HELPING YOU TAKE YOUR BUSINESS TO THE NEXT LEVEL

DISCUSSION PAPER #5

TYPES OF BUSINESS FINANCING

ADDING CLARITY AND VISION

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Debt Versus Equity

Debt funding is normally cheaper and easier to find than equity funding. Debt typically carries the burden of monthly payments, whether or not you have positive cash flow.

Equity investors expect little or no return in the early stages, but require much more extensive reporting as to the company's progress. They have invested on the gamble of very high returns. Therefore, investors anticipate that goals and milestones will be met.

Debt financing is usually available to all types of businesses. Equity is generally restricted to businesses with fast and very high growth potential.

Debt Considerations

- For what type of debt financing can my company qualify?
- How much debt can I afford?
- Can I handle the payments if the cash flow projections are off?
- What happens if interest rates rise?
- Am I willing to pledge company and personal assets?
- What about my personal guarantee?

Debt lending is more analytical than personal. Are your ratios right? Do you have the assets? Are you credit worthy?

Equity Considerations

- What type of investors do I target?
- Am I willing to share control and future profits?
- Do I really want investors as partners forever?
- How big of a share am I willing to give up?
- Will I be able to keep up with all the required reports?
- What about disclosing company secrets to potential investors?

Investors will want to take a much larger share of a start-up venture, than they will of a company with a two or three year track record of success.

Angels

Angels are individual private investors who make up a large portion of "informal" venture capital. These investors usually keep their money close to home (50 miles or so). They tend to invest small amounts ($25,000 to $250,000), and they can be difficult to locate because they usually don't belong to networks or trade associations.

Angels are found among friends, family, customers, third party professionals, suppliers, brokers and competitors. For the most part, once they invest in two or three deals they are out of money.

There are a few private investor-locating services out there. Beware of those who charge large ($1,000 or more) advance fees in order to put you in touch with an investor. Do your homework, check these people out and negotiate a commission if your request is placed.

Caution: *Don't advertise in your local paper for investors until you have spoken to a Chartered Accountant or Lawyer, or the securities regulators may give you a call.*

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Venture Capital
Affectionately known as "Vulture Capitalists" in the industry. That may not be nice, but it's often true. These investors are out looking for huge returns not just good ones. Venture capital is extremely hard to get and the competition is fierce. These funding sources get thousands of requests each year and only invest in two or three.

The managers who invest these funds are great at finding oysters that will produce pearls. They usually are very bright, well educated and very cautious. Tread lightly here and have your business plan as tight as possible, be prepared to be challenged!

Joint Ventures/Strategic Partnerships
This may be our favourite. It is where two companies with parallel interests get together based on their mutual needs:

- They have the money…you have the plan.
- You have the product…they have the distributors.

Do your homework. Seek out companies with parallel interests to your own. You have the world's best new phone design and you approach Bell Canada. This requires much more research than simply asking for a loan. Most of these partners will settle for 20% to 40% equity in your company. Be careful to protect your ideas by having any potential partners sign a non-disclosure document.

Small Business Loans (SBL)
A tremendous resource, but the paperwork can be tiring. This is a great place to look. Your local bank should have an SBL loan officer who can explain the requirements and procedures to you. These loans are backed by government guarantees and are used to finance equipment used in your business.

Letters of Credit
Issued to your funding source on your behalf, as a guarantee that you will pay. If you don't pay the issuer does. Your bank might issue the L/C based on your pledge of a receivable or other hard asset.

Receivables Factoring
An age-old method of financing. Funds are advanced against goods sold, accepted and not yet paid for. Normal advances on accounts receivable are 80% to 90%. The lenders are looking for ninety (90) days or less to be paid. Funding is available for older accounts receivable, but the rates take a dramatic turn upwards.

Purchase Order Advances
Leveraging your future. If you have purchase orders with your customer base, you may be able to get advances towards their completion. The typical advance is less than 50%, and the rates are very high. Don't choose this one unless there's no other way.

Equipment Leasing
You can think of this as renting assets. You gain the capital equipment you need and agree to pay rent for a specific period of time. Interest rates tend to be higher than commercial loans. However, depending on the structure of the lease, some of that may be offset by being able to expense 100% the payments (pre-tax). Check with your Chartered Accountant to be sure.

Asset Sale Lease-Backs
If you are cash poor and asset heavy, this may work for you. Here you are selling your asset for cash to a funding source who leases it back to you (typically with a lease end purchase option). The downside of this approach may be capital gains or sales tax.

Private Placements
A do it yourself stock offering. A great way to raise small amounts of capital ($500,000 or less) with a few investors (typically 25 or less). There are some legal and accounting issues to consider. Contact your Chartered Accountant or Lawyer for information on what is required to stay out of trouble.

Limited Partnerships
You can look for one or form your own. Limited partnerships usually exist for the purpose of investing. The general partner has all the exposure and management duties, while the limited partners have put up all the money. There are numerous Limited Partnerships out there that have been formed to invest in businesses. You can search them out or inquire with the Ontario Securities Commission as to the requirements for forming your own. A Lawyer will be required to draft the necessary documents.

Convertible Debt
This is normally a loan than can be converted (at the lender's option) into an ownership position in the company. These are most common with seed or start-up funding where the lender would like a piece of the rock in the event you become a tremendous success.

Lines of Credit
A revolving account that is continuous in its nature. The funds are available as draw downs against the total line. These types of accounts are most commonly secured with accounts receivable and inventory as collateral.

The Partners at SPA Group have a great deal of experience in assisting clients to secure the most appropriate type and source of financing for their businesses. Please feel free to call to speak with us about your situation or to arrange a confidential appointment.

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