

For Business Times
February, 2006

How much capital does it really take to start a small business? And if I don't have the money to get started, and want to get investors what will they be looking for to have confidence in financing my business?

The answer might surprise you. According to data from the U.S. Census Bureau, 60 percent of all new ventures take less than \$5,000 of start-up capital. Only three percent take more than \$100,000.

So maybe you really don't need that much capital to start that business that you have been dreaming about. How do you realistically determine how much money you will need for your new business?

Four important tools come into play here: a start-up cost budget, proforma financial statements, cash flow statements and breakeven analysis. Not only will you need to learn to use these tools to successfully start a business, you will have to put them in your business plan if you want to raise money. Potential investors will want to see this information as a part of the process of evaluating your business.

You will need to create a start-up budget – a list of costs that will need to be incurred to get the business off the ground. Examples of start-up costs are the costs of buying the equipment you will need – ovens for a bakery – as well as inventory and/or supplies. Because you will likely have to incur some costs to produce and sell your product or service, you will also need some working capital for the period when money is going out but not yet coming in. Identifying how you will use this start-up money is important when you are looking for investors—they will want to see how you are going to use their money.

Now you are ready to develop your proforma financial statements. Most potential investors will want to see them projected for three years. Proforma income statements estimate the profit and loss for the business. They are based on the information you have collected for your new business in the following areas: your market, customers, competitors, products and services offered, etc. The estimates of profit or loss depend on the business owners' ability to project sales. They also rely heavily on accurate estimates of costs. Many entrepreneurs underestimate costs. A good best practice here then would be to compare your financial projections with those of other businesses in your industry to make sure that they seem realistic and doable. Potential investors will likely be skeptical if your numbers are three times as good as the average firm in your industry.

The third tool important to determining how much capital you need for your new business is cash flow statements. Cash flow statements are calculations of the amount of cash that your business has at any given point in time. If a company has negative cash

flow, it will become insolvent. Managing cash flow is difficult because income statements do not measure the amount of cash in a business. Let's take the bakery example. Let's say that you sell \$2,000 in cookies and muffins to a wholesaler that sells to restaurants. Your cost is \$1,000. Therefore you book a profit of \$1,000. However your customer pays you after 30 days, following your 30-days-same as cash plan. As a result your business doesn't have positive cash flow in the first month of business. This emphasizes the importance of estimating cash flow as well as income. What strategies can you employ to improve cash flow for your business? One strategy here would be to minimize your accounts receivable by offering customers discounts for paying quickly, and by limiting the credit that you extend to customers. Try on the other side of this to delay your accounts payable.

The fourth tool that new business owners need to master is breakeven analysis which allows you to calculate the amount of sales you need to cover your costs. Take that bakery again. To calculate your breakeven level of sales for pies, do the following:

- Determine the sales price per unit of your product = pies at \$10.00 each.
- Estimate the variable cost per unit = \$3.00
- Subtract the variable cost from the sales price to calculate your contribution margin per unit = \$7.00
- Divide the contribution margin per unit by the sales price to estimate your contribution margin percentage = 0.70 ($\$7.00/\10.00)
- Estimate your businesses fixed costs = \$5,000
- Divide the fixed costs by the contribution margin percentage to calculate the breakeven sales volume = $\$5,000/.70 = 714$. Breakeven level of sales for the pies is 714 pies.
- Interpretation = As sales exceed 714 pies this item produces a profit.

You can determine break-even points for your entire business or based on one item as is illustrated in the example above. You will need a break-even analysis for your entire business but knowing what each product or service means to the business is important to the overall success of your venture.

It doesn't take long to realize that the **biggest** issue isn't raising enough money to **start** the business. It is getting enough money at the right times during the early life of the business to make sure that the business doesn't run out of cash. Almost all new businesses experience negative cash flow. Planning ahead for these times by using the tools described here is crucial to the long-term survival of the new business. Seeing this planning may also give investors the confidence to invest in your new business.