



Excerpted from
FastTrac® TechVenture™



TAKE CHARGE OF YOUR BUSINESS®

A program of the Kauffman Foundation

Debt Financing

Debt financing takes many forms. The essence of debt is that the borrower must repay the funds along with agreed-upon service charges such as interest and loan origination fees. If the money is not repaid as promised, the lender can start collection proceedings. This process can become very uncomfortable for the entrepreneur, who could stand to lose the business and any non-business assets pledged to secure the loan.

Seeking financing from an outside lender can be difficult. The process is made easier when the entrepreneur understands the lender's concerns. Lenders want to loan money to businesses that will provide a good return. They also want to do business with companies that pose little risk, which is why many technology and life science companies are not able to raise debt financing until they are down the road considerably.

Money should not be borrowed lightly. The borrower assumes a serious obligation. It is a basic lesson of finance that money should not be borrowed unless those funds will earn in excess of their cost. It is also important to consider that banks expect two forms of repayment, and entrepreneurs rarely have more than one.

Examples of debt include numerous types of loans:

- SBA-backed loans
- Long-term loans
- Line of credit
- Real estate loans
- Loans from friends or family

The first three types of loans are examined in more detail below.

SBA-Backed Loans

The Small Business Administration has a variety of guaranteed loans. They have programs for both start-ups and existing companies; for working capital, inventory, and equipment; for minority- or women-owned businesses; and for loans in the nature of lines of credit. The SBA does not make the loans, banks do, but because the SBA guarantees a portion of the loan, the bank's risk is lessened.

Entrepreneurs who might otherwise be unable to find a bank willing to make the loan may be able to obtain an SBA-guaranteed one. The entrepreneur should seek out banks that are not just SBA-certified lenders but those that are actively seeking to make SBA loans. SBA loan interest rates are generally slightly higher than conventional loans, but if they are the only available source of funds, they should not be dismissed simply for the additional costs.

Tip Debt financing does not dilute the stockholders' ownership share.

Reality Check ✓

Borrowing money is like placing a bet. The entrepreneur uses the company to bet with the lender that he will be able to perform according to plans. If the plans are wrong, an entrepreneur can lose his company and anything else he has invested.

Reality Check ✓

To request an SBA-backed loan, entrepreneurs with at least 20 percent ownership in a company must submit personal financial statements during the application process and personally guarantee that the funds will be repaid.

Long-Term Loans

A long-term loan usually has a payback period between one and five years. Depending upon the deal negotiated, these loans are normally secured (collateralized by assets) and guaranteed by the entrepreneurs. Rates and terms on long-term loans vary greatly based on the lending institution's policies and the business's age and financial status.

Collateral (personal assets) is pledged by the entrepreneur to offset the loss to the lender should the entrepreneur default on the loan. If a borrower fails to meet the terms of a secured note, the lender takes possession of whatever asset was pledged as collateral and sells it. The proceeds of the sale are then applied to the amount due on the note. The loss of collateral will not release the borrower from all liability on the debt if the collateral sale proceeds are not enough to pay off the loan and the lender's costs of retaking and selling the collateral. If the sale of the collateral is insufficient to repay the debt, the lender may then look to the guarantee provided by the entrepreneur for the remaining unpaid balance.

Long-Term Loan

One entrepreneur borrowed \$20,000 from the bank, using his company's injection-molding machine for security. After several months, he realized that he couldn't repay the loan, so he stopped making payments. The bank went to court and proved that the note was legal and the entrepreneur was in default. The bank received a legal document from the court that allowed the sheriff to take possession of the molding machine. When the molding machine was sold, it only brought \$5,000, some of which went to the lender and some to the attorney. The entrepreneur still owes the lender \$15,000 in interest, legal fees, and court costs. This costly loan could have been avoided if the entrepreneur had done cash flow projections to determine the business's ability to repay the loan.

From Real
Entrepreneurs 

Line of Credit

When a line of credit is awarded to a business, the funds can be drawn upon whenever needed. Lines of credit are usually only available to entrepreneurs after they have raised equity capital as leveraging funds. Certain venture banks offer lines of credit to companies who have recently secured a round of equity capital. This type of funding is appropriate to cover seasonal fluctuations in sales or regular cash shortages. The amount and terms of the line of credit are determined in advance based on the needs of the business and the policies of the lending institution.

In most cases, lines of credit are due to be paid within a year. Other policies may be imposed, such as not using the line of credit for two months after the balance has been paid. The rate will vary based on the institution and the business. In general, the rate for established companies is often one or two points over the prime rate, slightly higher for new businesses.

Tip Be sure you understand all the terms and conditions of the line of credit. Some banks require that the line of credit balance be paid down to zero at least once each year. Other banks will keep renewing the note without payment other than interest.