FINANCING BASICS

There are three major reasons why businesses borrow; the first and most common reason is to purchase assets. A loan to acquire assets could be for buying short-term, or current, assets – such as inventory – and would be repaid once the new inventory is converted into cash as it is sold to customers. Or, the funds could be for the addition of long-term, or fixed, assets, such as equipment.

The second reason is to replace other types of credit. For example, you may wish to use the funds to pay suppliers more promptly to get a discount on the price of the merchandise.

The third reason is to replace equity. If you wish to buy a partner's share in your business but you don't have the cash to do it, you may consider borrowing.

TYPES OF CAPITAL

Start-up Capital
Start-up capital is the money you need to spend before the business opens. The amount varies widely depending on the type of business. Some examples include:

1. Seed money - Research and planning (usually for high-tech businesses)

2. Security deposits for a lease, utilities, etc.

3. Construction, renovations, signs

4. Equipment, tools, office equipment, etc.

5. Inventory

6. Labor - Hiring and training staff before opening

7. Legal and accounting fees

Working Capital
Working capital is the money needed for day-to-day business expenses. You must have enough working capital available to pay all your bills until the business becomes profitable enough to support itself. This can take from several months to several years. After you complete your pro forma monthly cash flow projections you will have a very good estimate of the amount of working capital you will need. Allow a little extra for unexpected things. If you have just enough money to get started but not enough to properly operate the business, you may be doomed to failure from the start.

Where's the Cash?
Think venture capitalists and angel investors finance most small businesses? Think again: bank loans and equity from the owners, their families, and friends are still the major financing source.