CHAPTER 8

OBTAINING CREDIT AND FINANCING FOR YOUR BUSINESS

If you are not independently wealthy and perhaps even if you are, eventually you will probably need to obtain some outside capital for your business. In some instances, you may need to obtain capital for the initial expenses prior to opening your business or for instance, the funds you require may be for expansion or working capital during the off season.

Generally business financing can take two forms, debt or equity. Debt, of course, means borrowing money. The loans may come from family, friends, banks, other financial institutions or professional investors. Equity relates to selling an ownership interest in your business. Such a sale can take many forms such as the admitting of a partner or, if you are in a corporation, issuing additional common stock, options or warrants to investors. It is typically a prudent idea to consult with your attorney as there are many significant legal ramifications to such a step.

How Do I Get the Money?

Irrespective of the type of financing you need and are able to obtain for your business, the process of obtaining it is somewhat similar. There are several questions that must be answered during the course of raising money for your business. The ability to answer these questions is critical to your success in obtaining financing as well as the overall success of the business. Remember, in raising capital you have to sell the ability of your business to potential investors in much the same way as you sell your product to your customers.

1. **How much cash do I need?**

   To answer this question you will have to do cash flow planning, which will require estimates of future sales, the related costs, and how quickly you must pay your vendors. You will also have to factor into your planning some assumptions about when you will generate enough cash to pay the money back. However, if you raise cash through equity you probably don't need to pay it back but your co-owners will want to know how the value of the business will grow and how they will benefit through dividends or selling their shares.

2. **What will you do with the money?**

   One of the most important questions you will have to answer for a potential investor is how the money will be spent. Will you use it for equipment or to hire additional employees or perhaps for research and development for a new or improved product? Again, part of the answer on how you spend the money is how it will benefit the company.

3. **What experience do you have in running your business?**

   One of the primary reasons for business failure is lack of experience and management. You will need to convince your investors that you have the knowledge, experience and ability to manage your business and their money at the level at which you expect to operate.

4. **What is the climate for your type of business and your geographic location?**

Few investors will want to put money into your business if you haven't done sufficient "homework" to determine that you have a reasonable chance of success. If your business is based on existing economic or legal conditions which is subject to change in the near future your risk is substantially increased. Even if your business has great potential, if the local economy is sluggish to the point that it can't support your venture, you need to be aware of this before moving ahead.

Once you have developed concrete answers to these and other pertinent questions, you can begin looking for financing. One of the first steps is to determine whether to raise funds through debt or equity. There are positive and negative aspects to each type of capital. The cost to your company of each type of funding is different as is the way in which they are treated for income tax purposes. The interest on borrowed money is deductible by a business for income tax purposes, which reduces the effective cost to your company. Dividends which you might pay on the same investment in stock would typically not be tax deductible by your company. In selling stock there usually is no firm commitment by your company to pay the money back but your stockholder will want and generally will have a legal right to have a voice in the management of your company. Before you make the decision as to the type of financing you think is appropriate to fit your desires and needs it is probably a good idea to consult with your accountant as to alternative types of debt or equity financing available.

Financing Alternatives

Whether you determine that debt or equity financing is the best choice for your company, there are a number of alternative types of financing available. Depending upon the nature of your business the financing may be a combination of debt and equity and may be tailored to fit the specific needs of your company.

In conclusion we will only mention a few of the more conventional methods for a young company to obtain capital, though the possibilities are many. A good business oriented accountant can discuss these and other alternatives in greater detail.

Debt Financing Sources

Banks. The first source of funds which typically comes to mind when borrowing money is a bank. The primary reason banks are in business is lending money. Typically, banks loan funds to small businesses on a secured basis using equipment, inventory or accounts receivable. The more liquid and readily salable the assets you have to offer as security, the more acceptable they are likely to be to a banker. Loans from a bank may take several forms such as:

a. A line of credit which renews annually and allows you to borrow up to a predetermined maximum as you need it and pay it back as funds from sales and receivables are collected.
b. A short-term demand note in the future which is payable in full on a specified date.
c. A term loan for the purchase of a specific asset such as a computer or a machine.

d. As your banking relationship improves, you may consider a long-term loan (3 to 5 years) which is payable in installments.

Lease financing. In today's business environment it is quite common to acquire equipment through lease agreements. Leasing packages come in a variety of types through many sources. Leasing companies typically will accept a somewhat higher degree of credit risk because they are looking to the value of the equipment for collateral in the event that your business cannot make the agreed upon payments. For this reason, leasing companies generally prefer to finance new equipment of a general purpose nature which can be resold if necessary. Leases often run for a period of three to five years and because of the risk that leasing companies are willing to take, they are somewhat more expensive than commercial bank loans.

Trade credit. A very important source of financing for your company may be from the vendors and suppliers with whom you do business. Many suppliers will originally ask for cash on delivery or in some instances they want payment before starting on your order, depending on the nature of your purchase. Most suppliers will quickly establish trade credit with you once you have gained their confidence by continuing to do business with them and paying as requested. Establishing good relationships with trade creditors is essential because it allows you to use the goods and services in your operations and sell your product to your customers, in some instances before you pay for them. The trade credit you build today will be relied upon by other vendors as you attempt to establish yourself with other vendors in the future. Trade credit terms will vary depending on the type of purchase you make, the supplier's industry, and the industry you are in.

Equity Financing Sources

Equity financing usually means selling a portion of your business. This can be accomplished in a number of ways including the sales of common or preferred stock or stock warrants. Equity sales are usually carefully tailored to meet the needs of both the company and the investor.

Venture capital companies. A venture capital company or fund is typically a company that is in the business of taking risks. A venture capital fund is often backed by a group of investors which may be individuals or corporations. The investors are often represented by a management group which evaluates potential investments and manages the existing investment portfolio.

The price of venture capital financing is usually very high when compared to borrowing money from a bank, but it must be remembered that venture capitalists are dealing with much higher risk situations than commercial banks will finance. This cost of venture capital is measured in terms of the portion of your company you must sell to obtain the level of financing you require. A venture capital firm sometimes requires a 300 to 500 percentage return on its investment over a four to five year investment period. While this may seem like an enormously high return, a venture capitalist is in the risk business and the return on a good investment must help offset those companies that do not meet their projections or fail altogether. To determine the price of such financing, venture capitalists will start with the amount of financing you require and calculate what they must receive at the time the investment will be sold to allow them to achieve the necessary rate of return.

Based upon the operating projections you provide, discounted based on their experience, they will estimate what your company might be worth at the time the investment will be liquidated. This might be at the point of a public offering or a sale to a corporate investor. The last step for a venture capital company in determining pricing is to calculate what percentage of the company they must own to realize the return desired. At this point, the "horse trading" generally begins. As a general rule you will want to retain as much of the ownership of the company as you can. The venture capitalist wants enough ownership to achieve the investment goals and have some control over how the money is spent. This will often be achieved by voting power and representation on the Board of Directors. At the same time a venture capitalist wants to be sure there is sufficient reward in the company for you and your management team to be motivated and achieve the projections in your business plan.

A venture capital company is often managed by an individual or group of individuals with a strong background in business and management. They can often provide depth of experience and management assistance in areas where your management team may be weak. A venture capital group can very often provide contacts and valuable introductions in your industry. Remember a venture capital investor becomes a member of your team.

Private individuals. Very often, individuals who are successful in their own right and have accumulated substantial wealth may be looked to for investment in your business venture. Such individuals may believe that the success of your business may enhance theirs as well as help increase their personal wealth. These individuals, like a venture capital company, very often want to participate in the management activities of your firm and help guide your progress through representation on the Board of Directors. The business acumen and contacts of these individuals can often be a valuable asset of your business. An individual investor can often react to opportunity much quicker than a venture capital firm and typically has only their own interests to serve as opposed to a financial backer or group of investors.

Individual investors can be more flexible than organizations in the type of investment structure they can deal with, and often have personal, financial and tax motivations considerations.