Financing Your Business

Small Business Success Series
Developed by:

Alberta

The Business Link Business Service Centre

Financing Your Business

In addition to investments from the owner and cash flow generated by the business, most businesses require financing. This bulletin is designed to assist you as you consider seeking additional sources of investment.

Introduction

Why Do Businesses Need Financing?

Businesses need cash for three basic reasons: to acquire fixed assets, purchase and maintain inventory and meet ongoing operating needs. Consider the following issues associated with each requirement:

a. **Fixed assets —** Lenders are more willing to finance fixed assets such as real estate, equipment and vehicles because they have a lasting value that represents a higher degree of security.

b. **Inventory —** Lenders are generally less willing to finance inventory because of factors that limit their security value: seasonality, specialized use and high cost of liquidation.

c. **Operating Needs —** Lenders typically approve operating lines of credit based on a combination of security and economic considerations. These include accounts receivable, specific contracts, inventory, your track record and general business conditions. Personal guarantees are usually a requirement of loans for operational needs.

What Kinds of Financing Are There?

There are two types of financing: debt financing and equity financing.

a. **Debt financing —** This means borrowing money that must be repaid over time, usually with interest. Although lenders do not gain ownership, they retain an interest in the business through a charge against the assets. The owner is obligated to repay the loan as agreed as well as maintain business assets used to secure the loan.

b. **Equity financing —** In this financing strategy, money is provided in exchange for part ownership of the business. The equity investor becomes a business partner and gets a degree of control over how the business is run. This form of financing allows a business owner to obtain financing without incurring debt.

Option	Pros	Cons
1. Debt Financing	• business gets funding without giving up control of the business • owner retains control and gets all business profits	• regular monthly payments required • harder to obtain financing for a start-up business with no track record
2. Equity Financing	• money invested may not have to be repaid directly • equity investor has direct interest in helping the business grow • equity investors are often a good source of business advice and contacts	• owner loses some control over the business • equity investors may not agree with business decisions you want to make • complicated process that usually requires professional advice with applicable fees programming

Where Can I Get Financing?

Financing can come from various sources: private, traditional lenders, public financing programs and other sources.

Private Financing

a. Personal Assets

For most start-up businesses, personal finances will be the primary source of financing for short-term and long-term financial needs. Your investment may come from personal savings or from selling or mortgaging personal assets.

Many prospective small business owners use a portion of the equity in their homes to obtain needed funding for their new venture. A first or second mortgage, refinancing an existing mortgage or securing a home equity loan or line of credit may generate the required financing. Other assets that can be used to secure loans include real estate, vehicles, business equipment, investments or life insurance policies.

Additional personal funds can come from personal credit cards or a personal consumer loan. A prospective business owner who is still employed can take advantage of their employment income to obtain a personal loan or line of credit before starting a business. Be candid with your lender about why you want this loan.

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b. Family, Friends and Business Acquaintances

It is common to ask family and friends for loans to start a business. But be careful! Only approach those who can afford to invest their savings and who are willing to accept the risk associated with a business investment.

c. Partner Investment

You might consider bringing a partner into your business for two reasons: money and expertise. In most cases, a partner will participate in running the business and will want a say in how the business operates. However, in some cases, your partner will not want to participate in the business. This silent partner is normally only responsible to the business and its creditors for the amount they have invested.

If you are considering partners for your business, seek legal advice before you proceed. For further information, see ***Prepare for Success, Starting a Small Business in Alberta***.

Traditional Lenders

Banks, credit unions and some non-bank organizations offer a number of short- and long-term debt financing options to assist businesses. Loans provided are normally secured using some of the following approaches:

- lien against assets of the business
- covenants requiring their approval before assets can be sold
- insurance coverage of assets with lender named as a beneficiary
- conservative valuation of assets and advancing of only a percentage of asset value

Banks, credit unions and some non-bank organizations offer a number of financing options...

Financial institutions usually require business owners to have personal investment in the business to demonstrate an ongoing commitment to the health of the business. Lenders may expect personal investment of 20-75% of the loan amount requested.

a. Loans

Debt financing can be short-term or long-term. Short-term financing usually covers inventory and working capital. Long-term financing generally funds fixed assets including land, buildings and equipment.

b. **Business Credit Cards**

For small business, this is another source of short-term financing for quick cash to cover supplies and inventory. As the interest rate is usually high, it is not recommended for long-term asset purchases.

c. **Line of Credit**

In this approach, the lender establishes a maximum amount of funds available to the business based on a percentage of the value of inventory or accounts receivable. The amount used becomes a revolving, ongoing loan. Some business owners have a personal line of credit that they use for business purposes. The key benefit of this mechanism is no requirement to re-apply for a loan each time cash is required. Ideal for short-term cash flow issues and quick-turn inventory, it is not recommended for fixed asset purchases or other long-term financial requirements. Further, maxing out the line of credit for day-to-day requirements may limit your ability to obtain long-term loans.

Some business owners have a personal line of credit that they use for business purposes.

Public Financing Programs

Some lending programs supported by governments and non-profit lending agencies provide an alternative source of financing to traditional lenders. These agencies include:

- Business Development Bank of Canada
- AFSC Commercial
- Alberta Women Entrepreneurs
- Canada Small Business Financing Program

There are also specific loan programs for:

- Youth
- Aboriginal business
- Export marketing

Other Sources

a. Trade Credit

Suppliers may provide a deferred payment schedule for supplies and inventory. However, they may expect a new businessperson to earn this privilege by paying cash for early deliveries or limit the amount of materials provided until a positive payment record is established.

How Do Lenders Decide Who Gets a Loan?

Although every lender uses their own criteria to consider giving a loan, the following is a common loan evaluation process using the five "Cs" of credit: character, capacity, conditions, capital and collateral.

a. Character

This factor is about you as business owner. Do you treat your customers and employees fairly? Do you meet your personal and business obligations in a timely manner? What is your personal credit history?

b. Capacity

How much debt can your business handle? Will the business be able to repay the loan? What is the borrowing track record of the business? What are its cash flow projections? What is the debt to equity ratio?

c. Conditions

How is the economy doing? How might an economic downturn effect your business? What are the industry trends? How are you managing to respond to these trends?

> How much debt can your business handle? ... What is the debt to equity ratio?

d. Capital

How well is the business capitalized? How much have you invested in the business? Is there a capital reserve for emergency requirements? Lenders will typically review financial statements, your credit history and your personal net worth statement to form an opinion on this indicator.

e. Collateral

What unsecured collateral can you offer? Lenders typically look for relatively liquid assets such as real estate, equipment, vehicles, furniture and fixtures. Even if you have good collateral, expect your lender to want a personal guarantee that you will repay any loan. This may take the form of a charge against personal assets. If you proceed this way, remember to negotiate reduction or removal of this charge after several successful years in business.

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Applying For a Business Loan?

Make financing an important part of your business plan development. Indeed, any lending agency will expect to see your business plan before considering your loan request.

Planning Your Financing Requirements

Step 1. Determine the money needed by the business

If you are new in business and have no historical data to use, your estimated financial needs will come out of your business plan. Within your business plan you have identified all **start-up costs** (inventory, rental deposits, installation charges etc.). In addition, your cash flow projections may, in the early years, indicate a **cash shortfall.** These will both have to be covered by financing. Add up these two cash requirements and deduct any investments you have available, then you will know how much of a loan you will need. Prepare a written loan request based on your business plan.

Step 2. Support your financing request

Have a copy of your business plan, which presents cash flow projections etc., ready. Your business plan will also note positive market trends, customer demand (including anticipated market share), your management experience and expertise as well as skilled employees available. Identify how you will repay the loan.

Step 3. Select sources of financing

To maximize your time, consider who are the most promising potential lending sources. Talk to other small business owners for preferred lenders to small businesses. Identify which lenders you want to approach and in what order based on this information.

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Step 4. Prepare to meet your lender

Learn what each lender requires, assemble this information and prepare a presentation. Arrange a meeting; don't rely on dropping off a written proposal. Be confident in your presentation and show you believe in your business concept.

Need more information about developing a business plan? See **The Business Link's** guide ***Prepare for Success, Starting a Small Business in Alberta***.

Conclusion

Many new business owners find financing their venture the most stressful step in getting started. If you have done your homework, as reflected in the thoughtfulness and completeness of your business plan, obtaining the financing you need is more likely to happen. After that, you can get on with launching your business.

Other bulletins and guides in The Business Link's Small Business Success Series are available on-line at www.cbsc.org/alberta/SuccessSeries.cfm.

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