Types of Financing

Debt Financing – Commercial Bank Loans

Debt financing does not give the lender ownership control, but the principal must be repaid with interest. The length of the loan, interest rates, security and other terms depend upon for what the loan is being used.

- **Short-term**
  Loans for short periods (30-180 days) usually made to cover temporary or seasonal needs for inventory or personnel. These are common for established businesses, but may be hard for a new business to obtain. The key to getting a short-term loan is to always have an identified primary and secondary source of repayment. A short-term loan will probably be either a time loan or a line of credit, both with maturities of one year or less. These types of loans often possess the following characteristics:

  - Time loans are made for a specified period when there is an identified source of repayment that will be available within a specified period of time. Prime candidates for these loans are seasonal businesses, with the source of repayment being the conversion of inventory to receivables and then into cash.

  - Lines of credit are annually renewable pre-approved vehicles allowing the borrower access to credit whenever needed within predetermined terms. The business owner can borrow and repay as the business cash flow dictates. A line of credit is usually documented by a loan agreement, a contractual document that details the specific terms and covenants which must be observed. Self-liquidating purchases of inventory or the bridging of expenses pending the collection of accounts receivable are examples of uses for a line of credit.

- **Medium to long-term**
  These loans may be repaid over anywhere from one to five to even 20 years depending on how the funds are used. The source of repayment is the cashflow of the business. Typical uses are for equipment, fixed assets, etc. Most loans to start a small business will be of this type. Often referred to as term loans or installment loans, these usually cost more than short-term credit. The most common uses for long-term loans are to provide working capital, to purchase equipment, or to buy or improve land and/or buildings.

  - Working capital loans represent funding for all purposes that are not fixed assets or a line of credit. Examples could be general and administrative funds for expanding the business, a percentage of the purchase of permanent assets, the costs of building out leased space or for purchasing furniture, fixtures, or computer and automotive equipment. Banks usually require 20-30 percent cash as a down payment and will finance the balance for a period of five to seven years.

  - Loans for equipment generally will be extended for a term consistent with the depreciable values of the assets.

- **Real estate financing**
  Real estate is typically financed over a fairly long term, 10 to 30 years. Expect a down payment of about 20 percent.

- **Accounts receivable financing**
  Money loaned against accounts receivable pledged as collateral.

EQUITY FINANCING

In its most basic form, equity financing results in the repayment of principal and/or return only if the venture produces sufficient funds/revenues for that purpose; hence the term risk capital. Due to the risk(s), the possible capital sources could be anyone, anywhere, anytime depending on the amount, purpose, and stage of business at issue.

Equity financing will always require consideration of ownership, profit, benefit sharing, operational control, valuation, and exit strategies as important issues to be carefully evaluated. Although equity financing can cover a wide array of capital source types, there are, in general, several overall categories. The following summaries may help you in the equity search.

- **Your own savings**
- **Friends & relatives**
- **Venture capital/SBICs/Investment banking**

INTERNAL FINANCING

- ***Customers*** can be a source of temporary financing if they provide the raw materials or if they pay cash deposit. This is not feasible in most businesses.
- ***Trade Credit:*** Once you have obtained a good reputation with your suppliers you may be able to have credit for anywhere from 30 to 90 days. You may be able to order, receive and sell the goods before the bill is due.
- ***Profit:*** Hopefully you will earn enough profit to be able to invest in and expand your business.

LEASING

Leasing is simply another form of financing. Leasing reduces the cash needed up front, but like a loan you are obligated to the payment for a certain period of time. Some lease contracts give you ownership of the leased item at the end of the term for a specified amount. If your credit is less than perfect, leasing may still be an option. Leasing companies and manufacturers are sometimes less stringent with their lending practices because they are usually leasing equipment that can be easily repossessed. This might be a good option for vehicles, heavy equipment, computers, phone systems, etc.