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Planning and funding entrepreneurial start-ups and expansions in the current weak economy

Abstract

In times of depressed economic conditions, it is more challenging to start or expand a business. In the present weak economy, there are still opportunities if one researches the market to find an unfilled need for a new product or service and the location where that need has a demand strong enough to make a new venture profitable.

A detailed and well constructed business plan is needed to guide the new entrepreneur in the start-up and development of the new business and to aid in obtaining outside financing for the start-up or expansion of an existing business. Start-up financing can be obtained from several sources. Some of these sources include using one's own personal savings, personal credit, and funds from family or friends as well as funds obtained from banks, usually with a mortgage, angel investors, and grants. Start-up funds may also be acquired through equity investing where ownership of the business is shared with a venture capitalist or others to entice them to make loans to the new business. Once a business is operating, trade credit may be available from suppliers for supplies and other operating expenses. In some situations, it may be possible to obtain funds through grants from governments or private industry sources.

Keywords: entrepreneurship, business start-up, firm financing, business growth, business plans, weak economy, debt financing, equity financing, cash flow, business location.

JEL Classification: M1, M00.

Introduction

In a weak economy, businesses find it very difficult to begin and thrive, given that most start-ups suffer from lack of finances. This primarily affects the small entrepreneurial businesses that tend to rely on the individual's savings and personal loans. It happens that many people have business ideas but lack know how and the funds with which they can implement their ideas. In funding for entrepreneur start-ups, we shall look at the beginning of a business starting from the business plan preparation and ways the business could be funded to the actual implementation (Buzza and Mosca, 2009).

When an entrepreneur wants funding for a business, there is a need to first prepare a business plan to explain correctly the new business idea or expansion to prospective investors.

This step will also include selecting the right organizational plan for the business and the mission, objectives, and goals of the business should be clearly stated along with proposed marketing strategies, planned location, and pro forma financial statements for two or more years (Lesonsky, 2009).

Financing for the business may be obtained from many sources including personal loans, self-financing, banks, family and friends, venture capitalist, angel investors, and in some instances private or public grants.

There are various steps that need to be considered when an individual is starting a business. These are the basics that help in ensuring that the business will

not fail but will survive and grow thus profiting the entrepreneur and increasing the general health of the local economy through increased taxes to federal and local governments and job creation. Additional details will include such items as naming the business, finding the sources for needed products and/or the raw materials that will be needed, getting a license or permit from local or state government to conduct the business, and finding the best location for the business. Before any business is started there is need to do a thorough market research to determine if the proposed product or service is needed and if the demand is great enough to make the new business profitable. One may also need to find a good accountant or lawyer to assisting in setting up the legal structure of the business and assisting in finding financing for the business and later helping maintain proper financial and tax records.

1. Funding for entrepreneurship in a weak economy

A weak economy is discouraging at best, but this should not create a barrier in starting a new business. This is because for every crisis there is an opportunity. As we look at the richest people in the world, it is evident that the status of the economy did not block them from achieving or even starting a new business. People like Bill Gates and Paul Allen would not wait for the economy to improve.

The dream of many entrepreneurs is that once they have a good idea, then funds will just appear automatically. Finding funds for starting a new business is one of the most difficult tasks that many entrepreneurs encounter. The first thing that a person needs to do before seeking funds for a new business is

preparing a well developed and detailed business plan. This is because financing a business is a process that is difficult and slow and may be painful and tiring as well. Entrepreneurs need to be very careful, when searching for funds to finance the businesses they wish to begin, that they don't find themselves chasing blindly for funds that are no place to be found. In most cases, start-ups are limited in the kinds of financing that they can obtain; this is because they require long-term debt financing in order to finance the start-up and any expansion they may be anticipating and future growth as well. It is important that despite having found an option with which to fund the business, the entrepreneur should continue investigating the different ways of financing the business. This step is to ensure that the entrepreneur has other options in case the original planned source of funding develops problems or becomes unavailable.

This step also means considering self-funding, external funding, debt financing, and equity financing. In the end, most entrepreneurs finance their start-up businesses with more debt than equity. Although this approach may appear acceptable, it has several disadvantages such as negotiating credit terms that are available with various suppliers, which may result in restrictions on the flexibility of the entrepreneur's future actions, and it may have high interest rates. Debt financing affects the balance sheet and will make the business less likely to be able to later obtain additional funding from either debt or equity. Apart from this, debt funding has the advantage in that it usually does not reduce the entrepreneur's equity in the new business. This is not the situation if equity is given to a venture capitalist or others in order to obtain funding. On the plus side, debt financing may provide an advantage by being able to earn more return on the borrowed capital than the capital costs the business to use. In the present economy with low interest rates, this is an option to consider (Carter, 2009).

2. Surviving in a weak economy

When one has a good business idea and a business plan, then all that one requires is the funds with which to start the business. Most businesses, especially new start-ups, do require outside capital to begin operation for such things as physical facilities for the business, funds for marketing, and to purchase the starting inventory (Greco, 1995). In most cases, the failure of a business is blamed on poor management, but this blame may often be related to inadequate financing and poor planning of the business's finances. This has been observed in many failures as the businesses fail to manage their cash flow, resulting in forced closure.

3. Factors to consider before choosing a funding method for the business

There are several factors that need to be considered when seeking funding for a new business. Initially, consider the priorities in the business as this will help one to know whether the needs for funding are short-term or long-term and how quickly the business will be able to repay the loan or other investments received. Short-term funds are to be utilized primarily as working capital and should not be used to purchase fixed assets for the business. This is because if short-term funds are used to purchase fixed assets the business will lack the finances to repay the short-term loans since the business will not likely have generated significant profits at the early stage of its development.

The amount of capital to be raised should be carefully evaluated and outlined in the business plan. The amount to be raised should be carefully rationalized to have the right amount needed and help to avoid over financing. The business plan will also help to show how the funds will be utilized thus providing proof to the financial institution or others offering the finances how the funds will be utilized for both operational needs and capital outlays. Consider whether the business will need the full loan funds early or will need the funds in small monthly amounts. Consider the risks facing the new company and decide whether you want to take all the risks yourself or whether you would like to share the risks with a partner. It is very important to know at what stage to ask for more funding, this is because the risks involved in a business vary in degrees depending on the different stages of business growth (Morse, 2008).

4. Funding the business

After arriving at the total initial cost required to start and run the business, the next step will be to decide on developing a financing pattern. The pattern will mainly depend on capital introduction into the business either by owners' equity or through debt and/or equity financing. The amount to be obtained from outside financing will be dependent on the amount the business owner will be able to contribute; therefore, a comparative analysis will be needed in order to determine the most beneficial funding pattern for the business. Working capital needs to be considered, this entails inventories that need to be constantly maintained, and any credit services that will be extended to customers. The business can be funded using two known methods, namely debt financing and equity financing.

4.1. Financing through debt. Debt financing is when you borrow money and agree to repay the

amount borrowed at a particular later time plus interest. It means that you have a debt to repay whether your business succeeds or not. Common debt financing is primarily obtained through loans from banks. Funds may sometimes be obtained from venture capitalist but they usually require equity in the business in addition to the business repaying the loan provided.

4.1.1. Advantages of debt financing. Total ownership is maintained of the business when one borrows money from a lender such as a bank and is only obligated to pay back the money plus interest in the agreed manner. After payback, the relationship with the lender ends. Afterwards, the entrepreneur will be free to operate as he chooses with no interference from outside sources other than legal rules and regulations.

Interest on business loans is treated as expenses to the business and as such is not subject to federal or state income tax. This has the effect of reducing the effective interest rate that the business pays.

For example, given that the bank is charging an interest rate of 10% of the loan received and the business is subject to a tax rate of 30%, the owner of the business will have an advantage in taking a loan given that in this situation, after taxes are considered, the effective rate of interest is only 7%.

4.1.2. Limitations of financing through debt. Even though the tax advantage in reducing the effective interest rate of a loan may make the loan look advantageous, the interest rate may still be high because rates of interests are mostly affected by the economic conditions of the country, the owner's personal history of credit, and any credit rating of the business. Due to these factors, debt financing may prove to be rather expensive for the business.

Another approach for obtaining loans is to provide security to the lender in the form of a mortgage. This will likely reduce the rate of interest charged but it may be difficult for starters to obtain this type of loan given that they are new entrepreneurs and may lack assets to provide the necessary security for the loans they need. This technique may be more available when a business is seeking to expand and has amassed significant assets that may be used as collateral for new loans.

New businesses tend to have low credit ratings and even if the new entrepreneur is successful in obtaining an initial start-up loan based on his/her personal credit rating he will likely find additional loans, before repaying the initial loan, that are difficult to obtain and will be at a higher interest rate. Borrowing creates an obligation of paying back the loan plus interest. These payments are required whether

the business is succeeding or failing, it is an obligation that has to be met. The problem arises when the business is not doing well due to poor management, a weak economy, competition, or other reasons and one is still required to repay the loan. Given that a start-up business does not have large sales in the beginning and may even operate at a loss in early years of operation, loans must still be repaid, or the business may face bankruptcy (DeBaise, 2010).

4.2. Financing through equity. This is a situation where one transfers part of what is owned in the business to others to persuade them to provide the financing needed to start or expand the business. In this situation, the risk of the new business loan is born by the investor and the entrepreneur together. If the business succeeds both parties win. The equity investor, usually referred to as a venture capitalist, gets the loan repaid, but retains part ownership of the business and thus will receive a share of any future profits and increases in the net worth of the business. This kind of funding is very expensive as a way of funding growth of a business that is already successful, but may be cheaper and may provide the only way of obtaining financing for starting some new businesses.

One's own family may be a good source from which to get the funds for starting a business. Families tend to be very lenient when it comes to the repayment period and the expected returns on their investment. Although these are your relatives, you should still ensure that all necessary legal agreements are in place to avoid future problems, to ensure everyone is treated fairly, and to ensure good relations if further future funding is needed.

Personal credit cards are a source of financing for many small start-ups. They are very useful and cheap given that some cards have low introductory rates. If these cards are well managed, they can be effective and if poorly managed they become very expensive due to increased interest rates and fees.

Trade credit may be obtained from vendors who supply some of your inventory. Their charges, if any, should be considered in comparison to other sources of funds (Huyghebaert, Van De Gucht, & Van Hulle, 2007).

In general, for start-up small business funding, traditional funding is found to be the most suitable. Other sources may also be available especially for high-tech start-ups, the new "green" businesses, and others viewed as having high growth potential.

Funding for expansion may be easier to obtain if the business has developed a history of growth and a good rate of return on its initial investments.

4.3. Loans and grants from other sources. These kinds of funding are mostly for the start-up businesses that are viewed as having large future growth potential and are likely to contribute to improving the environment or some other worthy cause.

Angel capital is a source of capital that comes from experienced entrepreneurs and wealthy individuals. Venture capital is composed of funds that come from institutional investors as well as some wealthy individuals. These funds are mostly given to people who are viewed by the investors as starting businesses with the potential for rapid growth and high future profit potential.

Another type of debt financing that does not require security or collateral is available where the lender charges a high interest rate but also has the option of converting the loan from being a debt to it becoming equity, this may be done if the owner of the loan fails to repay the loan. This kind of financing, irrespective of it having a high rate of interest, is highly preferred by some entrepreneurs since they do not need collaterals to secure the loan for starting their businesses. It also offers liquidity quickly and even though there is the fear that the debt may be converted to equity, in most cases the lender that issued the loan will not want to become an equity holder, thus in the end the business will still maintain its ownership as the lender issuing the loan will not take control of the company but will try to work with the borrower to repay the loan (Kirsch, Goldfarb & Gera, 2009).

4.4. Financing through hybrid. There are situations where an entrepreneur decides to combine both debt and equity financing for the new business. This situation makes it possible to calculate the debt/equity ratio. The ratio is obtained through dividing the total amount of debt that the business has by the total amount of equity that the owner has in the business. Investors and lenders are mostly interested in this figure because it helps them to know how financially viable the business is and where their investments stand in the event the business becomes bankrupt. In the event of bankruptcy, debt holders are always given preference over investors in recovering their funds (Anonymous, 2009).

4.5. When to use debt financing. When one obtains a loan to finance a business it means that they are obligated to usually repay the loan in installments, which means that one needs to have plans for how they will use the funds. For example, if the loan is to be used for investing in fixed costs of the business such as purchase of land, buildings, or equipment, then it means that there is a likely chance of not receiving a cash returns on this investment quickly.

This will limit the growth of the business, as a debt investment needs to create a cash inflow, which means that it would be better if the money were invested in variable costs items that are more likely to create a positive cash flow. It is also important to consider the position of the lifecycle of the business. This is applicable to the business that has already begun and only wants funds for growth. Financing a business with loans is dangerous in the beginning of the business, as at that time the business is more likely to have low income or even lose money, which may harm its ability to make loan payments. As the business continues growing and becomes more profitable, debt may be more advantageous as the business will face a higher tax rate thus offsetting part of the interest rate of borrowed funds. By this time in the life of the business, cash flow will be more predictable thus decreasing the risk of bankruptcy.

5. Business plan

When a starting business seeks funding from the government, investor capital, or even loans from a bank, there is the necessity for a business plan that helps to show how the business is planned to be conducted. The business plan is always the first impression of the proposed business to the prospective investors and helps by showing them the kind of potentials the business will have. It can also act as the last impression to the investors if in presenting the business plan one happens to make some critical mistakes (Liao and Gartner, 2007). The investors who fund businesses for entrepreneurs have the opportunity of viewing many business plans, thus they always look for any errors that may cause them to say no to a particular business plan.

5.1. Importance of a business plan. A proposed business must have a resume that will help to sale it to potential investors or lenders. The business plan helps to outline what the business is all about and the purpose for the business is communicated to people who view the plan. The plan helps to explain and illustrate the proposed business owner's vision to convince others to help him or her achieve that vision. Apart from being used by the stakeholders outside the business, the business plan helps the owner to focus on priorities that are achievable and helps to identify goals and objectives. There are some groups of individuals who should not see the business plan because it may provide them with information that they may use to the detriment of the business. This group includes property managers and realtors who may try to maximize their profits based on their view of the new business's potential. Generally, the business plan portrays the expected business expenses involved in opening the business, projected sales and expenses to be incurred during the actual operation,

and the estimated volume of sales the business is expected to generate to meet the owner's goals and objectives (Mainprize and Hindle, 2007).

The business plan is also used for evaluation of the business operation. This is because it acts as a guide and a means to show the degree of progress attained and how well the business projections are being met over time. A viable business is adaptable to changes and the business plan will help in doing revisions as new goals need to be set and objectives modified (Bayon, 2008). The business plan also helps the business to know what goals have been achieved and what changes are needed to accomplish future growth in a dynamic business environment.

5.2. Types of business plan. A business plan should describe the business principles (owners and management team), concept, markets targeted, and the products or services to be involved. The financial part of the plan should entail a full financial forecast of future earnings and costs and will help to convince financial institutions and other potential investors to lend funds to the business. The plan examines the total cost of a given business's start-up and projected financials over the next few years (Moyer, 2008).

5.3. Funding successful business growth. As the business is growing, there are various aspects of the business that will be affected, such as insurance, staffing, marketing, finances, taxes, licenses, and many other aspects as well. Thus, choosing a flexible funding plan that one can easily adjust as the business has begun and grows is of particular importance (Taylor, 2003).

6. Other important aspects to consider before starting a business

Before starting a business one needs to have relevant knowledge and expertise in the field or industry into which one is venturing. Basic knowledge of products and services to be involved in the business is also very important and is a major key to a successful business venture (Bromage, 2008). Limited knowledge may make starting and running a business an uphill task as one will be prone to making mistakes in many areas, missing opportunities, and perhaps accepting bad advice from vendors and suppliers and even violating normal operating practices in one's industry.

A good entrepreneur is the one who explores the market to know what products or services are demanded and if competitors are already meeting this demand. Verify that the unfilled demand for this product or service is great enough to make the new business profitable. A business should only invest in products and/or services that have demands great enough to be

profitable early and have enough growth potential for the business to prosper in the long term. It is obvious that some products are in greater demand than others both locally and nationally, also some products may be successful locally or may be more profitable if marketed nationally or internationally.

Unless the business is a monopoly, competition needs to be assessed to have dependable information about market competition at the present and projected for the future. The success of a business depends on the gap between demand and supply. In the event of an overwhelming demand for a product or service, one may be able to enter into the market in spite of competition. However, when competition exists an entrepreneur will need to be stronger than the competitors or have some competitive advantage when entering into a competitive market (Kolacek, 2009). Information such as who the competitors are, where they are located, and any unique advantage they may have will help the new business develop unique products or services that will be very important for the success of the new business, especially at start-up, as they will assist in the survival and early growth of the business.

6.1. Return on investment. This relationship is calculated by obtaining the quotient between the total net profit realized and the total investment made. The quotient is very low during the start or the initial stages of a business and grows as the business continues to expand. The rate of return needs to be compared with other forms of investments the entrepreneur might have made and related business types in one's industry so as to be sure one's business growth is close to what should be expected and to convince the owner he has made a wise investment.

6.2. Location of the business. A strategic location for the business is very vital for optimum success. The location will strongly determine the success or failure of the business and serious attention needs to be focused on choosing an ideal location. Potential customers are usually the primary location factor but service businesses may take advantage of locations that provide savings on taxes and other overhead costs when choosing a business location, especially if customers do not visit the business location (Merchant, 2007). There are additional factors to consider when choosing a business location. These factors include availability of raw materials or goods to be sold, availability of labor, and any government subsidies or incentives that may be available such as lower taxes, help with financing, availability of industrial areas, or business incubators. Retail businesses are best located in safe well-populated areas that are easily accessible, with am-

ple parking, and other retail outlets that cater to customers similar to the business's potential customers (Smith Broady, 2009).

6.3. Legislations. There are certain compliances that a business must meet before becoming licensed to operate. Different states and cities have varied laws and regulations of compliances. Details concerning such rules and regulations need to be obtained, adhered to, and respected. Any special licenses and permits will need to be obtained and maintained. This information should be obtained and understood before one makes a location decision because certain types of businesses are restricted by zoning codes or other regulations to specific locations. Lack of expertise in this area may call for the services of lawyers or other professionals. Failure to comply with the set rules and regulations will lead to penalties such as fines and possible forced relocation that will hamper the success of the new businesses (Edwards, 2009).

6.4. Labor. For a business to succeed, labor with the correct skills and experiences and in the needed numbers will be needed. This calls for careful selection of employees since they are the ones who will greatly determine the success or failure of the business (Doms, Lewis & Robb, 2010). The cost of labor will be determined by the qualifications required and location of the business as some areas are endowed with the desired type of labor while other areas have scarcity of the skills needed. The size of the business will also determine the number of employees required and those with special skills such as supervisors, managers, and any special technical personnel. In the current economic environment, many businesses are cutting the number of employees and embracing more technology. This may be an advantage to new start-ups by providing a larger pool of potential employees from which to choose (Spicer, 2009). One also needs to stay abreast of government regulations concerning how one must administer labor rules, regulations, working conditions, safety issues, environmental issues, and other requirements.

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6.5. Technology. During the start of a business, it is advisable to invest in the best and latest technology one can afford. Choosing the best and latest technology to employ is not an easy task and continued future monitoring of technology is important to stay abreast of the most efficient and economical equipment and computer technology available. Technology can help to reduce some cost, reduce the number of employees needed, and increase efficiency in the operation of the business. A business, which embraces technology in its initial stages, is more likely to develop much better in the long run than a business that does not employ available technology (Anonymous, 2010, January 8).

Conclusion

History repeats itself, and history has proven that down markets do arrive and eventually end and prosperous economic conditions return. Business owners need to be vigilant and strive to obtain the best economic forecasts available in order to be proactive instead of reactive concerning future events. In poor economic times, it is obvious that business will grow at a slower rate but slow growth is better news than negative or no growth at all. It is very important to assess all the total project costs that are required to run the business efficiently and effectively and to strive to reduce these costs through better management, training, and use of technology. One should strive to be aware of the overall economic trend in the nation, world, and especially one's own industry and specific location (Henderson and Weiler, 2010). Some locations may be economically depressed while at the same time not far distance may present good potential. Thus, one should try to consider this situation before choosing one's business location. By being aware of changing economic conditions, customers' tastes and preferences, new products and innovations in the products and services one's business sells, the new business has an enhanced chance of better future growth, prosperity, and long-term survival.

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