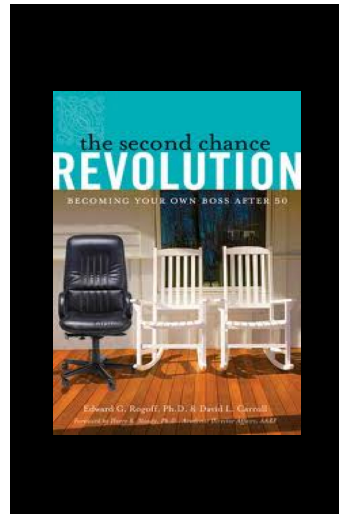
HOW SHOULD I FINANCE MY BUSINESS VENTURE?

Approximately ninety percent of businesses start with financial investments from entrepreneurs themselves. Most invest by providing collateral, using credit cards, and/or taking out personal loans. Other options include:

Venture Capital :" In most cases, venture capital firms are most comfortable investing several million dollars or more in large private companies that have strong probabilities for growth"



WAYS TO FINANCE A BUSINESS AFTER FIFTY

THE MONEY ISSUE

THE "WHERE WILL I FIND THE DOLLARS AND CENTS TO LAUNCH THIS NEW BUSINESS OF MINE?" QUESTION.

EVERY ASPECT OF A NEW BUSINESS REVOLVES AROUND THE FUNDING CHALLENGE. It's the literal and figurative bottom line. Happily, many studies show that career veterans in their fifties and older are more financially established *and* more economically savvy than their younger competition. As a result, banks and lending institutions are usually friendlier to their loan applications.

But not always.

It's a question of determining the best money sources to tap, knowing the ones you shouldn't waste your time on, and understanding the ground rules for the borrowing game in general.

IN THIS CHAPTER, WE WILL PRESENT AN INSIDER'S TOUR OF THE COMPLEX MECHANICS OF LOAN DECISION-MAKING FOR SMALL BUSINESSES.

CREDIT HISTORY, CREDIT SCORES, PERSONAL CHARACTER ASSESSMENT, PLUS PERSONAL GUARANTEES AND GOVERNMENT LOAN GUARANTEES ARE ALL DISCUSSED.

We also provide you with methods for determining the risk factors involved in potential businesses. We'll show you how to manage your credit information, and how to access powerful resources at the library or on the Internet.

Finally, we'll examine both conventional and unconventional ways of raising seed money for a business. Included are:

- Credit cards—Should you even consider using a credit card to finance a business if you are over fifty? Many people do. But with what results?
- Equity lines of credit
- Refinancing your home's mortgage—We'll show you how to figure the risks.
- Pension money, savings, IRAs—How safe is this? How sound? In what situations should you never dip into personal capital?
- Personal loans from family and friends—Anticipate both the best and the worst on this slippery slope. We provide advice for setting up win-win personal loans.

- Loans from business associates and business connections—You'll need to polish up your persuasive powers if you go this route and perhaps prepare a business plan.
- Angel investors—There are numerous web-based matching services that link up entrepreneurs with independent investors. You are, however, more likely to find the angel of your dreams in a proven professional relationship, such as with a personal accountant or a lawyer who handles your legal dealings. We'll tell you all the best places to seek and find investors.
- Small business grant loans—These are available through several state agencies. There are also private organizations that specialize in business loans for people over sixty. We'll help you find out if you qualify.
- Large companies—Almost impossible if you go in cold. However, if you have an address book full of customers and colleagues you've worked with in the past, and if you are creating a product that suits their needs, they may just be interested.

For the majority of fifty-plus entrepreneurs, high-profile funding sources like venture capital firms or going public are simply not viable options. More realistically, borrowers will find the money they need at banks and institutions or from private lenders.

Banks and independent funding sources do not, of course, lend money to people because they are brave, clean, loyal, and reverent. They lend money because they believe these people can repay said loan—with interest.

This decision, in turn, depends on a strong credit score, a positive business history, and money in the bank. It also depends on clients presenting a lender with a clear, reasonable, and well-thought-out business plan.

GOOD BUSINESS PLANS ATTRACT MONEY

After good credit and proof of personal assets, the most important tool you'll need for acquiring a loan is a strong business plan.

WHAT MAKES A BUSINESS PLAN STRONG?

It would take a book longer than this one you're reading to spell it all out. To give you a nutshell idea, however, it can be said that a strong business plan addresses a potential lender's doubts and goals, and it anticipates and answers a lender's questions before they're asked. Also, using the most relevant facts and figures, it demonstrates in clear, persuasive terms how and why your business will succeed.

A strong business plan must address the specific needs of the lender, whether these needs are evidence of the reasonableness of a business concept, a pledge of prompt payments, proof of financial stability, a guarantee of long-term profits, or simply assurances to a family member who wants you to pursue your dream.

Paula Hornbeck offers a good example of an entrepreneur who used the process of writing a strong business plan as a way to come to terms with the kinds of financing issues that affect people over fifty.

Paula worked for thirty years as a manager of optometrist, optician, and ophthalmologist offices in the Milwaukee area. When it came to the eyeglass business, she had seen it all (no pun intended). In fact, Paula understood so much about the eyeglass world that she often perceived opportunities for improvement that her bosses failed to notice. When she made her suggestions, however, she hit a brick wall. “I got tired of putting good ideas in front of my bosses’ noses, only to be shot down every time,” she said.

Finally, Paula decided that if she wanted to exploit her business brainstorms and reap the financial rewards, she would have to go entrepreneurial.

As it turned out, Paula had recently married, and her husband, a chemist, was supportive, promising to help her crunch numbers for the business plan. “Even when I saw big problems,” Paula said, “my husband kept saying, ‘So, why don’t you just do it anyway?’”

With her husband’s encouragement, Paula signed up for a class in writing business plans at a local college. She soon discovered there was much to learn. “The class started with fifteen people. Only two of us finished.”

When she finally wrote her business plan, Paula made it clear to investors that her store would stand out from the others. How? By selling smart, high-design eyeglasses that were unavailable from other stores in the Milwaukee area.

She also told potential investors that her store would provide a fun experience for its clients, and that she intended to exploit the selling power of her glamorous products with a glitzy store design. She also included a number of nitty-gritty business elements in the plan: her intended location, construction fees, a thorough breakdown of rents and salaries, a budget for a designer and a contractor, and an estimate of overall costs.

Paula and her husband had a hefty amount of savings socked away, plus plenty of equity in their home. Her husband also earned a good income. They had no desire to cash in their retirement accounts, nor did they want sell their house, borrow from friends, or take on partners. Most importantly, they wanted to maintain their lifestyle and to fully own the business themselves.

Paula's business plan eventually convinced a local bank to lend her $200,000 secured by a personal guarantee. Paula and her husband also took $10,000 from their personal savings.

This was a *canny solution that covered lots of bases, but it was not without risk.*

***A personal guarantee** means that if you default on a loan the bank can seize your private assets and sell them. Paula's house and personal savings were now at risk.*

At the age of fifty-two, Paula Hornbeck opened her store, Eye Candy Eyewear, in Delafield, Wisconsin. By the third month, she had passed the break-even point. Two years later, working seven days a week, ten–twelve hours a day, she was making a good profit, and loving her business more than ever. The formula for her success was found by mixing thirty years of work experience with a supportive family, a good case, not all of these stages apply, but many still do. If you are a fifty-plus entrepreneur, keep in of financing.

TWO TYPES OF BASIC FUNDING YOU SHOULD KNOW ABOUT

Debt funding—Debt is an agreement to borrow money and to pay it back on a fixed schedule.

Typically, the repayment plan for a debt includes both interest and principle, principle being the original amount of the loan. In our example, the $200,000 borrowed by Paula represents her principle. Common types of debt include loans, mortgages, lines of credit, borrowing against receivables (i.e., money, goods, or services owed by a customer), and leases.

All professional lenders, be they banks, institutions, *or private sources, are avidly concerned with reducing risk of nonrepayment. They therefore require that collateral be put up by a borrower—that is, private assets* that a bank can seize and sell if a borrower defaults. Collateral can *take the form of equipment, buildings, company stocks, and real estate, including a person's home. Debt with* collateral is called "secured debt" and is often required for new ventures.

As a borrower develops a track record for being a successful businessperson and making loan payments on time, lenders become more comfortable increasing the size of their loans and reducing the amount of collateral necessary to secure it. In this regard, many fifty-plus entrepreneurs have an advantage on their side. Older businesspersons tend to have more money *in the bank than their younger counterparts. They also have more material assets usable for collateral, and more of a borrowing/repayment history at banks and institutions.*

Equity funding—Equity investment grants ownership in a business. It can take the form of stock in a corporation or shares in a partnership. The $10,000 that Paula Hornbeck and her husband invested in their store represents their equity investment.

When investors buy equity, the entrepreneur promises to give them a share of the profits from business operations or from the eventual sale of the company.

Some hardball equity investors require control of the companies they invest in and may demand at least fifty-one person of the stock. Others are content to be minority shareholders without control.

In either case, stock sales in private companies usually involve a contract specifying the precise terms of the investment and the rights of the shareholders. These rights can vary greatly but often include an option to buy more shares or to force the company to buy back the stock within a certain time at a preset price. Creating ***a shareholders' agreement requires an experienced*** lawyer who specializes in this area of business law.

DECIDING ON THE BALANCE BETWEEN DEBT AND EQUITY

Whether debt or equity is preferable for your particular entrepreneurial adventure depends on how much of each your venture can sustain.

Because debt requires that interest and principle be paid on a fixed schedule and that it be paid right now—say, the beginning of each month—from the start, your company will be forced to generate enough cash to feed the hungry beast. These mandated payments reduce a company's financial flexibility, yes. But because debt is the least expensive form of financing, usually below ten percent in annual interest, most businesses seek as much of it as they can find. This is why Paula used twenty times more debt than equity to finance her store.

Equity investment, on the other hand, does not require fixed, scheduled payments. This arrangement provides a company with far greater financial flexibility. But it comes at a cost. Because equity investors do not receive financial returns until their debt is paid, they assume greater risk and uncertainty. Ergo, they expect much higher returns in the long run, often at levels two or three times the interest rate on debt. This is why equity investors so often gain control over a company through ownership of shares—often a majority of its shares.

The balance of debt and equity also depends on the track record of the entrepreneur, including business and personal collateral. Remember that Paula was obliged to provide a personal guarantee in order to receive her bank loan. This guarantee meant she had to offer her personal assets as collateral.

In general, investors are most swayed by the attractiveness of the business the entrepreneur is proposing, and by the presence of a clear exit strategy. Example: In a given business plan it states that if the company fails, it will be sold, thus providing lenders with profits despite the fact that the entrepreneur has gone belly-up.

One important question that all fifty-plus entrepreneurs must ask themselves is: "How much should I invest?"

There is no right answer to this question. The tradeoff, as with most financial questions, is one of risk versus reward.

You may, for example, invest as little as possible in a new business to reduce your financial risk (or because you don't have enough money to invest). But this tactic also reduces your share of any eventual profits. On the other hand, you may feel so positive about your company's prospects that you are willing to invest the most money possible. The next section on sources of financing shows that the answer to the risk-versus-reward question involves both a financial and a personal decision.

POTENTIAL WAYS TO FINANCE YOUR NEW BUSINESS

1. The Entrepreneur

Approximately ninety percent of businesses start with financial investments contributed by the entrepreneurs themselves. Most invest by providing collateral, using credit cards, and/or taking out personal loans.

Now it should be said that no matter how much confidence you may have in the likelihood of success for your new business, the reality is that many new businesses fail. You must, therefore, do some serious soul searching.

Are you prepared to sell your house, empty your savings, give up your retirement account, or file for personal bankruptcy in case things don't work out as planned?

And going into credit card debt to finance a business is a step that must be considered very, very carefully, for obvious reasons. A twenty-two-percent monthly interest rate is no bargain on anybody's books. Moreover, if you are just one day late on your monthly payment, you can sit back and watch your interest rates zip up to over thirty percent in some instances.

Also, have you calculated the interest payment you'll be making on, say, a $9,500 credit card balance at, say, twenty-four percent? Don't even bother. It's a lot of money; so much, in fact, that you'll have to work twenty-four hours a day at your new job simply to pay your tab to Mother Visa/MasterCard and Father American Express.

Many independent fifty-plus entrepreneurs, it should be mentioned, see their venture as just one part of their already established financial situation. They may intend to start the business on a part-time basis, operating other businesses at the same time and opening new ventures when the time is ripe. They may also be focused on a relatively short-term strategy for their businesses, including building it and selling it within a few years.

Many entrepreneurs in this category adopt the "O.P.M." strategy—Other People's Money. They prefer risking as little of their own financial resources as possible while maintaining the flexibility to undertake other ventures. Others see their ventures as a long-term undertaking that they want to control completely without giving half or more to their backers. For the latter group, focusing on the financing they can procure at the lowest possible rate is the best strategy.

2. Family and Friends

Relatives and close friends are a common source of financing for entrepreneurial ventures. Usually their agendas are more personal than financial. They want to help you succeed.

Some would like to share in your success, and they may see investing in your business as an opportunity to get in on the ground floor. But such goals are usually secondary. Family and friends make good investors for several reasons. They are accessible. You can use your personal relationship with them to encourage their investment. The interest rates they offer, if any, are rarely cutthroat. And if you do get into trouble, most relatives will cut you slack on the monthly payback schedule.

The negative is that if the business fails you must now deal with the "Thanksgiving factor," meaning that during holidays you will be seeing Uncle Martin and Aunt Edith sneering at you across the table. The guilt, oh, the guilt! It was their last $100,000! Can you look them in the eye? Can you ever make things right again?

An early middle-aged entrepreneur named Randy who we met at the entrepreneurial center in Baruch College started a moving company with investments from his parents and father-in-law. On paper it was a good idea. But Randy soon saw the business fail despite all his efforts when the city where he established his company underwent a sudden downturn in the economy.

Randy's parents treated the investment simply as a gift. They told him they thought he had done the best possible job, and that they would invest again if he wanted to start another business. Across the metaphoric Thanksgiving table, however, Randy's father-in-law could never come to terms with his financial loss, and he angrily raised the issue every time they met. Soon, they were barely on speaking terms.

There are several important lessons here. First, be selective about whom you ask for money in the family. Second, be sure to warn your investors of the real financial risks they are taking, and give them every opportunity to say "no." Third, be prepared for long-term negative consequences if your endeavor fails—this is a definite possibility, no matter how thoroughly family investors may have been warned in advance. Nothing ruins relationships, even deep, loving relationships, faster than misunderstandings over money.

All these caveats notwithstanding, family and friends remain a strong potential funding source for most entrepreneurs.

3. Angel Investors

Angels are wealthy individuals who invest directly in businesses.

Although there are numerous web-based matching services that put potential entrepreneurs in touch with these sources, you are more likely to find one of these heavenly beings through an established personal or business relationship—i.e., via an accountant, perhaps, or a lawyer who handles your business affairs.

Angel investors tend to focus on industries with which they are familiar and with which they have had financial success in the past. Most know the risks involved in investing in a startup or relatively new business. As a result, they tend to expect high returns for their investment. Some will ask for a seat on your board of directors or for an option to purchase enough stock to control the company.

Making a deal with an angel is a bit like getting married. It requires careful thought before the actual commitment is made.

Angel investors who have experience in your industry often have strong ideas about how your business should be run. Unless these ideas closely match your own, this particular marriage may not be the best route. Moreover, when it comes to making deals and talking money, angel investors can be tough, experienced negotiators. They know how important obtaining financing is for you because many have been in the same position. So be prepared for potentially long and complex discussions. Having a lawyer or business consultant by your side during these sessions can be helpful.

4. Venture Capital

Venture capital firms are generally large, professionally managed funds that invest money that originates from pension funds, large corporations, and/or wealthy individuals. Many are organized as Small Business Investment Corporations (SBICs). This position enables them to obtain Small Business Administration (SBA) guarantees on part of the investments they make in ventures.

Many entrepreneurs think that venture capital is a serious option for them, but in reality, venture capital is a relatively small and highly specialized source of funding. Even in peak years, the venture capital industry makes fewer than 10,000 investments. In most cases, venture capital firms are most comfortable investing several million dollars or more in large private companies that have strong probabilities for growth. Likewise, they prefer to invest in businesses that offer a clear and profitable exit strategy if the company is sold, goes public, or merges with another company. Despite having invested heavily in startups during the dot.com boom, venture capital firms today rarely invest in new businesses.

Another point to note is that when venture capital firms invest in a company, they usually exert as much control over the company as possible. This control gives them many angles of leverage. They can decide what type of financing to obtain. They can decide when and if to sell the business. When push comes to shove, they even have the right to fire the entrepreneur who founded the business in the first place.

When an entrepreneur and a venture capital firm share the same financial agenda, things generally work well. When their goals are different, conflict usually follows. The entrepreneur may feel that the venture capitalists don't have confidence in the long-run prospects of the company, and the venture capitalists may think that making money is not the entrepreneur's main objective.

5. Corporations

Occasionally, corporations will make direct investments in outside ventures. This situation takes place most frequently in technology industries when a large company such as Intel, for example, invests in a small company that is developing a product Intel desperately needs.

Corporate investments of this type are relatively rare, and almost always carry with them an agreement to sell the company to the corporate investor at some time in the future.

It only makes sense, therefore, to consider corporate investors if you have personal contacts at a specific company, if you know for certain that your product is uniquely useful and desirable to that company, and if you feel comfortable with the prospect of losing your independence and becoming at some point a division of the corporation that invests in you.

6. Banks

Banks usually focus on the financial record and strength of each individual entrepreneur.

In the example of Paula Hornbeck's eyeglass store, the bank exploited Paula's personal financial strength in the form of the personal guarantee that she and her husband provided before they approved the loan. Banks will also look at an entrepreneur's business record, reputation in the industry, and credit score (which is discussed later in this chapter in the section called "How Banks and Other Lenders Decide on Loans").

Banks usually insist that the owner of startup companies back up his or her loans with some form of collateral. Entrepreneurs may be asked to sign a personal guarantee, for instance, or to put up personal assets, including their home. If a company already has a strong record of good credit and high profitability—an unlikely situation in any entrepreneurial startup—or if the company's business assets exceed the amount needed to secure the loan, this personal risk can occasionally be avoided. But this is seldom the case.

Banks tend to be "formula lenders." One formula may, for example, demand a certain percentage of business assets. Others may ask for a multiple of the cash balances that the company maintains in the bank, a multiple of profits, or a multiple of revenue.

Then again, the formula can take the form of a lease. This option is especially attractive to new companies that need heavy-duty equipment and vehicles but that do not have the capital to purchase them.

In a typical lease, the financing firm (usually a bank, but sometimes a commercial leasing or credit company) maintains ownership of the equipment until the lease is fully paid off. If the lease falls into arrears, the leasing company reclaims the equipment. Since the amount of money that changes hands in a lease is relatively small and is extended over a period of time, leases tend to be easier to obtain for entrepreneurs than business loans.

Banks and their rigid lending guidelines frustrate many fifty -plus entrepreneurs. They feel that banks do not “get” the unique financial opportunities their business idea offers, or that the bank’s ironclad policies put the kibosh on any real negotiating give and take. What’s more, trying to change a particular bank’s guidelines is a more or less futile enterprise. A star chamber of senior bank officers set these guidelines. A prospective borrower rarely has access to these individuals, and often the loan officers themselves don’t know these Star Chamber members’ names.

But take heart. Not all banks are the same. Some maintain harsh, unbendable lending policies. Others are more willing to negotiate. A few negotiate a lot. The challenge is to find the reasonable lending organizations and to avoid the inflexible ones. So, shop around. Talk to loan officers at as many banks as possible.

Weigh the assets and liabilities of each. Get expert financial advice if it is available. Then take the best deal that comes your way.

7. Going Public

For most businesses, reaching a position that allows one to go public is the equivalent of winning the lottery.

Look at the numbers. There are more than 10 million businesses in the United States. Only 17,000 are public companies. Of these, 2,800 are traded on the New York Stock Exchange, and 3,300 are traded on the NASDAQ exchange. To be a candidate for a public offering, a company needs around $20 million in annual revenue, plus they must be part of an industry—such as biotechnology or satellite communications—on which Wall Street is currently bullish.

It is, of course, true that during the dot.com boom, many companies with little more than a cute logo were sold to the public. Historically speaking though, that period was an anomaly, and it is now as faint a memory as is much of the money that was so lavishly invested in these soon-to-burst bubbles.

A public company runs on entirely different principles than a private company. Every quarter a public company's performance is held up to the bright light of Wall Street scrutiny. It is the subject of extensive reporting and regulatory requirements and is generally visible to its industry and its competitors.

Public companies, in short, are a world of finance and complexity above the typical entrepreneurial startup. They represent, as it were, the end rather than the beginning of any successful independent business venture. They are definitely not a viable alternative for those who are just starting in any given business.

CHARACTERISTICS OF VARIOUS FUNDING SOURCES

Financing Source	Requires Current Payments?	Requires Share of Profits?	Wants Operating Control?	Cost of Capital
Entrepreneur	No	Yes	Yes	High
Family and Friends	Probably Not	Probably Yes	No	Low
Angel Investors	No	Yes	Input on operations but probably not control	High
Venture Capital	No	Yes	Yes	High
Corporations	Probably Not	No	Eventually, through buyout	High
Banks	Yes	No	No	Low
Public Investors after company goes public	No	Yes	No	Low

ESTIMATING YOUR COMPANY'S VALUE

Many people, including potential investors, will ask you: "What is your business currently worth?" or a variation on the theme: "How much will your business be worth in the future?"

Experienced entrepreneurs reply that their company's value is worth whatever an interested buyer will pay for it. And this is true enough. But business valuations, truth be told, are based mainly on approaches and theories that fit the goals of the purchaser, not the seller. Indeed, investors and lenders will want to know where they stand if the company is sold, or if the company is suddenly shut down. Which means, in turn, that the business plan you use to gain financial backing should include estimates of your company's worth for every year of financial projections that you provide. Typical financial methods of calculating a company's value include the following:

- **Discounted Cash Flow**—This approach relies on estimating profits for the next ten or fifteen years, then calculating the current cash equivalent of this stream of cash inflows (profits) and outflows (investment and losses).

- **Asset-Based**—This method focuses on the value of your company's assets, whether they are physical assets such as real estate and equipment, or nonmaterial assets such as patents, customer lists, customer relationships, brand names, and contracts. Lenders will often ask a business to calculate their book value, which is a company's total assets less total liabilities—two numbers that can be found in the financial statements on any good balance sheet. Since assets are likely to have changed in their actual value since they were first recorded on the company's balance sheet, an adjusted book value is sometimes created that is based on the current market value of the company's assets.

• **Replacement Value**—The value of a business can be based on the amount of money it would cost to duplicate that business. For example, replacement value can be applied to a research firm with a strong team of scientists and unique technical systems; or to a restaurant with a well-known name, a good location, and a long-term lease.

• **Liquidation Value**—Liquidation value represents the amount of money a company would produce if it were quickly put up for sale. Liquidation value can include the value of accounts, databases, inventory, physical assets, contracts, leases, and/or the amount of money another company or competitor might pay to purchase the business. The calculation of liquidation value should account for the costs related to these sales, such as commissions, legal fees, moving expenses, and penalties on leases or contracts.

• **Revenue- or Profit-Based**—Some industries such as real estate, retail businesses, or the media industry, have relatively well-accepted guidelines for estimating value based on revenue or profits. It is not unusual, for instance, for retail businesses to sell for one or two times their annual revenue. Or for real estate to sell for ten–twenty times profits. Public companies are generally valued at a multiple of their earnings, called the price/earnings ratio. Public companies' shares generally sell in the range of ten–thirty times the earnings per share.

• **Cash Flow/EBITDA-Based**—Private companies are often valued at a multiple of cash flow, which in acronym form, EBITDA, stands for Earnings Before Interest, Taxes, Depreciation, and Amortization. This measuring device informs a prospective purchaser of how much cash a company is producing from its operations. And since new owners are not likely to assume the acquired company's outstanding loans, interest and principal payments (amortization) are likely to change after the sale. Depreciation is not a cash item, moreover, so it will reduce profitability on the bottom line of the accounting statements but will not have an impact on the amount of cash a company is generating. Taxes are similarly specific to an ownership situation, and to the amount of interest a company is paying. Using EBITDA is a good way to value a private company. It allows prospective owners to decide on the amount and type of financing to obtain, and helps them calculate what their new tax situation will be. Private companies generally sell in the range of three–ten times cash flow or EBITDA.

CREATING FINANCIAL MODELS

Because your projections represent the heart of the business plan you show to potential funding sources, it is critical that you work with a high quality financial model that combines all the financial aspects of your venture into one. Financial models are usually produced via a spreadsheet program that allows numbers to be linked. In this way, a change made to one figure automatically generates changes to projected statements and analyses.

Creating a model from scratch is an excellent exercise. It forces you to consider all the financial assumptions in your business plan. It also shows you how well—or poorly—the model works, allowing you to make changes where appropriate. There are several readily available spreadsheet tools that can help in this regard:

- www.bankablebusinessplans.com has many resources, including sample spreadsheets you can review and download.
- One of the best spreadsheet models is Active Ventures produced by the Columbus Enterprise Development Corporation. It is comprehensive, all the tables are linked, and it is free. It is available at: www.cedcorp.com.

- An easy-to-use financial projection model is available on the Missouri SBDC website: (http://www.missouribusiness.net). Produced by Aldis Jakubovskis, this model is simple, yet it clearly shows which assumptions have to be entered. It also produces completed projected statements based on these assumptions.

- Commerce Clearing House (CCH) has a very useful site for entrepreneurs at www.toolkit.cch.com. It has model spreadsheets, as well as useful and up-to-date tax-planning tools.
- Many quality sample business plans are available on websites for business plan competitions such as the MOOT Corp. competition at the University of Texas, at www.businessplan.org.
- Excel templates are available with the CD that accompanies the MBA's Guide to Microsoft Excel 2002 by Stephen L. Nelson, published by Redmond Technology Press.

If you intend to build your financial model from scratch, or to modify an existing one, there are several helpful guidelines to follow:

- Examine your finished model in detail. It is not sufficient to review the model to see if it "looks" correct. Test it by proofreading carefully and by checking all spreadsheet cell references and formulas.
- Test the model by making changes to assumptions and checking to see if these changes flow through the rest of the model.
- Compare the model to others from similar companies to ensure that it uses standard industry categories.

- Have accountants, financial professionals, or people with industry experience review the model.

HOW BANKS AND OTHER LENDERS DECIDE ON LOANS

Every time banks, equipment leasing companies, commercial credit companies, and credit card companies make a loan, they assume a risk that they will not be paid back. They manage this gamble in a number of ways:

1. *By lending to low-risk people whom they deem creditworthy;*
2. *By lending less than the customer is requesting;*
3. *By exacting a guarantee from a third party whom they judge to be creditworthy;*
4. *By charging higher interest rates and fees to compensate for accepting the risk;*
5. *By obtaining collateral to seize and sell if the loan is not paid back; and, most often,*
6. *By not lending at all.*

What's more, loan decisions at a lending or business institution are made on the grounds of personal factors, including all of the following:

- **Credit history**—In this electronic age, lending sources can instantly evaluate how quickly you have paid your bills and how thoroughly you have fulfilled your obligations to banks and other financial companies.

Information on late payments, delinquent loans, and bankruptcies, as well as how much credit has been extended to you in the past by banks, credit card companies, department stores, and credit bureaus is readily available to potential financial sources at the touch of a few computer keys.

• **Character**—A loan decision will often come down to a personal evaluation of the borrower made by one or more loan officers. Sometimes financing may be denied to people with stellar credit histories because the loan officer's sixth sense is triggered. At other times—though rarely—lenders will grant loans to entrepreneurs of exemplary character who show very low credit scores or even bankruptcies in their past. A loan made to a person with low credit worthiness is called a "character loan." A bank may make such a character loan to meet its internal guidelines for lending within certain geographic areas or because the bank is truly impressed with the novice entrepreneur.

• **Collateral**—Houses financed by them collateralize mortgages. The equipment being leased collateralizes the lease. Collateral assures banks they will be paid back if loan payments are in arrears or if the business defaults on the loan. Most lending sources require existing collateral, such as an entrepreneur's house, securities, or other assets, before they will grant a small business loan.

• **Personal guarantee**—Lending sources go to great lengths to make sure that entrepreneurs are liable for their loans. Personal guarantees provide this assurance. If you own a home with significant equity value, or if you maintain a large savings or investment account, giving the bank a personal guarantee on these items will make the officers very happy—just as it should make you very nervous.

• **Government loan guarantees**—Federal agencies, such as the Small Business Administration (SBA) and various state programs help banks say "yes" to loans by agreeing to guarantee repayment of some portion of the loan in case of default, ranging between fifty percent and ninety percent. While these government loan guarantees carry a paperwork burden for both the entrepreneur and the lender, they encourage lenders to feel more comfortable approving a loan. Going this route offers an excellent option to banks for several reasons:

- Banks often obtain government guarantees on loans they would have made without the guarantee. This increases the safety of the loan without reducing its profitability.
- Banks can "bundle" and sell the guaranteed portion of these loans to larger financing companies or on the public bond market, thus earning an immediate profit.
- Banks receive credit with bank regulators for making SBA-guaranteed loans. This credit helps the bank remain in good standing with the government regulators.

The presence of a government guarantee rarely stops a lender from asking for—and usually receiving—other collateral or personal guarantees for the loan. This gives bankers more than 100 percent in collateral and guarantees and is rather like wearing both a belt and suspenders—unnecessary and unattractive, but they certainly keep your pants up.

• **Credit Scoring**—Some credit research firms, most notably Fair, Isaac, and Company—now FICO®, calculate a single figure, which they call a credit score. Factors used in determining this figure include your payment history, the amount of your borrowing relative to your credit lines, recent inquiries made by other financial institutions, and the types of credit you most frequently use.

All these are then put into a computer model that then produces a single number. This number is scored on a scale that begins at 400, the lowest possible credit rating, all the way up to 900, which represents that illusive pie in the sky, "perfect credit." Although there is no single credit score number that banks require, most prefer a credit score of 680 or higher before they say yes to loaning anyone money.

A credit report lists the history of all your financial activity. It is different from a credit score that pulls all this information together and calculates a single number. Credit reports and scores are produced by three main credit-ratings companies: Transamerica, Equifax, and Experian. You can check your credit report with the credit-ratings companies directly, or go to www.myfico.com and for about forty-five dollars purchase your credit reports and the scores from all three credit-ratings companies. There is also a nationwide system in the U.S. currently being rolled out state by state that will enable individuals to obtain their credit scores from the credit-ratings companies at no charge once a year.

Finally, for any banker, the best loan is one in which the business generates enough money to make interest payments comfortably, and to eventually return all the bank's money. When a company performs as anticipated, meets its obligations, and even grows to the point that its credit needs increase, the bank, the loan officers, and the entrepreneur have a win-win situation on which they can build a long-term, mutually beneficial business relationship.

This long-range, productive business relationship must start with financial projections that bankers find credible, and which then prove to be credible. A strong credit score, showing yourself to be of good character, and providing quality collateral or guarantees are all well and good. But in the end, the thing that banks like to see most is the prospect that your new company will be a strong and steady earner for many years to come.