

Sources of Funding for Your Business

by Mike Pendrith

You have decided to “take the plunge” and to start your own business.

You have prepared a preliminary budget and realize that you will have to borrow some money in order to start your business and to operate it for the first few months, until cash flow from operations are positive.

There are several sources of financing that can be considered. Some have advantages and disadvantages.

Family and/or Friends

Many business owners look to borrow money from family and / or friends in order to start their new business. This can be one of the best sources of funds because if those individuals that you approach respect and trust you, the approval is almost guaranteed and approval times are usually very short.

Friends and family may however ask to see a copy of your Business Plan before lending you the money. They will want to make sure that you have thought through your business very carefully before they risk their hard earned money. Money is often lent at or below current bank rates.

Registered Retirement Savings Plans

Often businesses are started with money from individual RRSP's. In this situation, a business owner does not have sufficient personal savings in order to start the business and he/she does not have friends or family from which he/she can borrow money (or does not want to approach friends or family).

The business owner elects to use some or all of the savings in their retirement plan. The advantage is that the business owner will not be paying interest to a lender.

There are however two main disadvantages: the first is that in many retirement savings plans, the money will be taxed when it is brought out, so you will end up with less capital than what you may have thought; the second is that the business owner will have less money available for retirement purposes should the business not succeed.

Personal Line of Credit

Banks like to lend money to people who have demonstrated credit worthiness. If you have been dealing with a bank for several years, and have demonstrated that you are capable of paying your bills on time and have managed to accrue some savings, your

bank may have extended to you a personal line of credit. You may have never used that LOC (line of credit) or may have used it and then repaid it.

Either way, there may be “an open offer” from which you can borrow up to the established level of your personal LOC.

This can be a good source of funding as well because the amount has been pre-established and you have already been pre-approved. Like any other loan, you will be subject to monthly interest payments.

Credit Cards

For some, after they have exhausted other sources of funding, utilizing money from their credit cards can be a method to finance the start of a business. The main advantage is that the borrowing level (maximum) has been established and the access to funds is immediate.

The main disadvantage is that interest rates on credit cards are higher than other sources of conventional financing and if you do not pay off the full balance due each month, the interest starts to compound.

Extension to the Home Mortgage

Perhaps you have paid off a significant part of your home mortgage or have paid it off in full. Most likely your property has appreciated in value since the time that you first took out your mortgage.

You could consider re-mortgaging your home and using the available funds to start your business. The main advantage is that the mortgage holder already knows you as a dependable customer and the funds should be readily available. The major disadvantage is that in the event that your business does not succeed, you will be left with a higher (or new) mortgage to repay.

Bank Loans

When starting a business, most people tend to think of borrowing money from a chartered bank, caisse populaire or credit union. The Branch Bank Manager or Loan Officer will want to see a copy of your Business Plan.

If you have been dealing with the same bank / financial institution for a number of years, have a good credit rating and a well prepared Business Plan, based on my experience, it is not too difficult to obtain a loan of up to \$50,000 from a bank / financial institution. Usually decisions of up to \$50,000 are made at the local branch level.

That is not to say that banks will not lend you an amount larger than \$50,000. Most often, when the amount requested is greater than \$50,000, the loan application goes to an individual or a committee at head office. Unfortunately these people do not know you, whereas your local branch manger does. Head office will examine your credit rating,

banking history and carefully review your Business Plan. Sometimes the local branch manager or loan officer will put in a good recommendation for a customer.

Banks like to see that the business owner is willing to invest some of their own money in the business. As an example, if you need \$100,000 to start your business and you can provide \$50,000 and request \$50,000 from the bank, that will carry a lot more weight than if you ask to borrow the full \$100,000 with no personal investment.

The bank will likely structure the loan so you are making principle and interest payments each month.

If you do elect to borrow from a bank / financial institution and get turned down by the first bank / financial institution, do not get discouraged. Try several others. Bankers are human beings. One banker may see an opportunity that another banker sees as a huge risk.

(For more about borrowing from a bank, see the article entitled, "How to Approach Your Banker").

Venture Capital

After exhausting all of the above methods of financing, some individuals turn to venture capitalists.

Venture capitalists are organizations that lend money for start up purposes or for business expansion, provided they see potential in the business.

In order to approach a venture capitalist, you will require a Business Plan. The venture capitalists will want to carefully understand the industry (the trends, opportunities, and threats), the competition (current and potential, their strengths, and weaknesses), the positioning of your product or service within the industry, the target market for your product or service (demographics, psychographics) and your marketing plans and programs (advertising, promotion and channels).

In addition, they will also want to closely examine your financials to ascertain the viability of the business and how quickly they can expect to be repaid.

If they like your Business Plan, they may agree to lend you an amount of money at a fixed interest rate, which is usually considerably higher than what one can obtain from a bank. You will agree to repay them over a specified period of time. They often will also want a couple of seats on your Board of Directors.

In some cases, it is not uncommon for a venture capitalist to include a convertible in their financing agreement. In simple terms, a convertible allows them the option of owning a portion of your business. One of my clients dealt with a venture capitalist that offered them a loan at an interest rate of 14% per year. The agreed to repayment term of the principle was 3 years. However, the agreement also contained a convertible clause. If the venture capitalist elected to exercise the convertible, they would forgive the loan,

but end up owning 42% of my client's business. The client had to carefully consider whether or not they wanted to proceed with the arrangement.

The obvious advantage to the venture capitalist is that should the business not do very well or just moderately well, the borrower still has to repay the loan. If the business does extremely well, the venture capitalist will exercise the convertible and own a significant portion of a profitable business, which they can then sell at a future point in time.

A business owner who decides to approach venture capitalists will have to first decide whether or not he or she is prepared to give up some the equity in their business.

Angel Investors

Angel investors are retired professionals or entrepreneurs who are looking for solid investment opportunities.

In some of the major cities in North America there are networks or clubs of angel investors. They meet regularly – usually once a month or once a quarter to provide one another with information about potential opportunities.

Prospective borrowers can approach the club about arranging for a presentation to the group. After a screening process, if the selection committee likes business idea, they will invite you to attend one of their meetings and to make a 20 – 30 minute presentation to the larger group.

After your presentation, if any members of the group are interested, they will approach you for additional details about your business. Interested angel investors will ask to see a copy of your Business Plan. Angel investors want to know about the terms of the arrangement – what the return will be for them and how long it will be before they can expect to take their money out (this is often called an exit strategy or exit plan).

Often angel investors are often looking for companies with anticipated high growth rates (25% or more a year) with a product or service that caters to a large and ever expanding market.

From an angel group presentation, a business owner may attract anywhere from as few as one or two prospective investors to as many as several. Each could be willing to invest different amounts of money in your company, depending upon their level of interest and their confidence in your business.

Sometimes lawyers and accountants are aware of prospective angel investors. Ask your accountant and lawyer if they might know of someone who may be interested in investing in your business.

Dealing with angel investors can be a rewarding experience for a new business owner. Working with a well known investor can often raise the credibility and sometimes the value of your business.

When conferring with an angel investor, respect their time and their knowledge.

Business Development Bank of Canada

In Canada, the Business Development Bank of Canada (BDC) is a financial institution owned by the Government of Canada. BDC provides financing to owners of small to medium sized businesses located in or starting up in Canada.

BDC does not offer grants, but they do provide loans to eligible businesses, usually at rates comparable to or slightly higher than the chartered banks.

To approach the BDC for a loan, you will require a Business Plan. A representative from one of the BDC offices told me that they receive hundreds of requests for financing each month. Typically, they will only do 2 – 3 projects a month.

The BDC also told me that there is a wide range in the quality of the Business Plans that they receive. Some of the plans are very well done with 30 – 40 pages of information. Others are extremely incomplete, written on one page. When approaching BDC, as with any lender, more information is better. The more information that you include in your Business Plan, the greater the chance you will have of securing a loan.

Usually the BDC will not lend you the full amount you require to start your business.

My experience with BDC is that they will match what you have contributed. So as an example, if you require \$120,000 to start your business, they will lend you \$60,000 provided you can also contribute \$60,000.

BDC prefers to lend money against tangible assets such as equipment, property or inventory. However, they also look for experienced management, a solid Business Plan and positive cash flow from operations in assessing any project.

Government Grants and Loans

I am occasionally approached by prospective business owners who are interested in securing government grants or loans.

Some people feel that the provincial governments and the federal government have a cache of money just waiting to give to “would be entrepreneurs”. That is just not the case. The simple answer is however that there are some government programs available, but these programs do not always fit the needs of start up businesses.

My experience with government loans is that they are made available to existing businesses (as opposed to start up businesses) for the purpose of purchasing equipment and machinery, additional property or to conduct leasehold improvements.

Money is usually not made available for financing such things as working capital (inventory, accounts receivable), paying franchise fees or professional fees (legal, accounting), conducting feasibility studies, for incorporation costs, for building permits or for purchasing a vehicle for personal use.

Government loans are sometimes made available for those new businesses that are willing to locate in economically depressed areas, provided it can be shown that the business will create jobs. Sometimes this type of assistance is not a loan but is available in the form of a wage subsidy or property tax deferral.

Government money can sometimes be available for the development of a unique product or technology.

Under the Canada Small Business Financing Act, a start up business may apply for a loan of up to \$250,000 to finance the purchase of fixed assets (equipment, machinery, leasehold improvements). The loan is designed to cover up to 90% of the cost of those assets.

CSBFA loans are designed for establishing, expanding, modernizing and improving small businesses. The business owner applies for a loan at the financial institution of his / her choice - through chartered banks, caisses populaires and credit unions throughout Canada.

These loans must still be granted by the participating financial institution. However, in the event of a default, the federal government will reimburse 85% of the lender's losses.

The lenders will still frequently take security in the assets being financed or other business assets. Loans can be repaid over the life of the asset (up to 10 years) and are usually at prime plus 3%.

It is worth investigating if there are any types of government financing that could assist your start up business. One word of caution: in dealing with most arms of the government, the process can be slow and cumbersome.

Mike Pendrith is the CEO of PerformancePoint Corporation. He works as an advisor to owners of small and medium sized businesses. Mike writes business plans for start up organizations. He also works with owners of existing businesses to help them to develop strategies and implement plans to grow their businesses, increase profits and improve operating efficiencies. For additional information, Mike can be reached at: pendrith@performancepoint.ca