From Bootstraps to Banking

There are Many Ways to Finance a Startup Business

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It is one of the often-harsh realties of the business world: While new ventures begin with an idea, they can only truly get started with money.

Indeed, entrepreneurs and new-business owners alike are challenged by finding sources of funding during the startup phase. And unlike existing businesses with a proven track record relative to cash flow, customer base, and revenue stream, new businesses are often not profitable for at least the initial six to 12 months of operations.

That said, a new business nonetheless faces the same economic realties of an existing business, such as the need to purchase inventory, pay employees (including a salary to the business owner until profitability is maintained), and pay rent and other ongoing expenses. In addition, new businesses often have initial expenses such as equipment purchases, capital improvement, and initial inventory expenses, which can be significant.

What follows is a primer on determining what it will take to get a business venture off the ground, and also how to secure that financing.

Startup Cost Estimates

A sound business plan for a startup company should consider any and all costs that will be incurred during the startup phase of the business, and then on an ongoing basis. Initial substantial costs will likely be incurred for such things as inventory, equipment and machinery purchases, leasing and/or other real estate expenses, marketing expenses, insurance premiums, specific costs, such as franchise fees or license costs, and initial payroll costs.

If you're considering starting a new business, it is wise to avoid understating and underestimating your initial capital needs during the startup period. The rule of thumb should be to overestimate initial capital needs and underestimate initial business operating revenues to avoid running into budgetary deficit. Whether or not you have contemplated seeking financing through an institutional lender, commercial lenders are often an invaluable resource for you relative to evaluating your business plan. In fact, since commercial lenders often are presented with numerous business plans by potential and current borrowers, they are often uniquely positioned to understand and challenge your estimated initial capital needs. Even an informal conversation with a commercial lender would likely be highly productive.

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Once the associated needs and costs have been identified, your challenge is to identify a source to finance the startup of your business. There are a number of different forms of startup financing, including self-financing, equity financing, and debt financing.

Self-financing

Self-financing simply means that you fund the startup costs, drawing upon initial cash options such as savings accounts, home equity loans, retirement accounts, and other sources of liquidity. Often called 'bootstrap' financing, self-financing a business is the least complex and most popular form of financing new small businesses. You simply draw funds off the available liquidity on an as-needed basis, both during the inception of your business operations and during the course of your business startup period.

You should bear in mind, however, that frequently the same funds utilized for your business will also be needed in lieu of income during the startup period. Since it takes a potentially significant period of time for most new businesses to see profitability, you will likely need to draw upon existing cash surpluses to substitute income. So, if you're contemplating utilizing bootstrap financing, you should consider covering not only business expenses that will be incurred during the startup period, but also living and personal expenses that will arise as well.

An alternative to bootstrap financing is seeking funding from family and friends. Not without a whole host of issues unto itself, family financing can be a cost-effective way to manage your business's startup needs. Young entrepreneurs often seek initial loans from parents and other close relatives, with terms, conditions, and formality all determined by the circumstances. That said, even in the informal circumstance of a loan from a parent or close family relative, such a transaction nonetheless constitutes an obligation that could have other legal and/or account implications. Even loans between family members should be reflected by minimal documentation including at least a promissory note by and between the parties, and, as with all financing transactions, it should follow legal and tax consultation.

An advantage to startup self-financing or funding by family and friends is the ability to receive funding without relinquishing equity or control. In addition, the informality of loans from relatives and family members could lend itself to flexibility otherwise unavailable with other sources of financing.

Debt and Equity Financing

In the case where substantial capital needs are required by your business during the startup phase, more traditional debt financing or equity financing would most likely be needed. Debt financing is essentially funds borrowed to run your business, including loans from traditional lending institutions, commercial finance companies, and government organizations, such as the Small Business Administration (SBA).

Equity financing is a financing mechanism by which, unlike debt financing, you relinquish some portion of equity ownership in your business in return for a capital contribution. This often takes the form of an initial investor seeking stock (in the case of a corporation) or membership interests (in the case of a limited liability company), to reflect the contributor's investment. While certainly an attractive and available option for many new-business owners, seeking equity investors should be undertaken with thorough evaluation.

In most circumstances, you have spent quite a bit of time developing your business plan with the intent of growing a successful and prosperous business. By incurring a new equity owner, you are relinquishing control and ownership, two factors that should be thoroughly considered at the onset. Indeed, private investors in a new business venture want to understand such things as how much control he or she will have over their new investment, and will want to know how long it will take for them to recoup their investment, as well as the nature of the potential returns that they can hope to achieve.

Angel Investors and Venture Capital

An additional method of financing is through angel investors and venture capitalists. They are available, albeit limited, funding vehicles. Angel investors are wealthy individuals or groups of individuals who provide capital financing in return for an ownership stake and control in a new business. Venture-capital firms similarly seek to provide capital investments, often-sizable ones, in return for ownership and control, including rights such as positions on the company's board of directors.

In most circumstances, funding from angel investors and venture capital firms is unlikely to be available to a new business owner. Given the risky nature of these investments, most angel investors and venture capital firms look for the proven track record of an existing business seeking financing to provide some level of comfort relative to the profitability and success of the operation's business plan. That said, while angel and venture-capital financing may not be available at the onset of the business operations, funds may be available after a period of demonstrated success.

Traditional Debt Financing

Unlike equity financing, traditional debt financing allows you to seek a loan without the need to relinquish ownership or control. Once a traditional business loan is paid back, there are no further obligations to the lender. This means that you will maintain ownership of 100% of your company and will benefit exclusively from its profitability on an ongoing basis. If you're not looking to relinquish control and ownership, or incur a new business partner, traditional debt financing may be an attractive option.

Such debt financing generally involves some type of loan facility, including a traditional lending institution and/or a government agency such as the Small Business Administration. SBA loans administered through traditional lending institutions may have the ability to offer financing with slightly fewer qualification requirements than may be required through the institutional lender without involvement of the government agency. This is possible because agencies such as the SBA may guarantee repayment of some portion of your loan.

Institutional loans, whether or not government agency-guaranteed, will most likely be secured by some form of collateral. Often, collateral will include your personal guaranty, mortgages on your real estate, including your personal residence, and liens on business assets such as inventory and equipment. It should be noted that nearly one-half of all startup businesses seek initial financing through traditional bank loans.

As discussed above, commercial lending officers are often an excellent resource for evaluating the strength of your initial business plan. Additionally, as your business grows, an existing track record and relationship with a bank may assist you in receiving further financing such as credit lines and large term loans.

Even within the current economic climate, it is possible to launch a new venture. But it helps to know — and fully understand — all your options.v

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