careful not to give up control of your company when raising outside equity. The easiest way to ensure that you retain control is to keep at least 51 percent ownership in the company.

The advantages of equity funding are that it has no fixed costs — you do not have to make regular interest payments — and higher equity levels allow you to leverage your company by negotiating favorable loan terms. The major disadvantage of equity funding is that you may have to sacrifice ownership and future profits to attract investors.

Personal Sources

You should invest some personal funds into your business. These funds may come from your savings, or they may come from personal debt that you incur for this purpose. Consumer loans, such as a home equity loan, are common personal sources of equity capital. Your willingness to place personal assets at risk will be an important factor when you approach investors or lenders about financing your business.

Venture capital

Venture capitalists are looking for a high return on investment and are therefore willing to take risks. Generally, they want an average 25% return. They do not want to be involved in the operation of your business, but they do want to be kept informed, and they expect to be consulted on major issues. Venture capitalists look for innovative ideas and are usually interested in companies that market a product rather than a service. When venture capitalists make a decision about whether to invest in your company, the quality of your management team and its track record will be weighed heavily.

Debt funding

Debt funding is available from commercial banks, credit unions, community development financial institutions, friends and relatives. Debt funding can take the form of personal loans or business loans. In addition, some startup businesses can take advantage of operations-related financing.

Personal loans

You may incur personal debt for your company by borrowing from a bank on a secured or unsecured basis, by borrowing against the cash value of your life insurance, by obtaining a home equity loan, or by borrowing from friends and relatives. Be sure that the cost of the loan is reasonable and that you have a sound plan for repayment.

Business loans

Your business may qualify for a term loan or a line of credit from a commercial bank or other entity. It is important to the viability of your company that you match the type of credit you obtain with your needs. Banks will want your personal guarantee on any loan they make to the company. As a general rule, banks are typically not interested in financing startup businesses, and service businesses, which offer little or no collateral, are usually the hardest of all to finance.

- Term loans are set up on an installment basis with a regular amortization schedule, usually requiring monthly payments. Term loans should be used to finance fixed assets. Term loans are made on a secured basis, and lenders rarely will advance 100% of cost. An advance ratio — the amount of money a lender will advance against the value of the collateral used to secure the loan — in the range of 75 to 80% is common for assets such as real estate and some equipment that have reasonable liquidation possibilities. An advance ratio against other fixed assets, such as leasehold improvements, will be much lower. You may be asked to supplement the collateral package with personal assets, such as marketable securities or your residence.
- Lines of credit are generally extended

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