Borrowing Money for Your Business

After you have developed a cash flow analysis and determined when your business will make profit, you may decide you need additional funding. Borrowing money is one of the most common sources of funding for a small business, but obtaining a loan isn't always easy. Before you approach a lender for a loan, you will need to understand the factors the bank will use to evaluate your application. This page outlines some of the key factors a lender uses to analyze a potential borrower.

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 between 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. However, if your company has a high proportion of debt to equity, experts advise that you should increase your ownership capital (equity investment) for additional funds. This will prevent you from being over-leveraged to the point of jeopardizing your company's survival.

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 of time, 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, and debt obligations are typically limited to repaying the loan with interest. Loans are often secured by some or all of 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, savings and loans, 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

The ability (or capacity) to repay the funds you receive from a lender must be justified in your loan package. Banks want to see two sources of repayment—cash flow from the business as well as a secondary source such as collateral. The lender reviews the past financial statements of a business to analyze its cash flow.

Generally, banks are more comfortable offering assistance to businesses that have been in existence for a number of years and have a proven financial track record. If the business has consistently made a profit and that profit can cover the payment of additional debt, it is likely that the loan will be approved. If however, the business is a start-up or has been operating marginally and has an opportunity to grow, it is necessary to prepare a thorough loan package with a detailed explanation including how the business will be able to repay the loan.

Credit History

When a small business requests a loan, one of the first things a lender looks at is personal and business credit history. So before you even start the process of preparing a loan request, you want to make sure you have good credit.

Get your personal credit report from one of the credit bureaus, such as TransUnion, Equifax or Experian. You should initiate this step well in advance of seeking a loan. Personal credit reports may contain errors or be out of date, and it can take three to four weeks for errors to be corrected. It is up to you to see that corrections are made, so make sure you check regularly on progress. You want to make sure that when a lender pulls your credit report, all the errors have been corrected and your history is up to date.

Once you obtain your credit report, check to make sure that all personal information, including your name, Social Security number and address is correct. Then carefully examine the rest of the report, which contains a list of all the credit you obtained in the past such as credit cards, mortgages, student loans and information on how you paid that credit. Any item indicating that you have had a problem in paying will be toward the top of the list. These are the credits that may affect your ability to obtain a loan.

If you have been late by a month on an occasional payment, this probably will not adversely affect your credit. But it is likely that you will have difficulty in obtaining a loan if you are continuously late in paying your credit, have a credit that was never paid, have a judgment against you, or have declared bankruptcy in the last seven years.

A person may have a period of bad credit as a result of divorce, medical crisis, or some other significant event. If you can show that your credit was good before and after this event and that you have tried to pay back those debts, you should be able to obtain a loan. It is best if you write an explanation of your credit problems and how you have rectified them, and attach this to your credit report in your loan package.

Each credit bureau has a slightly different way of presenting your credit information. Contact the bureau you used for more specific information how to read your credit report. If you need additional help in interpreting or evaluating your credit report, ask your accountant or a local banker.

Equity Investment

Don't be misled into thinking that 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.

Equity can be built up through retained earnings or by the injection of cash from either the owner or investors. Most banks want to see that the total liabilities or debt of a business is not more than four times the amount of equity. So if you want a loan for your business, make sure that there is enough equity in the company to leverage that loan.

Owners usually must put some of their own money into the business to get a loan. The amount of financing depends on the type of loan, purpose and terms. Most banks want the owner to put in at least 20 to 40 percent of the total request.

Having the right debt to equity ratio does not guarantee your business will get a loan. There are a number of other factors used to evaluate a business, such as net worth, which is the amount of equity in a business, which is often a combination of retained earnings and owner's equity.

Collateral

When a financial institution gives a loan, it wants to make sure it will get its money back. That is why a lender usually requires a second source of repayment called collateral. Collateral is personal and business assets that can be sold in case the cash generated by the small business is not sufficient to repay the loan. Every loan program requires at least some collateral. If a potential borrower has no collateral, he/she will need a co-signer who has collateral to pledge. Otherwise it may be difficult to obtain a loan.

The value of collateral is not based on market value; rather, it is discounted to take into account the value that would be lost if the assets had to be liquidated. This table gives a general approximation of how different forms of collateral are valued by a typical lender and the SBA:

COLLATERAL TYPE	LENDER	SBA
House	Market Value x 0.75 - Mortgage balance	Market Value x 0.80 - Mortgage balance
Car	Not applicable	Not applicable
Truck & Heavy Equipment	Depreciated Value x 0.50	Same
Office Equipment	Not applicable	Not applicable
Furniture & Fixtures	Depreciated Value x 0.50	Same
Inventory: Perishables	Not applicable	Not applicable
Jewelry	Not applicable	Not applicable
Other	10%-50%	10%-50%
Receivables	Under 90 days x 0.75	Under 90 days x 0.50
Stocks & Bonds	50%-90%	50%-90%
Mutual Funds	Not applicable	Not applicable
Individual Retirement Account (IRA)	Not applicable	Not applicable
Certificate of Deposit (CD)	100%	100%

Collateral Coverage Ratio

The bank will calculate your collateral coverage ratio as part of the loan evaluation process. This ratio is calculated by dividing the total discounted collateral value by the total loan request.

Management Experience

Managerial expertise is a critical element in the success of any business. In fact, poor management is most frequently cited as the reason businesses fail. Lenders will be looking closely at your education and experience as well as that of your key managers.

To strengthen your management skills, SBA offers a wide range of free, online training courses. You can also get management advice from counselors at your local SCORE office.