Obtaining Credit and Finance

If not independently wealthy and perhaps even if you are, eventually you will probably need to obtain some outside capital for your business. In some instances, you may need to obtain capital for the initial expenses prior to opening your business or, for instance, the funds you require may be for expansion or working capital during the off-season.

Generally, business financing can take two forms: debt or equity. Debt, of course, means borrowing money. The loans may come from family, friends, banks, other financial institutions, or professional investors. Equity relates to selling an ownership interest in your business. Such a sale can take many forms such as the admitting of a partner or, if you are in a company, issuing of additional shares to investors. It is typically a prudent idea to consult with your accountant, as there are many significant legal ramifications to such a step.

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How Do I Get the Money?

Irrespective of the type of financing you need and are able to obtain for your business, the process of obtaining it is somewhat similar. There are several questions that must be answered during the course of raising money for your business.

The ability to answer these questions is critical to your success in obtaining financing as well as the overall success of the business. Remember, in raising capital you have to sell the ability of your business to potential investors in much the same way as you sell your product to your customers.

1. How much cash do I need?

To answer this question, you will have to do some serious cash flow planning, which will require estimates of future sales, the related costs, and how quickly you must pay your suppliers. You will also have to build into your planning some assumptions about when you will generate enough cash to pay the money back. However, if you raise cash through equity you probably don't need to pay it back, but your investors will want to know how the value of the business will grow and how they will benefit through dividends or selling their shares.

2. What will you do with the money?
One of the most important questions you will have to answer for a potential investor is how the money will be spent. Will you use it for equipment or to hire additional employees or perhaps for research and development for a new improved product? Again, part of the answer on how you spend the money is how it will benefit the company.

3. What experience do you have in running your business?
One of the primary reasons for business failure is lack of experience of management. You will need to convince your investors that you have the knowledge, experience, and ability to manage your business and their money at the level at which you expect to operate.

4. What is the climate for your type of business and your geographic location?
Few investors will want to put money into your business if you haven't done sufficient "homework" to determine that you have a reasonable chance of success. If your business is based on existing economic or legal conditions that are subject to change in the near future your risk is substantially increased. Even if your business has great potential, if the local economy is sluggish to the point that it can't support your venture, you need to be aware of this before moving ahead.

Once you have developed concrete answers to these and other pertinent questions, you can begin looking for financing. One of the first steps is to determine whether to raise funds through debt or share capital.

There are positive and negative aspects to each type. The cost to your company of each type of funding is different, as is the way in which they are treated for tax purposes. The interest on borrowed money is deductible by a business for tax purposes, which reduces the effective cost to your company.

Dividends which you might pay on the same investment in shares would typically not be tax deductible by your company. In selling shares there usually is no firm commitment by your company to pay the money back but your shareholder will want, and generally will have, a legal right to have a voice in the management of your company.

When you have made the decision as to the type of financing you think is appropriate to fit your desires and needs, it is probably a good idea to consult with your accountant as to alternative types of debt or equity financing available.

Business Plan

Typically, a potential lender will want to know all about you and your proposed venture. Many of these details will have already been provided but are best provided in a logical consolidated format. This format, or business plan, is a document that enables the investor to readily obtain an understanding of your proposal. It follows that in order to successfully raise funding, the business plan should be commercial and realistic.

We have experience in writing business plans and can assist you in the effective drafting of your plan.

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Financing Alternatives

Whether you determine that debt or equity financing is the best choice for your company, there are a number of alternative types of financing available. Depending upon the nature of your business, the financing may be a combination of debt and equity and may be tailored to fit the specific needs of your company.

In the summary, we will only mention a few of the more conventional methods for a young company to obtain capital, though the possibilities are many. We can discuss these and other alternatives in greater detail.

Debt Financing Sources

1. Banks
The first source of funds, which typically comes to mind when borrowing money, is a bank, which is why they are in business. Banks typically lend to small businesses on a secured basis preferring bricks and mortar as security in preference to equipment, stock or debtors.

The more liquid and readily saleable the assets you have to offer as security, the more acceptable they are likely to be a banker. Loans from a bank may take several forms such as:

a) An overdraft limit which is reviewed annually and allows you to borrow up to a predetermined maximum as you need it and pay it back as funds from sales and receivables are collected.

b) A short-term loan that is repayable on specified dates.

c) A term loan for the purchase of a specific asset such as a computer or a machine.

As your relationship with your banker becomes better, and your business becomes established, you may consider a longer (3 to 5 years) loan which will be payable in instalments.

2. Lease Financing
In today's business environment it is quite common to acquire equipment through lease agreements. Leasing packages come in a variety of types through many sources. Leasing companies typically will accept a somewhat higher degree of credit risk because they are looking to the value of the equipment for collateral if your business cannot make the agreed upon payments.

For this reason, leasing companies generally prefer to finance new equipment of a general-purpose nature which can be resold if necessary. Leases often run for a period of three to five years and because of the risk that leasing companies are willing to take, they are somewhat more expensive than commercial bank loans.

3. Trade Credit
A very important source of financing for your company may be from the creditors and suppliers with whom you do business. Many suppliers will originally ask for cash on delivery or, in some instances, they want payment before starting on your order, depending on the nature of your purchase. Most suppliers will quickly establish trade credit with you once you have gained their confidence by continuing to do business with them and paying as requested.

Equity Financing Sources

Equity financing usually means selling a portion of your business. This can be accomplished in a number of ways including the sales of ordinary or preference shares.

Equity sales are usually carefully tailored to meet the needs of both the company and the investor.

Venture Capital Companies

A venture capital company or fund is typically a company that is in the business of taking risks. A venture capital fund is often backed by a group of investors that may be individuals or companies.

The investors are often represented by a management group that evaluates potential investments and manages the existing investment portfolio.

Private Individuals / "Business Angels"

Very often, individuals who are successful in their own right and have accumulated substantial wealth may be looked to for investment in your business venture. Such individuals may believe that the success of your business may enhance theirs as well as help increase their personal wealth.

There are generous tax breaks that may be available to such investors if they subscribe for shares in a limited company that qualifies under the Enterprise Investment Scheme (EIS), or the Seed EIS scheme for start-up companies.

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