
FUNDING YOUR BUSINESS: A CASE STUDY¹

Sisters Tara and Laura Peterson had spent their entire adult lives working for other people. Tara worked in sales, and Laura in advertising. They often talked about someday going into business together. When Tara turned 40, she knew it was now or never. It didn't take long for her to convince her sister. After weeks of discussions, they decided to open a small gym. They had both spent a lot of time working out, and were sure their business expertise would enable them to deliver a better gym experience. Their business name came easily. Funding their startup was proving to be a lot more complex.

Tara had managed to put away some seed money while she worked in sales. She also purchased a 2-bedroom condo several years earlier that had increased in value. Then there was an IRA that she funded every year and that had grown steadily. To make things easier, Tara chose to keep her checking, savings, mortgage, and IRA accounts all at the same bank—where she was fairly well known and liked.

Laura, on the other hand, was more spender than saver. She rented her apartment and uses a collection of credit cards to maintain her affluent lifestyle. Her one real investment was a fully vested 401k from her company. Laura's bank of choice was the nearest ATM.

The Sisters knew they would have to secure funding to get their business off the ground. They decided they would apply for a joint business loan. Tara wanted to try her bank first, and she was quite certain Laura wouldn't object. Before applying for a loan, they both did some preliminary research on the number of families in the surrounding areas, they checked out other local gyms, and spoke to people in their gym community to get a better feel for the business issues, costs and metrics. They then put together a business plan that would demonstrate to prospective lenders that they had considered the business contingencies, and identified the key risks.

¹ This case study is meant for educational purposes only. All characters and information referenced are fictional.

When they were ready, they went to meet with Tara's banker. After reviewing their financials and credit scores, the news from the banker wasn't very positive. Laura's lack of assets and less than stellar credit score would limit the amount of money the Sisters could borrow.

There were other funding options that were available to them. Tara knew that she could take a second mortgage on her home and borrow against her life insurance policy. Even though the business would eventually pay her back, this meant that she'd be assuming more of the financial risk. Because they were Sisters, Tara didn't feel this would be a problem. Laura offered to take a loan against her company 401k, but there were limits to how much she could borrow. Using their credit cards wasn't an option as it would likely further impact Laura's credit score.

Before Tara and Laura could decide on the best way to fund their new business, they explored other financing avenues. Their tax accountant told them about commercial lenders and private equity investors that could potentially provide them with some of the funds they needed. However, the interest rates associated with these types of loans can be very high and difficult to pay back.

The two Sisters were at a crossroads. They knew they could obtain the funding to open their gym. They just weren't sure which approach made the best business sense for them. Complicating the Lauraer: they heard that a new gym would be opening soon, not far from their preferred location. They had to move quickly. Having finally settled on a realistic solution, the Sisters paid another visit to Tara's banker—this time feeling confident they would get a head start on their competition.

QUESTIONS

What did Tara and Laura do right and wrong in terms of qualifying for a loan?

What are the pros and cons of various forms of new business funding?

What approach would you recommend Tara and Laura take to fund their business idea?

FUNDING: ANSWER KEY

WHAT DID TARA AND LAURA DO RIGHT IN TRYING TO QUALIFY FOR A BUSINESS LOAN?

- **GET TO KNOW YOUR BANKER:** Tara built a relationship with the bankers at her local branch. Getting to know them helped her when she applied for her loan.
- **KNOW THE NUMBERS:** Business loans have terms and restrictions that may require you to meet or maintain certain operating parameters that could restrict profit, cash flow, or balance sheet ratios. Tara and Laura discovered some of the key ratios and business metrics, which they then built into their business plan.
- **SWEETEN THE DEAL:** Tara had all her banking, mortgage, and retirement accounts with the same bank. As a result, the bank may be willing to reward her with favorable rates and terms.
- **PLAN NOT TO FAIL:** Tara and Laura were able to demonstrate to their banker that they had thought through of all the contingencies and identified the business risks. A lender may also require the sisters to have a life insurance plan to show that they truly have thought through every eventuality and that the lender will be repaid no matter what.

WHAT ARE SOME OF THE THINGS THEY DID WRONG?

- **CREDIT CARD DEBT:** Laura was supplementing her income with credit cards and carrying high balances. This lowered her credit score and limited her ability to qualify for a business loan.
- **KNOW YOUR CREDIT SCORE:** Tara and Laura should have learned their credit scores before going to the banker. They would have discovered that Laura's low credit score would hinder them. Laura could have paid down some credit card debt before she applied for a loan.
- **THE BOTTOM LINE:** The sisters didn't seem to know if the income the gym would generate in the short term would service the debt they would have. The risk is that they may not have been able to cover their other business expenses.

WHAT ARE THE PROS AND CONS OF VARIOUS FORMS OF NEW BUSINESS FUNDING?

- **DO-IT-YOURSELF:** Investing your personal funds in your business shows lenders that you've taken a risk alongside of them. But, invest your savings carefully. Talk to a financial advisor before you take out a second mortgage on your home as there may be better options. And, remember to pay yourself back.
- **EQUITY:** Equity investors (a private equity firm or angel investor) offer funding for your business in return for a certain percentage of ownership in your company. It can be attractive as the risk is shared, but equity investors will expect a rate of return high enough to make it worth their while -- meaning it can be expensive for you when they cash out.
- **DEBT:** Loans, which must be paid back, are a common form of financing. However, in a tight credit market, loans become more difficult to obtain as bankers become more risk-averse. If you're experiencing rapid growth, you may need help from a commercial finance company. Though they have fewer restrictions than a traditional bank, these lenders still look for hard assets to use as collateral or enough cash flow to make debt payments. Examples include asset-based loans, mezzanine debt, or subordinated loans. (See Finance Article provided in your monthly materials for information on these forms of financing.)

WHAT APPROACH DO YOU THINK TARA AND LAURA SHOULD TAKE TO FUND THEIR BUSINESS? DISCUSS THE PROS AND CONS

- Second Mortgage or Home Equity Loan
- Life Insurance Cash Value, 401ks and IRAs
- Secured Bank Loan vs. Private Equity Investors
- Loans from Family and Friends

What could the possible outcome be from each type of business funding?

By taking a second loan against her condo, what risks could Tara be taking in carrying a larger share of the business debt than her sister?

KEY TAKEAWAY

Before you can obtain funding for a new or growing business, you should conduct a thorough analysis of your personal and business assets, determine your credit score—trying to improve it, if necessary—and identify the key metrics, income potential, and risks associated with the business. While there are several sources of funding available to a business owner—from personal assets, to commercial and government loans—they each have their own pros and cons. However you proceed, it's imperative that your business earnings cover your debt payments without draining your business.

ADDITIONAL TOOLS & RESOURCES

SCORE: Counselors to America's Small Business:
www.score.org/financing_your_business.html

OPENforum:
www.openforum.com/financetips

Make Mine A Million \$ Business:
www.makemineamillion.org