Business financing through home equity - Smart move or too risky?

Are you willing to risk your home to finance your business? One way to infuse your business or startup business concern with cash is by tapping the equity in your home. Is it a smart move? The answer depends on a number of different factors.

Financing a Business

One of the biggest stumbling blocks for a new business owner is acquiring financing for the early costs of establishing the business. Unless you have an established banking relationship or collateral to put down, few banks or lenders are willing to make a loan without a personal guarantee of some sort. It makes sense for a homeowner to turn to their largest asset as collateral. A home equity loan or line of credit is often the easiest way for a new business owner to acquire a sum of money that can be used to fund their business startup.

The Case against Home Equity Business Financing

Financial experts almost unanimously warn against using your home as financing for a business. It's a risky move. If your business fails, you could be putting your home in danger. Since most entrepreneurs begin a business with the intent of supporting their families, does it really make sense to put your family's biggest asset at risk?

On the other hand, your home is the biggest asset. Using it as collateral can be a very cost-effective way of financing a new beginning. Home equity loans often carry the lowest rates of interest of any other type of loan. Add to that the fact that many banks will require a personal guarantee for a business loan to a startup, and the effect is about the same. You'll still be personally liable for paying the money back if your business fails.

The trick is to borrow smart. Before you decide to put your house on line to finance your business, do a bit of soul-searching and a lot of research. Here are some factors to consider before you decide to put your home up as collateral for a business loan.

1. Are you counting on the success of the business to pay back the loan?
Keep in mind that most business concerns do not turn a profit within the first year. Can you make payments on a home equity loan for a year without tapping business profits? If you can, then a home equity loan may be a good option for you. Even if the business fails, as long as you know you can make the payments on your loan, your home is safe.

2. Is a home equity line of credit an option?
A home equity loan makes sense if you need a chunk of money to purchase equipment and pay starting expenses. A home equity line of credit has a number of advantages over a closed-end loan under some conditions. While you may be paying slightly higher interest rates on a line of credit, one of the biggest advantages is the revolving feature. In other words, when you pay back money on a line of credit, it becomes available for you to borrow against again. A second advantage is that you'll only be paying interest on what you actually owe. A home equity line of credit for business purposes is a good way to have cash in reserves for emergencies without having to pay interest on it until you use it.

3. Do you have an exit plan?
One of the biggest failings for most business owners is that they fail to plan for failure as well as success. We all hope that our businesses will be wildly successful, and it's easy to make big plans based on that dream. But there's a real danger in not planning what you'll do in case of failure. At what point will you decide that enough is enough, and what steps will you take to get out with the least possible damage? Deciding when to call it quits can save you from disaster if the business doesn't fly as high as you hoped.

4. Should you tell your lender that your loan is for business?
While home equity loans can generally be used for any purpose, including funding a new business, some loan experts recommend against volunteering the information to your lender. They may feel obligated to direct you to the commercial lending arm of their institution if that's bank policy. If, on the other hand, you are asked directly, it's best to be honest. Lying about your purpose for the loan could be construed as misrepresentation and open you to charges of fraud. Misrepresenting yourself could also negate the loan and call it due immediately.

The long and short of it is this: your home is probably your best source of funding for your business in the early stages. If you do decide to use a home equity loan to finance your business, be sure to think it through and safeguard your home before signing on the dotted line.

About the Author

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