From Good to Great:
Finding the Right Financing to Grow your Business

Different types of financing

1. **<u>"Friends and Family"</u>** – Friends and family financing is exactly what the name suggests. Many times, a startup entrepreneur's most viable means of obtaining funds is to either finance the business startup from his/her personal funds or obtain financing from a network of friends, associates, and family members. These parties will typically, but not necessarily always, want an ownership stake in the company. Investing in startup companies involves a high degree of risk and the early investor must therefore be rewarded appropriately for the risk being taken. Strategies for obtaining this type of financing generally revolve around the creation of a solid business plan and the entrepreneur's ability to sell the business concept to the potential investors. As the business grows and obtains an operating history, the list of available financing options grows.
2. **<u>"Angel" Investors</u>** – Similar to friends and family, Angel investors typically invest in companies at earlier stages of the company's development. The term "Angel" investor is typically used to describe a wealthy private individual who seeks to make investments in emerging private companies. The Angel investor has the flexibility to make investment decisions independently, at his or her discretion, and may have a particular industry or group of industries that he/she likes to invest in. This is usually based upon personal familiarity and/or comfort level with certain industries. Again, the strategy for obtaining this type of financing generally revolves around the creation of a solid business plan and the entrepreneur's ability to sell the business concept to the potential investor. This is often accomplished through face to face meetings with the investor. The key is in networking and identifying potential wealthy "Angel" investors.
3. **<u>Venture Capital</u>** – Venture Capitalists are companies that earn a living by investing in private companies. There are many different types of venture capital companies, with many different objectives. Most venture capital companies will specialize in investing in certain types of companies. Their investment criteria may depend upon the industry sector, sales size, profitability and growth potential of the company. It is important to remember that while venture capital companies are willing to take greater risk than a bank, they also expect higher investment returns for the risk that they take. Typically, venture capital companies will take an equity ownership position in the companies that they invest in. Additionally, they often like to have a certain level of control over the situations in which they invest, which is usually obtained by appointing a member to the company's Board of Directors. It is important for the entrepreneur to understand how the venture capitalist achieves their profits. While the dream of the entrepreneur may be to grow and run a business, the goal of the venture capitalist is to achieve a profit on invested assets. A tangible profit can only be realized by the Venture Capitalist's sale of their ownership stake in the company for more than they invested. This is

what is commonly referred to as an "exit strategy". In other words, they ultimately have to have someone to sell their shares in your company to in order to realize a profit on their initial investment. The most common exit strategies for the V.C. are to either cash out through an acquisition of the company at a higher valuation, or the ability to sell their shares into the public market after a public offering of the company's stock (an IPO). In order to be attractive to the Venture Capitalist, your company must usually present the type of explosive upside growth potential that would allow the V.C. to reasonably envision a future exit strategy and achieve an above average return on their investment.

4. **Bank Financing** – Bank financing is ideal for closely held, profitable companies with at least one complete fiscal year in business that need capital to help them continue to grow. Bank financing may also provide a more limited option for startup businesses as well. Most banks have a general set of criteria that they use to evaluate businesses.

What Banks Typically Look At When Underwriting a Business Loan

Five C's of Credit

- Character
- Credit
- Cash Flow
- Capacity
- Collateral

Character

- What kind of person is the borrower?
- What kind of borrower will this customer be for the bank?
- How well has the borrower managed their personal obligations

Credit

- Personal Credit Score (FICO)
- Business Credit History (Dunn and Bradstreet)
- Trade References
- Public Records

Cash Flow

- Bank determines borrower's ability to repay the loan by means of cash flow of their business
- Bank reviews previous financial statements from borrower to predict future cash flow

- Debt Service Coverage
    - Net Profit
    - Depreciation & Amortization (add back)
    - Interest Expense
    - Combined Cash Flow
    - Existing Obligations
    - Payments on New Requests

<u>Capacity</u>

- Ability to get through a sudden downturn in the business
- Converting assets to cash
- Sometimes referred to as secondary sources of repayment

<u>Collateral</u>

- Business Assets
    - Cash or cash equivalent
    - Accounts Receivable & Inventory
    - Equipment
    - Real Estate

- Personal Assets
    - Liquid Assets (cash, marketable securities)
    - Real Estate equity
    - Retirement Assets

What type of bank financing is the best option for my business?

1. **Line of credit –** Short term needs to help support the collection of accounts receivable or help purchase inventory or raw materials. A line of credit can help make running your business a little easier by smoothing out short-term cash flow shortages that may arise from time to time. You don't want to finance long term cash needs using a line of credit.
2. **Installment loan –** Generally issued with repayment terms ranging from 2 to 7 years. These fully amortized loans offer a fixed rate of interest and fixed payment schedule. An installment loan can help to provide long-term working capital for your business. It may also be used to purchase equipment, hire additional staff, or provide the necessary capital to assist the long-term growth of your business.
3. **Installment loan with draw –** This loan gives you the ability to draw the proceeds of your installment loan over a period of up to 6 months. This is perfect for situations in which you have a long term financing need that requires cash over a period of time as opposed to requiring all of the cash up-front. A great

example of this would be an office expansion or renovation project in which you had to pay architects, contractors, and equipment suppliers in stages over the course of several months. You would be allowed to take money as you needed it, paying interest only on the amounts that you had drawn. At the end of the draw period, the loan converts into a 2 to 5 year repayment schedule with a fixed payment of principal and interest. This type of loan offers increased flexibility while still maintaining a fixed repayment structure for your debt.

4. **Bank Leasing –** Leasing may be a good option for the purchase of equipment. It is possible to get a Fair Market Value (FMV) option lease, which may allow you to turn in the equipment at the end of the lease period. This could give you the option to upgrade to newer equipment, while also keeping your payments lower during the course of the lease. Another leasing option would be the Dollar Purchase option in which you can pay $1 at the end of the lease term to own the equipment outright. The payments are higher due to the fact that you are essentially financing the entire purchase amount of the equipment over the lease term.
5. **Commercial Real Estate Financing –** The bank can help you finance the purchase of the commercial space that your business occupies. There is a requirement that your business must occupy at least 51% of the overall space in the building. The remaining space may be leased out to other business tenants. The SBA 504 financing option allows for the purchase of commercial real estate with only a 10% down-payment. Purchasing your own commercial building can be a great way to increase your net worth through building equity.
6. **Start up Financing –** The bank offers limited financing to startups through the SBA Express startup program. Loan amounts are limited to $50,000. The bank would like to see that the owner has his/her own capital invested into the business as well. Investing your own money in the business shows your commitment and confidence in the success of your business. Business startups that require larger amounts of capital are best to be self-financed or financed through private equity or debt investors.