Raising Financing

While poor management is the most frequently cited reason businesses fail, inadequate or ill-timed financing is a close second. Whether you're starting a business or expanding one, you will need ready access to cash at all times, and you will need to manage that cash well.

In order to avoid common mistakes in borrowing money, such as securing the wrong type of financing, miscalculating the amount required, or underestimating the cost of borrowing money, it's important to manage your existing funds wisely.

Before Inquiring About Financing, Ask Yourself the Following:

- Do you need more capital or can you manage your existing cash flow more effectively?
- How urgent is your need? You should plan your borrowing activities well in advance of your cash needs, as you can obtain the best terms when you are not under pressure.
- How great are your risks? All businesses carry risks, and the degree of risk will affect the cost of borrowing and the available financing options.
- For what purposes will the capital be used? Any lender will require that you are requesting the capital to fulfill very specific needs.
- What is the state of your industry? Depressed, stable, or growth conditions require different approaches to money needs and sources. Businesses that prosper while others are in decline will often receive better funding terms.
- Is your business seasonal or cyclical? Financing options for seasonal needs are generally short-term.
- How strong is your management team? The quality of a company's management is the most important element of the application package that lenders consider.
- How does your need for financing fit with your business plan? If you don't have a business plan, make writing one your first priority. All capital sources will want to see your business plan, regardless of whether you are starting up or in a growth phase.

Types of Financing

- Equity Financing – "Equity" is the net investment of owners or stockholders in a business. "Equity financing" is financing in exchange for stock and/or options in the business, without any guaranteed return, but with the opportunity to share in the company's profits. Most small or growth-stage businesses use limited equity financing. This type of money often comes from non-professional investors such as friends, relatives, employees, customers or industry colleagues.

- Another common source of equity funding comes from venture capitalists. These are institutional risk takers and may be groups of wealthy individuals, government-assisted sources, or major financial institutions. Different investors expect different levels of involvement in managing a business in which they invest. Relinquishing some decision-making power and some potential for profits are the main considerations of equity financing.

- Debt Financing –There are many sources for debt financing: banks, savings and loans, commercial finance companies, credit unions, micro/community lenders, state and local governments and the U.S. Small Business Administration (SBA) are the most common. Family members, friends, and former associates are all potential sources especially when capital requirements are smaller. Traditionally, banks have been the major source of small business funding. Their principal role has been as a short-term lender offering demand loans, seasonal lines of credit, and single-purpose loans for machinery and equipment. Very small businesses should consider credit unions and micro/community lenders as a viable option.

The Six C's of Loans

The six "C's" listed below are an easy way to remember lenders' considerations when evaluating any loan application. For a partial list of banks, micro-lenders and credit unions and what they are looking for, review SBS' Financing Resources.

• Credit History – Your credit history is a record of all of your credit-based transactions. If you have ever applied for a credit card, an auto loan or a loan from a bank, then you have a credit history. This is recorded in a "credit report." All lenders use this credit report to determine your credit history and evaluate your record of repaying credit. Some will place more emphasis on your "credit score" – a number grade that summarizes your overall likelihood of repaying credit. Others weigh particular individual items most heavily, such as your total outstanding credit, the length of time of your credit, your dependability of making payments, the type of credit, etc.

• Your credit history could make the difference between your getting approved or denied for a loan. It will also affect the interest rate you are offered. Therefore, it is good practice to review your credit report before you apply for a loan so that you are prepared for lenders' likely questions. (Appendix A summarizes how to obtain and correct your credit history.)

• Character – Loan officers look for evidence of your trustworthiness. Your application can be rejected even before lenders review your business proposal if they find evidence in your background suggesting lack of integrity.

• You can expect lenders to look to your business plan and references for answers to questions such as "How long have you lived in your current home? How long have you been in business? Do you live up to your obligations? What is your standing in the community?"

• Capacity to Manage the Business and to Pay – As poor management is the foremost reason for the failure of new businesses, lenders will evaluate a company's business owners or management team carefully. Loan officers will want to know business owners' professional background, previous business experience, relevant education, and previous successes.

• As part of this analysis, lenders will seek to determine the capability of your business to turn a profit. They will ask, "What is your ability to repay the loan? How are the loan proceeds to be used? How will they be repaid?" Lenders are particularly interested in (a) how soon you can generate a positive cash flow; (b) when you will show a profit and what amount; and (c) whether various assets will be financed via debt or equity. The answers to these questions come from a review of your financial statements, particularly your cash flow statements, profit and loss statements and personal and corporate tax returns. Demonstrate that you can manage cash during slow periods as well as growth by tracking cash in- and out-flows, creating a cash reserve fund, aggressively collecting accounts receivable, and regularly liquidating old and unused inventory.

• Collateral and Guarantees – "Collateral" is something of value that you pledge to support the repayment of your debt. "Co-signers" are people who pledge to repay your loan if you cannot. Co-signers or collateral are considered secondary sources of repayment, or a lender's "safety hatch." Lenders will normally want the collateral to be valuable enough to cover any losses and be easily convertible to cash. Looking at your projected cash flow and list of assets, lenders will ask, "How can you be sure of your ability to repay the loan? What can you offer the bank as an alternative source of repayment?" In most instances, the bank will require the personal guarantees of all principals. In addition to providing another source of repayment, it also shows your commitment to the business. The more money owners have invested or are willing to invest in their business, the easier it is to attract other sources of financing.

• Context of the Business – No business exists in a vacuum, and loan officers will look at a number of external factors that may affect your business. They will pay particular attention to potential economic, legal, labor, supplier or environmental problems. Expect questions such as "What is the state of the economy? Are there environmental issues to be concerned about that may put the business at risk? How could these affect the financial condition of your business?" Loan officers tend to consider loan applications more favorably if (a) you are introducing a new product or service for which there is an obvious demand; (b) there is little competition; (c) your market is composed of small independent businesses; (d) there tends to be a lower rate of failure in your type of business, and/or e) you have a high gross profit margin.

• Conditions or Terms of Loans – The nature of your loan request is another important factor that could affect the results of your application. Lenders will want to know three important things: "How much money are you requesting? What will it be used for? For how long will you need it?" Lenders often prefer to approve loans for the purchase of items that can be identified, have lasting value and can be repossessed and sold if you cannot repay.