Financing New Ventures

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Introduction

In order to expand, it is necessary for business owners to tap financial resources.

Business owners can utilize a variety of financing resources, broken into two categories, debt and equity.

Debt involves money to be repaid, plus interest.. In smaller businesses, personal guarantees are likely to be required on most debt instruments; commercial debt financing thereby becomes synonymous with personal debt financing.

Equity involves raising money by selling ownership in the company. This form of financing allows the owner to obtain funds without incurring debt; without having to repay a specific amount of money at any particular time.

Debt Financing

- Must be repaid or refinanced
- Requires regular interest payments. Company must generate cash flow to pay.
- Collateral assets must usually be available
- Debt providers are conservative. They cannot share any upside or profits. Therefore, they want to eliminate all possible loss or downside risks.
- Debt has little or no impact on control of the company
- Lender is entitled only to repayment of the agreed-upon principal of the loan plus interest, and has no direct claim on future profits of the business.
- Except in the case of variable rate loans, principal and interest obligations are known amounts which can be forecasted and planned for.
- Raising debt capital is less complicated because the company is not required to comply with state and federal securities' laws and regulations.
- The company is not required to send periodic mailings to large numbers of investors, hold periodic meetings with shareholders, or seek the vote of shareholders before taking certain actions.

Equity Financing

- Can usually be kept permanently
- No payment requirements. May receive dividends, but only out of retaining earnings.
- No collateral required.
- Equity providers are aggressive. They can accept downside risks because they fully share the upside as well.
- Equity requires shared control of the company and may impose restrictions.
- Shareholders share the company profits.
- Equity investors usually do not need short term income and can afford to take the long term view.

Debt vs. Equity

There is no exact recipe for the best debt/equity mix, therefore the right mix must maximize the growth in long-term profits. This mix is likely different for each individual situation. At one extreme may be start-ups. Because these may lose money in their initial years, and because they have neither cash flow nor much collateral to support debt, start-ups mostly need equity to enable growth.

Debt and equity financing should not be seen as substitutes for each other. Instead, they are very different in nature and complement each other. Depending on individual circumstances and opportunities the trick for each investment is to find the best mix of both.

Sources of Finance for New Ventures

Debt

- Family Friends and Fools (3Fs)
- Customers & Suppliers
- Retail Banks & Development Banks
- Government Backed Loans
- Credit Cards

Equity

- Family Friends and Fools (3Fs)
- Customers & Suppliers
- Angel Investors
- Venture Capitalists

Mistakes to Avoid: Half-baked business plans

There's nothing worse than going into a money meeting unprepared. If you haven't put the time and energy into writing a full-blown business plan complete with elements, such as a business description, financial projections and a competitive market analysis, the people with the cash won't put the time into evaluating your proposal.

Mistakes to Avoid: Focusing too much on the idea and too little on the management

It's not enough to convince potential backers that you've invented the next must-have gadget or can't-miss clothing store concept. You also need a team that can generate the revenues to repay a bank loan or provide an exit strategy for a VC or angel investor. Many business novices ignore the second part of the equation; that can doom their money quest.

The greatest racehorse in the world still needs a great jockey to a win a race. The same principle applies in business. Showing that you have recruited a top-notch salesperson, a skilled marketer, an accountant with startup experience, other key personnel, and even outside experts like an attorney or business coach who can supply professional guidance is essential to finding a funding source.

Mistakes to Avoid: Not asking for enough money

In a 2004 U.S. Bank study of reasons for small business failures, 79 percent cited "starting out with too little money" as one of the causes of their collapse. That's often because entrepreneurs who are wet behind the ears don't realize that they should calculate their borrowing needs based on their worst-case scenario instead of their best-case forecast.

An old accounting axiom says that everything will take twice as long and cost twice as much as you expect. While that may be an exaggeration, new business owners are frequently too optimistic about how soon they will begin to fill their cash pipeline and how fast the money will flow. If you're underfunded, you won't have a cushion to tide you over in the event of slow initial sales or unexpected market conditions.

Mistakes to Avoid: Having too many lenders or investors

One of the hazards of securing financing from multiple sources is managing too many relationships and expectations. It takes time away from your core business. These not-so-silent partners may have conflicting interests or demands and the consequences can be devastating.

This is particularly true when you raise money from friends and family. One hairdresser I know borrowed money from seven or eight relatives to open her own salon. The business was successful, but there were perpetual battles over how the profits should be distributed. The arguments couldn't be settled to everyone's satisfaction, so the salon was forced to close.

Mistakes to Avoid: Failing to get the proper legal agreements

This is arguably more important than a prenuptial agreement for a couple with significant individual assets. Every lender or investor eventually will need his money back, and a legal document covering everything from the terms to the timing can avoid the kind of acrimony just described.

Mistakes to Avoid: Poor cash flow management

Too many new business owners burn through their seed money too quickly and fail to reach cash flow-positive status in a timely manner. Some causal factors, such as late product deliveries and economic downturns may be beyond one's control, but the executive team is clearly at fault for others, such as unnecessary spending and overly optimistic expense/income forecasts.

Financial sponsors don't take kindly to that sort of mismanagement. And if they turn off the tap, all of your hard work may go down the drain.