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Why a Start Up Loan May Not Be a Good Idea

During a recent Pitch and Brew session at Impact Hub Philadelphia, a topic of discussion was whether starting a business with a loan is a good idea.

One participant stated she heard billionaire Mark Cuban say on Shark Tank that starting a business with a loan is not a good idea; and for the most part, I agree with him. Here's why.

Some studies have suggested that better than 70% of all new business survive less than three years. In addition, 90% of the businesses in the U.S. generate less than $100,000 in annual revenue. At best, starting a business is a very risky proposition.

Also consider the fact that at the start of a business there are many unknowns, particularly related to sales.

When you open that new clothing boutique, you can project what your sales may be or how many customers you will serve, but you really don't know. The reality is the start of a business is where the risks are highest because of the sales and financial unpredictability.

In the face of this reality, let's look at the implications of a loan to start the business.

First, more than likely you will have to provide a personal guarantee for the loan, meaning, if the business cannot repay the loan, you will. No, incorporating or forming an LLC to apply for the loan will not eliminate this requirement.

Second, with your personal guarantee on the line, your credit is on the line.

Next, you probably have to pledge collateral in the form of some asset you own (i.e. home, other real estate, stock, etc.). The lender requires collateral just in case the business fails. This is the lender's safety net to recapture some, if not all of their money.

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Finally, if you have a family, significant other, etc., because you have so much on the line, if the business goes wrong it can upset the household or your relationship. That may prove more detrimental than the personal guarantee, credit and collateral.

Remember, you are placing all of this on the line at a point where the risk of the business not succeeding is at its highest (the beginning). That's why I agree with Mark Cuban.

So, when starting your business consider these financing options:

1. Create some revenue and attain some customers by developing a test model of

your business. For example, instead of renting a store location to sale your new tee-shirts, make a few dozen attend some vending events/trunk shows.

2. Before the shows define your game plan consisting of details such as:
    - **Clearly Defined Objectives**
        1. Sales
        2. Number of names on customer/prospect list
        3. Customer feedback
    - **Clearly Define Strategy**
        1. Sales strategy
        2. Strategy for securing contact information list
        3. Strategy/system for securing customer feedback (one set of questions for those that buy; one set for those that do not buy
        4. Customer/prospect follow up, continuity and up-sells

You are now positioned to create a consistent cash flow by building on the customer/prospect base you have established at each selling opportunity. By taking this approach, you have a better understanding of the feasibility of your idea; a sense of predictability as it relates to revenue; more knowledge about how to make more effective use of loan dollars and you are more aware of what your financing needs are.

Make the loan amount the smallest portion of your financing strategy. For example, if you need $20,000 to start, borrow $5,000 and find other sources for the rest. The less debt the business has at the start-up stage the better.

I'd love to get your feedback. Take the poll below and leave your thoughts in the comment box… I'll be sure to give you my feedback!

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About Pitch & Brew

Pitch and Brew is a free, open public meetup offering collaborative brainstorming, idea checking & concept validation, and business advice for startups, entrepreneurs, and established organizations. Pitch and Brew is sponsored by Entrepreneur Works and Impact Hub Philadelphia and is held Tuesdays at 10:30am at Impact Hub. Earl Boyd is the facilitator/business coach.

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