The Orangeville & Area Small Business Enterprise Centre (SBEC)

87 Broadway, Orangeville ON L9W 1K1
519-941-0440 Ext. 2286 or 2291
sbec@orangeville.ca
www.orangevillebusiness.ca

Supported by:

The Money You'll Need

Revised 1-3-16

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Money (also referred to as capital, funds, and financing) is a critical factor in starting a business. You will need "seed money" to launch the business to cover costs such as vehicles, equipment, machinery, land, building, fixtures, and supplies. You'll also require money for your daily operating expenses – inventory, rent, taxes, salaries and wages, advertising, utilities, etc.

You can finance your business through debt (borrowed money) and equity (invested money). The type of financing you seek depends upon how much you need, how you plan to use it, how long you need it and how you'll pay it back. In most cases, a combination of debt and equity is the most effective way to go. Debt financing and equity financing come in several forms and are used for a variety of purposes.

Debt Financing

Debt financing is money you borrow to run your business. You must repay borrowed money in full, usually in installments, with interest. A lender incurs risk and charges a corresponding rate of interest based on that risk. The lender usually assesses a variety of factors such as the strength of your business plan, management capabilities, financing, and your past personal credit history, to evaluate your company's chances of success.

Many new businesses started in Canada use financial institutions (banks, trust companies, credit unions and caisses populaires) for debt financing. Other sources include family and friends, suppliers and equipment manufacturers, government agencies, third-party leasing companies and other financing organizations.

Types of debt financing include demand loans, lines of credit, credit cards, term loans, leasing and supplier credit. Remember to shop around and compare terms, costs and flexibility. Let's look at each one...

Demand/Short-term Loan A demand loan is usually a short-term loan that carries a floating rate of interest (it varies according to the prime rate). Business owners use short-term loans to cover cash-flow shortages, to purchase inventory, or to take advantage of supplier discounts. The loans are usually repaid within 30 to 180 days. A short-term loan is secured by a personal guarantee or company assets, or it may be extended solely on the basis of the company's financial statements, track record, and ability to repay the loan. By definition, a demand loan can be called at any time. This means you must pay back the loan on demand from the lender.

Line of Credit Also called an operating loan, a line of credit provides a business with money to cover day-to-day expenses. As funds are used, the established credit line is reduced. Your line of credit is replenished when you make payments towards it. Like a demand loan, it's usually secured by assets, receivables, inventory, or other means. The loan has a limit and you pay interest only on the amount outstanding, usually on a daily basis.

Credit Cards Actually a type of short-term operating loan, they allow you to make relatively small purchases today and pay for them later. As long as you pay off your credit card every month, you pay no interest on the loan. (You may have to pay an annual fee for the card.) Many financial institutions provide credit cards designed for small businesses. These cards help you keep track of your day-to-day spending and expenses and relieve you of some time-consuming bookkeeping. Several banks and other financial institutions have recently introduced a number of card-based products that access business lines of credit.

Business Term Loan It provides medium- to long-term financing to cover some or all of the cost of capital equipment, expansion, or renovation of buildings. Term loans are usually secured by the asset being financed, and they come with different repayment schedules, interest rates and periods, depending on the purpose of the loan.

Leasing Unlike a loan, leasing is like a long-term rental. At the end of the lease, you don't automatically own the asset – you have the option to buy it as its residual value. A lease requires little or no money down and is an alternative to purchasing such items as cars, machinery or office equipment. By leasing instead of buying your business can usually write off the monthly lease expenses.

Supplier Credit Many manufacturers of cars, machinery or computers have developed credit programs that are variations on debt financing. They provide the goods; you pay for them with interest, over a specified period. In addition some suppliers will offer various terms of sale, letting you take three months to pay, for example or they may offer discounts for prompt payment.

Equity Financing

Equity financing is accumulated from savings and investors. Outside investors typically receive a portion of your company equity (ownership) in return for their investment.

The most likely sources of equity financing for start-ups are yourself and people you know. It's not easy to attract investors to a new business. No matter how sure you are that your business will succeed, others will not always share your confidence. Without a track record of steady earnings from the business, you have only your enthusiasm, character and talent – and of course, your business plan – to persuade them to invest in your idea.

Personal savings: Many entrepreneurs invest their own savings when they start a business. It makes sense as your own money is the most readily available. If you invest your own money in the business, other people will feel more confident about investing theirs.

Love money (Friends and relatives): Many entrepreneurs rely on friends and relatives for at least a portion of their financing, either on a debt or equity basis.

Government: Most governments in Canada operate programs to boost employment, training, or technology transfer. A government program may pay some or all of your costs of developing a new technology, for example, or training new employees.

Informal Investors ("Angels"): They are often seasoned professionals looking to put their money into promising businesses, hoping to earn a larger return on the investment than through more traditional methods. Usually, angels want to play an active role in the management and/or strategic planning of the business they invest in. Your own professional advisers such as lawyers, accountants, and bankers can often direct you to these informal investors.

Equity For Existing Businesses

Once you get your business going, you may want to raise more money to pay for its expansion or for other purposes. Equity financing at this stage is available from additional sources, including:

Retained earnings As your business begins to generate a profit, you can use the money to pay for its continued growth. Most growing businesses combine their retained earnings with other forms of equity and debt financing as they expand.

Venture capital Venture capital is typically targeted at high growth, high-tech sectors. Firms providing capital for ventures offer financing in exchange for ownership in the company. Venture capitalists generally prefer to see a business in operation before they put their money behind it. They expect a healthy return on their investment, often generated when the business starts selling shares to the public.

Going public Once again, this option is available primarily to fast-growth companies. This is when you offer and sell equity interests in the company (e.g. shares, warrants, options) through a stock exchange or broker network. Going public involves a rigorous process of regulatory compliance and promotion.

Credit rating is critical for borrowers

Before a loan is approved, financial institutions check your credit rating and the credit capacity of your business. They do this through the help of a credit bureau. Canadians who have borrowed money have established a credit history that reflects their repayment habits. This information is gathered from public records and lenders such as financial institutions, department stores and gas companies. If you plan to apply for a loan, it will play an integral role, so you should make sure your credit history is accurate. You can obtain your own credit history by contacting the bureaus directly. For instructions on obtaining your credit record, contact:

Equifax Canada Inc. at 1-800-465-7166 *www.equifax.ca*;

TransUnion at 1-866-525-0262 *www.tuc.ca* or (1-877-713-3393 residents of Quebec) or

Northern Credit Bureaus Inc. at 1-800-532-8784 *www.creditbureau.com*

Financing tips

- Develop a long-term financing strategy
- Find financing to suit your business
- Use all your contacts – friends, family, and other entrepreneurs for advice
- Be prepared to walk away from a deal you don't like. If it's too expensive, too restrictive, or too unwieldy, the option may not make sense
- Consider the various ways to find financing. Payments in advance, for example, can provide a cushion to get your through a production period
- Regard your lenders as suppliers. They want your business as much as you want their product, which in this case happens to be money
- Re-examine the capital structure of your business from time to time to make sure it is still appropriate. The proportion of bank financing, owner's equity, and private investment, for example, may rise or fall, depending on the circumstances.

Source: Canadian Bankers Association, Getting Started in Small Business. Reprinted with permission.