How to Finance a Startup Business

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The number one reason people who want to start their own business don't do it is because they can't figure out how to finance it. Financing is by far the biggest hurdle Entrepreneurs have to face.

Banks are usually the first thing that comes to mind when an Entrepreneur starts trying to get his or her business going. But banks are actually down the list of optimal financing sources for startup businesses.

First of all, there is a gigantic difference between financing a startup and financing an existing business. Mainly, an existing business has proof, history, that it's a viable business which is invaluable because of the startup failure rate. Also, existing businesses usually have assets or equity and credit that most startups don't have. All are mandatory for debt financing.

There are only two kinds of financing mechanisms: debt financing or equity financing. Debt financing is what most of us are familiar with: loans. Equity financing is giving up part of the ownership in the business, or selling part of the company, to raise capital. Equity financiers become partners in the venture.

In a study of the Inc 500, the 500 fastest growing young companies in the country, most were started solely with the Entrepreneur's personal savings, using neither debt nor equity financing. Almost half of those companies were started with less than $20,000 which means you may need to spend more time figuring out how to start up for less.

The second most common financing source was bootstrapping or self financing which is cutting corners (e.g. used equipment instead of new), working long hours for no pay (which is mandatory anyway), and reinvesting all income back into the firm.

It's easy to see how the second mechanism would easily be coupled with the first in the real world.

Third was family, friends, and fools. Many businesses are started with money from a rich uncle or friend. The fools part comes in later when the business doesn't live up to predictions and the uncle or friend loses their investment and then they feel like a fool.

Using family or friend's money is a very treacherous way to finance a business because the relationship will be strained at least, many times broken, somewhere along the way. Relationships should always more important than business.

Fourth on the list was credit cards. Everyone uses credit cards to some extent; in today's world it's almost mandatory. It's also precarious because it's easy to run up a big debt and interest rates can be staggering. Also, your total available credit limit is considered an outstanding loan by banks which limits your credit worthiness.

Leasing was fifth on the list. Leasing is not usually thought of as a financing mechanism, but it is. Cash is king in a startup which means that you have to keep as much cash as you can. Leasing is one of the best ways to get the equipment you need and still keep as much of your cash as possible.

And finally sixth on the list was bank financing and then Venture Capital and Angels which are the two main equity financing sources. We'll talk all about them next time.