Small Business Financing Realities

There is no doubt that financing a venture can be a very difficult endeavor. Finding the right investor, the best type of financing and the most agreeable terms can be a complicated process. To complicate the process even further, sometimes the need for financing becomes so desperate that many small business owners become easy prey for investors who offer financing with unreasonable terms. Even worse, there are many fraudulent financing schemes that advertise easy access to capital, but provide nothing once they collect a hefty application fee or sell an expensive list of resources that could have easily been acquired for free.

Before seeking financing for your business venture, consider the following two basic realities to accessing capital:

You Have to Know What You Need

Probably the largest complaint I get from commercial lenders is that people approach them for financing without knowing how much money they need. You probably will not earn the confidence of any investor if you cannot demonstrate you have done your homework regarding your business needs. This is a significant indicator that you have not done enough planning for your business.

Before approaching any financing deal, have a clear plan that identifies how much financing will be necessary and try to be specific in how the money will be used. Always separate start up/expansion costs from operating/working capital needs. When seeking money to cover some operating expenses, be sure to create a cash flow spreadsheet that clearly shows how you arrived at that amount you need to borrow and when you expect the business will generate enough revenue from operations to cover expenses. While it is a good idea to be conservative in your estimates, don’t overburden your business with debt service by borrowing too much working capital. In some instances you may need two years of operating capital, in others you may only need two months. The key is to have a plan that is based on realistic assumptions of anticipated operating revenues and expenses.

Financing is a Business

No matter which financing source you use, it is important to remember that financing is a business and successful investor will need to make a return on their investment (ROI). There are two types of financing, debt financing and equity financing. Debt financing is money borrowed with an obligation to pay the financing back over a period of time with interest (a loan). Equity financing is the provision of capital in exchange for stock or ownership share in the business without any guaranteed payment, but with the opportunity to share in the company’s profits (selling ownership rights in your business).

Whether you structure a debt financing deal, an equity financing deal or a hybrid of these options, your investor will be expecting to make some interest or profit share to make the deal worthwhile to them. A general rule of thumb is that the higher the level of risk, the larger the ROI that will be expected from an investor.

Risk is usually assessed by considering the five C's of financing-Capital, Credit, Collateral, Capacity and Character. Think about your share of investment into this business, your history of paying obligations, assets you have available to secure financing, your earning history and ability to satisfy debts outside of your business and your standing in the community.

Since most traditional commercial lenders will charge interest rates just a few points above the prime interest rate, they can only withstand a small amount of defaults to remain profitable. In most cases traditional commercial lenders maintain a default rate of less than 1% of their financing and they can only achieve that by carefully securing their financing deals and working with clients who have other means to satisfy the debt should the business fail.

If you do an honest self assessment of the 5C's and it shows that you are a high risk venture, then you may need to seek other financing sources. Some other means of financing includes friends and family, leasing companies, trade credit, credit cards and angel investors. We recommend doing some due diligence before choosing a financing source and please consider using an attorney or accountant to help you analyze any financing plan before making a commitment.

The best means of ensuring a positive financing for your business will always relate to how much energy you invest into writing a clear business plan with financial projections. If creating financial projections or understanding financial terms is not one of your strengths, consider a visit to our office at the SBDC or meeting with a local accounting professional. Understanding some basic financial fundamentals is a critical component to making smart financing decisions.

Written by Rick Leibowitz (March 2006)