Borrowing Money

Types of Financing

There are two types of financing: equity financing and debt financing. When looking for money, you must consider your company's debt-to-equity ratio. This ratio is the relation to dollars you have borrowed and dollars you have invested in your business. The more money owners have invested in their business, the easier it is to obtain financing. If your firm has a high ratio of equity to debt, you should probably seek debt financing.

Equity Financing

Equity financing (or equity capital) is money raised by a company in exchange for a share of ownership in the business. Ownership accounts for owning shares of stock outright or having the right to convert other financial instruments into stock. Equity financing allows a business to obtain funds without incurring debt, or without having to repay a specific amount of money at a particular time. Most small or growth-stage businesses use limited equity financing. Equity often comes from investors such as friends, relatives, employees, customers, or industry colleagues. The most 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. Most specialize in one or a few closely related industries.

Debt Financing

Debt financing means borrowing money that must be repaid over a period, usually with interest. Debt financing can be either short-term, with full repayment due in less than one year, or long-term, with repayment due over a period greater than one year. The lender does not gain an ownership interest in the business. Loans are often secured by some or all the assets of the company. In addition, lenders commonly require the borrower's personal guarantee in case of default. This ensures that the borrower has a sufficient personal interest at stake in the business.

Loans can be obtained from many different sources, including banks, credit unions, commercial finance companies, and SBA-guaranteed loans. State and local governments have many programs that encourage the growth of small businesses. 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. The principal role of banks includes short-term loans, seasonal lines of credit, and single-purpose loans for machinery and equipment. Banks generally have been reluctant to offer long-term loans to small firms. SBA's guaranteed lending programs encourage banks and non-bank lenders to make long-term loans to small firms by reducing their risk and leveraging the funds they have available.

Ability to Repay

Your ability to repay the funds received from a lender must be justified in your loan package. Banks want to see two sources of repayment: cash flow from the business and a secondary source such as collateral. The lender reviews past financial statements to analyze the business's cash flow.

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Generally, banks are more comfortable lending to businesses with a proven financial track record over several years. If a business has consistently made a profit that can cover additional debt payments, the loan is likely to be approved. However, if the business is a start-up or has been operating marginally but has growth potential, a thorough loan package with a detailed explanation of how the loan will be repaid is necessary.

Credit History

When a small business requests a loan, one of the first things a lender looks at is the personal and business credit history. Before preparing a loan request, ensure you have good credit.

Obtain your personal credit report from one of the credit bureaus, such as TransUnion, Equifax, or Experian. Do this well in advance of seeking a loan, as personal credit reports may contain errors or outdated information, which can take three to four weeks to correct. Regularly check on progress to ensure all errors are corrected and your history is up to date.

Review your credit report to ensure all personal information, including your name, Social Security number, and address, is correct. Examine the list of all past credit, such as credit cards, mortgages, and student loans, and check how you paid them. Items indicating payment issues will be at the top of the list and may affect your ability to obtain a loan.

Occasional late payments may not adversely affect your credit, but continuous late payments, unpaid debts, judgments against you, or bankruptcy in the past seven years can hinder loan approval. If bad credit resulted from a significant event like divorce or a medical crisis, and you can show good credit before and after the event, you might still obtain a loan. Write an explanation of your credit problems and how you rectified them and include it with your credit report in your loan package.

Each credit bureau presents your credit information differently. Contact the bureau for specific information on how to read your credit report. If you need help interpreting or evaluating your report, consult your accountant or a local banker.

Equity Investment

Owners typically need to invest some of their own money to obtain a loan. The amount of financing depends on the loan type, purpose, and terms, with most banks requiring the owner to contribute at least 20 to 40 percent of the total request.

Do not assume a start-up business can obtain all financing through conventional or special loan programs. Financial institutions want to see a certain amount of equity in a business, built up through retained earnings or cash injections from the owner or investors. Most banks prefer the total liabilities or debt of a business not to exceed four times the amount of equity. To secure a loan, ensure there is enough equity in the company to leverage it.

Having the right debt-to-equity ratio does not guarantee loan approval. Other factors such as net worth, a combination of retained earnings and owner's equity, are also evaluated.

Collateral
Financial institutions require a second source of repayment called collateral to ensure loan repayment. Collateral includes personal and business assets that can be sold if the business cannot generate enough cash to repay the loan. Every loan program requires some collateral. Without collateral, a co-signer with collateral may be necessary. Otherwise, obtaining a loan may be difficult.

Management Experience
Managerial expertise is crucial for the success of any business. In fact, poor management is often cited as the primary reason businesses fail. Lenders will closely examine the education and experience of both you and your key managers.

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