Business Insights

Abstract

Entrepreneurs wear many hats, but finding and securing appropriate financing typically remains a major responsibility throughout the life cycle of their business ventures. Funding a startup is often a bootstrap undertaking, but financing needs may expand and become more complicated as the business grows, matures, and, ultimately, enters a period of decline. This guide takes a closer look at the types of financing typically available to businesses during various life cycle stages and what business owners can do to make themselves more attractive candidates to obtain it.

Life Cycle-Based Financing

Four Stages of Business Life Cycle

As every entrepreneur knows, or soon finds out, it takes money to make money. Business owners are constantly faced with the challenge of getting their products or services to market as quickly as possible in order to generate the cash flow that is the lifeblood of every commercial endeavor. The ultimate goal, of course, is a self-sustaining ecosystem producing a steady stream of profits to provide wages for business owners and their employees and to help support additional growth. However, it's the rare entrepreneur whose pockets are deep enough to finance a business entirely on his or her own. The vast majority of owners need access to financing at different points in their business's life cycle, and those needs tend to change over time, as does the owner's access to various types of financing.

Most business ventures follow a similar path when it comes to life cycle-based financing needs. In the startup and early stages, entrepreneurs face unique challenges as they juggle the simultaneous responsibilities of developing and launching their products or services, raising capital from investors, and establishing their brands. The growth stage raises a new set of challenges. Many companies find themselves booking robust sales at this point, but still struggling to generate the profits and cash flow required to finance inventory, receivables, and needed equipment and infrastructure. Client/customer bases and cash flow tend to stabilize during the maturity stage, but now a business may find itself stuck in a competitive marketplace with limited growth potential. Financing may be required for diversification, merger and acquisition, or for vertical integration activities. Finally, it's a fact of life that most businesses will enter a stage of decline at some point, due either to industry-wide changes or to factors unique to their own situation. At this point, they may need a capital infusion simply to keep the doors open, to divest themselves of product lines on the decline, to reorient into other lines of business, or to facilitate an exit strategy.

Startup/Early-Stage Financing

As entrepreneurs first set out to obtain financing for their business, the top challenge most face is convincing investors and banks that there is a market for the products or services they plan to sell. "You must be prepared to demonstrate how you will be competitive in a difficult marketplace," says Kirk Jacobson, Director of Business Banking Credit Risk at KeyBank. "Do you have a sound plan? Do you have credibility? The first financial challenge most entrepreneurs face is establishing credit lines with vendors and suppliers, as well as gaining credibility with potential lenders and/or investors. It's not enough to have a good idea. Lenders and investors want to know that you have industry experience, as well as some financial acumen or at least advisors that can assist."

Many first-time entrepreneurs start out believing startup funding is easily obtainable from venture capitalists or angel investors, but they are mistaken. "The plain reality is that 2% or less of businesses qualify for, and are successful at securing, venture capital funding," says Carolynn Duncan, an educator for the White House's Startup America initiative and CEO of Founder Training Center, which helps emerging entrepreneurs and business owners sharpen their business skills and reach early-stage revenue milestones.

Be careful making early decisions

Most businesses will need to rely on self-financing or independent revenue sources to get through the bootstrap and product/service-development

days, but how an owner chooses to self-finance can have repercussions later on, Duncan warns. "Most commonly, we see entrepreneurs get anxious about cash flow and then tackle financing in a reactive way (i.e., accepting capital from anyone who makes it available, racking up significant high-interest credit card debt, pouring personal savings or home equity funds into an unsuccessful or stagnant business model, accepting money from friends and family without clarifying expectations or providing written documentation about when and how the funds will be repaid)," she says.

It's important to note that Duncan is warning about the potential dangers of *how* these types of startup/early-stage financing are structured, not the vehicles themselves. In point of fact, home equity lines of credit, credit cards, personal savings, and small investments or loans from family and friends represent the most important and accessible sources of financing available to many entrepreneurs, but they must be structured properly and used wisely. Failure to think these strategies through, to document them thoroughly, and to implement them strategically can result in damaged relationships and a deterioration of your personal creditworthiness, which will be an important consideration when you later approach conventional lenders for additional financing.

Making Yourself More Attractive to Lenders

The first few years are typically the most difficult for a new business, but they are crucial to its long-term survival and success. While relying on nontraditional sources of funding during this period is common, businesses should still work at establishing relationships with conventional lenders, and there are steps they can take to make themselves more attractive as borrowers. "You need to plan ahead so that when the time comes to approach a conventional lender you can demonstrate that you have equity in the business," Jacobson says. "Banks want to see that entrepreneurs have their own money at risk — skin in the game, as the saying goes. Your business plan has to be thorough and must realistically address the marketplace. There are plenty of resources available to those starting a new business, such as the SBA's Small Business Development Centers and SCORE (a nonprofit network of 13,000-plus volunteers, mostly retired business executives, dedicated to helping new businesses get off the ground, grow, and achieve their goals), and you should leverage them to your advantage."

The best recipe for making your business an attractive candidate for conventional bank financing is a successful track record, says Michael C. Mazzarino, a partner in The SCA Group, LLC, which provides comprehensive board and management advisory services to companies ranging from small private startups to large public companies. In the current environment, that usually means a minimum of 18 months of continued profitability and generation of cash flow available to meet obligations when they come due and some reinvestment into the business where appropriate and necessary. "Two to three years is better, but some requirements may be relaxed if the owners have sufficient wealth or assets to offer a strong guarantee of the debt," he says.

Dot your i's, cross your t's, and don't give up

Demonstrating that your business is organized from both a management and information standpoint can help make it more attractive as a candidate for bank financing, Mazzarino adds. On the management side, that means having all the key managers responsible for running the business in place and introducing them to potential lenders. On the information side, it means having all financial and other relevant information packaged in an orderly, professional manner: a brief description of the business and its strategy, market, and operations; financial statements, cash flows, projections, and key metrics (sales, profitability, etc.); executive summaries of important aspects of the business; and biographies of key people.

"It makes sense to establish a relationship with a bank through your personal finances to create some history, but you should begin working on a business relationship as soon as possible," Jacobson says. "Begin a business depository relationship; perhaps use the bank's merchant services if they are relevant to your business's needs. That can help you build some history with the bank and get a grasp of how the bank operates, what online banking services it provides, etc. It's important for the bank to see you properly manage your business accounts, which includes avoiding overdrafts. It demonstrates that you handle things responsibly, are attentive to detail, and understand the importance of a bank relationship. These are all pluses when you apply for financing."

Growth- and Maturity-Stage Financing

Growth and maturity present a new set of challenges, including generation of sufficient cash flow to finance the working capital cycle, inventory, receivables, FF&E (furniture, fixtures, and equipment), and real estate, as well as the potential need to diversify into new lines of business or pursue new business combinations (mergers, acquisitions, vertical integration) to sustain growth in the face of competitive forces and/or a shrinking market. "This is when businesses become candidates for the core products and solutions that banks can supply, such as business lines of credit to finance receivables and inventory and their related cash cycles," Jacobson says. "Banks also offer term loans, lease financing for equipment and real estate, and a growing array of SBA products. Asset-based loans are another important option, especially for fast-growing companies with thin margins."

The best way to improve your standing as a candidate for these types of financing is to demonstrate a track record of consistent profitability and cash flow, Mazzarino says. "Let's face it, banks want to be repaid, and they are always ready to offer new capital as long as it's reasonable with respect to the financial strength of the borrower, and the borrower displays the ability to repay the loan," he says. Having a track record of several years of increasing revenues and a respectable profit performance also makes a business a more viable candidate for other sources of funding such as private equity and hedge funds. "The large caveat here is that most funds are looking for an equity investment, even if they also offer debt financing. Equity usually represents the highest cost of capital, so it just may not suit many owners' needs," he warns.

Decline-Stage Financing

When a business enters a period of decline, its financing options can become more limited, as might be expected, but an important consideration for lenders will be the cause of the decline. If the fundamentals of an industry sector are changing, requiring a divestiture of old product lines or a shift in focus, an otherwise viable business might have access to the same types of financing vehicles available to companies in the growth and maturity stages. Likewise, if capital is needed to make a business a more attractive acquisition target as part of the owner's exit strategy, financing might be available as long as the company's underlying fundamentals are solid. However, if the decline is the result of macroeconomic conditions or changing market conditions that expose an inherent weakness in a company's organization or basic operating principles, financing options are likely to be minimal, if they exist at all.

"Cash is king, and liquidity is the key to successfully navigating an economic downturn for most companies, as the recent recession illustrated," Jacobson says. "You have to plan ahead rather than wait for the next crisis to hit. You should have a contingency plan that addresses the potential loss of 20 or 30% of your sales. Liquidity is your first safety net in terms of both your personal and business finances. Banks are a regulated industry; before we can make a loan, we have to see that the cash flow exists to repay it. So being conservative does pay off, and it can make your business healthier when the economy comes out of a recession."

Conclusion

Securing financing for a business requires a high degree of preparation on the part of the owner. Jacobson suggests that entrepreneurs watch a few episodes of the reality TV show *Shark Tank* to get a taste of what might be expected from them when they go looking for money. "It really illustrates how challenging this can be and what types of questions potential lenders and investors are going to ask in order for you to prove that you are credible and a worthwhile risk," he says. "Many times on that show an entrepreneur has what seems like a great product or idea, but that doesn't mean they're going to get the capital they seek. Most often, that's because they fail to demonstrate the other qualities the show's experienced investors demand. That's a pretty accurate depiction of the real-world situation."

KeyBank is providing this brief overview to raise awareness concerning the changing economic landscape. The aforementioned represents the interpretations and comments of KeyBank and from sources believed to be reliable and represent the best current opinion on the subject. Before entering into any financing arrangement, please consult your own financial, tax, and legal advisors.

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