Janmar Consultants Inc.

Ensure there is the right mix between short-term and long-term financing. Are loans or equity the right choice?

If borrowing money, your lender relationship needs to be solid as this is usually your most important supplier.

Capital, Financing & Lender Relationships

Each specific business situation will dictate whether the right capital solution is short-term debt, long-term debt, equity, or some combination of all three.

Having a strong relationship with your lenders is also critical as it can either help make the process of accessing and maintaining capital easier or more difficult.

Executive Summary

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Business is always changing – whether it's business expansion or contraction, the purchase of a new piece of equipment, or the launch of a new product, the one thing you can be sure of is it will never stand still. These changes inevitably at some point lead to your business needing additional capital/money/funds ("capital"). This can be a very challenging exercise, and the key question as a business owner is, what is the best type of capital to pursue and where and how do you access it? Acquiring additional capital when required can be a very time consuming, frustrating, worrisome process, not only for business owners, but also for a seasoned expert who has raised capital many times before. No one solution is right in all circumstances. Each specific business situation will dictate whether the right capital solution is short-term debt, long-term debt, equity, or some combination of all three. Knowing what is needed to access capital is vital to any business.

Having a strong relationship with your lenders is also critical as it can either help make the process of accessing and maintaining capital easier or more difficult. By keeping your lender informed and up-to-date on what is going on with your business, it will pay additional benefits, such as:

- Business advice at no additional cost
- Additional sources of capital, if needed
- Access to additional customers and suppliers
- Preferential rates and better terms

Acquiring additional capital when required can be a very time consuming, frustrating, worrisome process

In This Issue

- **What type of funding is right for your business**
- **Debt vs. Equity - Advantages and Disadvantages**
- **What are the sources of funding?**
- **Why is a strong relationship with your lender needed?**
- **How a part-time CFO from Janmar Consultants help you to access additional capital and strengthen relationships with your lender(s)**

Introduction & What Type of Funding is Right for your Business

No matter how much money your business needs, there are only two sources of capital:

1. **Debt, whether short-term or long-term, is borrowed capital**
2. **Equity, is capital in exchange for an ownership interest in your company**

As a rule of thumb, debt is cheaper capital than equity. The reason is the cost of debt is merely the interest rate you pay. When the debt is repaid the cost is eliminated. With equity you give away future earnings in exchange for the capital and there is no end. It is said you can only spend equity one time since once you give it away you can never get it back (subject to buying your shareholder(s) out), whereas with debt you can spend it multiple times. This is driven by the fact you can borrow money, pay the loan off, borrow money again, pay the loan off, and so on.

Cost of debt is cheaper than equity

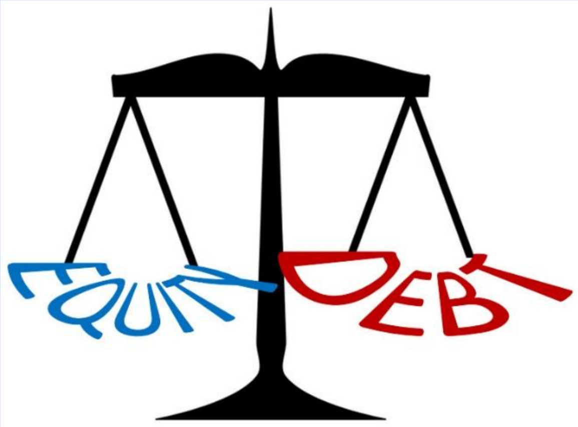
The first thing that you as the business owner needs to decide is what type of capital do you want to raise – debt, equity or a combination? This decision is usually determined by the owner, however if your company is an early stage company you may have no choice other than debt.

To help with the answer, you need to decide if you want to maintain control and/or do you want to be the sole decision maker. If the answer to this is yes, then you will prefer debt to equity as you will be able to continue to make all decisions yourself and will not need to report to any other shareholder(s) which certainly makes your life easier.

Determining what type of funding is right for your business is dependent on your own circumstances. One shoe does not fit all. This will be impacted by many factors which include:

- Your business circumstances
- Your personal goals and views
- The current economic environment
- The industry you operate in

If debt is the route you chose to take, normally this comes from your current lender. Afterall, this is the path of least resistance since they already know your business and you already have a relationship with them. There are sources of debt outside of your current lender/bank, however these are normally harder to access as they do not know you and have no relationship with you. These sources are generally more expensive then your current lender, so if this is the route you choose to take, make sure you are asking for enough money to make the cost of this worthwhile.



If you are an early stage company, you should expect to provide a personal guarantee to back stop the money you are borrowing, so you need to make sure this makes sense to you. Additionally, our experience is once you give a personal guarantee, lenders will not give this back to you in the future.

For smaller companies, equity financing normally comes from either angel investors or venture capital funds. As mentioned before, you can also use a hybrid approach by using a combination of both debt and equity. By doing this you can put in place the long-term capital to support long-term growth and the short-term working capital to support the working capital the business needs. One of the keys is to ensure you are supporting long-term business requirements, like equipment purchases and product expansion, with long-term debt or equity, and to support short-term requirements like accounts receivable and inventory with short-term debt.

Owners of smaller companies should expect to provide a personal guaranty to a lender

In our experience, most business owners and senior executives, see their lender as a necessary evil. In fact, they are normally your most important supplier, as they are usually the one entity you, as a business, owe the most money to. Accordingly, they should be one of your most important relationships. However, this relationship does not happen by chance, it needs to be cultivated and worked on to ensure it is as solid as it can be. By keeping your lender informed of what is going on in your business, it will make their decision to support you when needed, easier when the time comes.

The goal of this article is to focus on businesses that are past the start-up phase.

Additionally, no matter how much money your business needs, $10,000 - $5,000,000 or more, the steps to follow and the information/documentation you require is the same. This information will include historical financial statements, forecasts and budgets and a business plan. This is referred to as due diligence materials. To get more insight into what these due diligence materials are, please see our article entitled “Succession and Exit Planning”.

Debt vs. Equity - Advantages and Disadvantages

Before deciding on what is the best type of money to raise between debt and equity you should understand some of the advantages and disadvantages of each.

Debt vs. Equity?

Advantages of Debt vs. Equity

- Debt does not dilute the owner's interest in the business
- The lender is only entitled to repayment of their interest and principal, and accordingly, has no claim on future profits of the business. With a successful company this results in lower payments than if stock had been sold
- Principal and interest obligations are known amounts that can be budgeted and forecasted, unless variable rate loans
- Interest can be deducted on the company's tax return, hence lowering the cost of the loan to the business
- There is a lower duty of care owed to a lender than an equity investor, especially if they are a minority shareholder
- If only one shareholder, the decision process is easier with debt

Disadvantages of Debt vs. Equity

- Debt must be repaid, unlike equity
- Interest is a fixed cost and raises the company's breakeven. High interest costs during tough financial periods can increase the risk of bankruptcy
- Both the principal and interest repayments require cash and must be budgeted for. Generally, debt repayments are a fixed amount and not variable depending on how well the business is performing
- Debt usually comes with covenants from the lender that can restrict what the business can and cannot do
- A company's ability to borrow debt is not unlimited. It's debt to equity ratio and the lender's appetite for risk will dictate how much debt a business can access/carry
- Normally assets are pledged as security for borrowing money from a lender as collateral. The lender may also require a personal guarantee from the owner of the business to secure the loan

What are the Sources of Funding?

There are many sources of funding available to businesses. We will highlight some of those in the pages that follow.

Working Capital Loan/Operating Line of Credit

Most businesses utilize operating lines of credit to finance their businesses as they are normally relatively quick and easy to set up. It is normally supported by the accounts receivable and inventory of the business.

One of the drawbacks is, they are normally on demand and accordingly, the bank can call the loan at any point in time with little notice to the company. If the business runs into problems, because this is a demand loan, the lender may demand repayment at one of the worst times for the business.

Term Loans

Unlike a working capital loan/operating line of credit, a term loan is a loan from a lender with scheduled payments of interest and principal over a set period, on average 2 - 5 years. The exception is real estate whereby the term will be longer, 10 – 20 years depending on the lender.

Term loans are generally used for long-term asset purchases such as equipment and are normally not due on demand. The reason is they are for long-term asset purchases that can not be sold or liquidated easily. Normally, term loans are secured by pledging the assets of the business to the lender, and in some cases by a personal guarantee by the shareholder(s) of the business.

Ironically, banks normally offer loans to companies when they don't need them and then either tighten credit or don't offer loans

when the business needs them. The reason? If a company is doing well it is less likely to need money, however if it runs into problems/issues it is more likely to require a loan/money.

However, the key to borrowing money is to have a proven track record, over years, of generating profits and cash flow and a solid go forward business plan of continued profits and cash flow. This lends credibility to the business and confidence in the lender that any loans made to the company will be repaid.

The other factor that impacts your ability to access money from your lender is having a strong relationship with them, but we will discuss this in more detail later.

Asset-Based Financing

A modified lending arrangement is asset-based financing. These are bank loans secured by the underlying assets pledged as security for the loans. All major banks have asset-based lending arms and there are also specialist companies that operate in this space.

Debt:

Working Capital Loan
Term Loan
Asset-Based Financing
Invoice Discounting/Factoring
Alternative Financing

The amount of money you can borrow with an asset-based lender is based on what the liquidation value is of the underlying assets that support the loan. This can include accounts receivable, inventory, plant and equipment.

If looking to obtain one of these loans you need to have realistic expectations. Lenders will generally advance 75-85% of accounts receivable and from 0-40% on inventory depending on the type of inventory – raw material, work-in-process or finished goods. Lenders will have a liquidation analysis prepared, normally by a third party, which will dictate what they believe the liquidator will realize if they need to sell off the inventory due to an insolvency/bankruptcy. The advance rate on inventory is dependent upon how easily it can be sold to a third party.

Invoice Discounting/Factoring

Invoice discounting/factoring is a lending facility whereby you, as a business, sell your accounts receivable to a factoring company.

The factoring company lends you money for your accounts receivable, less the discount factor (typically 15-25%), resulting in your business getting 75-85% of the face value of each invoice. The loan from the factoring company is paid off for each invoice when your customer pays. The security for the factoring company is the accounts receivable.

Sometimes this can be visible to your customer, and potentially can be a negative for your business, as some factoring companies will call your customers to collect the money. This can normally be avoided by the using a blocked bank account, so if you chose this option, we recommend using a factoring company that will utilize a blocked bank account agreement.

Advantages

- Better liquidity
- Fairly easy to obtain
- Usually quick to put in place
- Few covenants, if any
- Lower costs than non-conventional bank loans
- More flexible than conventional loans
- Allows you to easily establish credibility with a lender

Disadvantages

- Reporting requirements can be onerous
- More costly than conventional bank loans

One alternative to this option is to factor specific invoices rather than all accounts receivable. This may be a viable option if the amount of money this yields meets the funding requirements of the business.

Alternative Financing

Outside of the financing options already discussed, there are many alternative sources of financing.

Some of these include:

- You, the business owner
- Family
- Friends
- Specialist lenders – i.e. mezzanine lenders
- Credit cards
- Peer-to-peer lenders (borrow from individuals, through online organizations like Lenders Club)
- Crowdfunding (through organizations like Kickstarter, and others)
- Trade finance from your suppliers (this is the cheapest form of financing as most suppliers do not charge interest or if they do charge interest it is seldom, if ever, paid)

The advantage of these lenders is they have greater flexibility as many are not regulated like banks, however, generally they are more expensive than the traditional avenues already discussed.

Equity:

Private Equity
IPO (Initial Public Offering)
Angel Investors

Private Equity

Private equity firms provide medium to long-term funding in exchange for an equity stake in the companies they invest in. Their return, as an equity investor, is dependent on how well the company performs after they invest in. Accordingly, they want the business to grow profitably and will work with you to grow the business, both in size and profits. Quite often equity investors want a controlling interest in the company they acquire, or a formula that allows them to acquire control at some point in the future.

Advantages

- Cash infusion – private equity groups normally have deep pockets to provide the financial resources for growth
- Expertise – they can provide talent you need, that you do not have in-house
- Connections – they can connect you with other people and businesses they own or know to fuel growth

- Management incentives – normally they provide management with bonuses for performance

Disadvantages

- They are short-term investors as typically, private equity firms hold their investments for between 3-7 years, so they are not your forever friend

IPO (Initial Public Offering)

This is where a business is publicly listed, and the public can buy or sell shares. Normally this is for larger businesses.

In Canada, the Toronto Stock Exchange ("TSE") is the most senior equity market. In the US it is the New York Stock Exchange ("NYSE").

Advantages

- If you need additional capital, you can issue additional shares
- Increased public awareness because shares are publicly traded – positive sales impact

Disadvantages

- It is expensive and time-consuming to get and remain listed
- Because you are publicly traded you are subject to more scrutiny from shareholders, regulators, and customers
- There are required filings that need to be made ad deadlines adhered to including financial statements, and corporate governance

For most of our target clients this not a realistic option as they are too small for this to be feasible.

Angel Investors

Angel investors are high net worth individuals that use their own financial wealth to invest in companies and provide their business experience and expertise to help companies grow and become successful in exchange for an equity interest in the business. Normally they invest with the expectation the business will rapidly grow and be sold. This sale is how they get a return on their investment.

Why is a Strong Relationship with Your Lender Needed?

We strongly believe your bank is your most important supplier since they are normally the supplier you owe the most money to. For this reason, you need to ensure they intimately know and understand your business. Inevitably your business, at some point, will need the support of your bank/lender, whether this is to support growth or during hard times. By building trust and credibility, it will make getting this support easier. You need to ensure your bank knows your business, your industry, your customers and your suppliers. You need to provide your bank with a credible business plan with sound strategy and a realistic forecast, and then provide periodic updates on how you are performing in accordance with the plan. With realistic forecasts your lender will build a history of you and your business, and they will see that you say what you are going to do, and then do it, and this in turn will allow them to support your business when you need it.

You don't build this track record with only regular telephone calls. You need to schedule regular visits from your bank with your business so they can see first-hand what you do and how you do it. Reports are one thing, but having your bank physically attend your business allows them to see, feel and touch. Not only this, but they will feel they are a part of the team that has built the success your business is and will be.

Share both good and bad news with your bank. Tell them what worries you.

Another key is don't make the mistake of only sharing good news with your bank. Tell them good news and bad news on a timely manner and let them know what worries you – this will add to your lender relationship.

However, not only does having a great relationship with your lender ensure you will get the support you need when you need it, but it will also be a free source of advice and information. Your relationship manager at your bank has a portfolio of clients they look after, and these other clients can serve as potential customers and suppliers to your business. By providing information and asking for advice you will build a solid relationship.

When the time comes and you need additional financing or support from your bank, there is some basic information and documentation they will need:

- A proven track record
- Historical results
- A realistic business plan
- Audited financial statements, or some externally vetted financial statements
- Current listing of accounts receivable and accounts payable
- A cash flow forecast
- A budget for the next year, as a minimum

How a part-time CFO from Janmar Consultants help you to access additional capital and strengthen relationships with your lenders

Very few smaller businesses have the expertise in-house to access additional capital when needed, not only in good times, but more importantly in difficult times. A part-time CFO from Janmar Consultants gives you and your business the expertise of someone who has raised capital many times before. Additionally, they will have their own contacts they can make available to you. With their support you will be able to access the capital you require in significantly less time, not to mention their expert help and advice. This will in turn allow you to focus on growing and improving your business, rather than chasing money.

Your part-time CFO will also help build a solid relationship with your bank, by taking on the responsibility of your banking relationship by keeping them up-to-date with what is going on in your business. They will also provide your lender with the required reporting and information they need to continue to keep them informed and build trust and credibility for you and your business.

Some of the things your part-time CFO will do:

- **Develop a strong relationship with key people at your bank**
- **Provide your bank with the information they require as well as additional information needed to keep them fully informed**
- **Provide you with a trusted, independent advisor on your team that understands how banks work and think**
- **Provide your lender with a credible, realistic business plan**
- **Help negotiate the best deal possible with your lender as they have done in the past**
- **If needed, they will provide you with alternative financing options**

Conclusion

When it comes to needing additional money for your business to take it to the next level the first thing you need to decide is whether you want to do this through debt or equity. If you choose debt you need to decide what is the best source of these funds – traditional banking, factoring your receivables or an alternative source. The big benefit of a debt is you do not give up any ownership of your business and you maintain control as you grow. If you decide that equity is the best option, you need to decide how much equity you are willing to give up to an investor. You also want to make sure you select the right equity partner as you and they will be partners for the foreseeable future.

You also need to set realistic expectations with respect to timing. Raising financing can be a difficult and time-consuming exercise that is not for the faint of heart. Having a part-time CFO from Janmar Consultants on your team will provide you with a seasoned professional who has raised both debt and equity numerous times before, and they will understand many of the pitfalls you want to avoid. Additionally, they will provide this expertise at a fraction of the cost of a full-time junior accountant.

As we have stated before, your lender is your most important supplier and you need to have a strategy to ensure you treat them as your most important supplier. They are not a necessary evil, so don't treat them like they are. Having a member of your team that understands the importance of this is critical to your business, and the sooner you have a seasoned professional on your team that can take this task to heart the better off you and your business are. A part-time CFO from Janmar Consultants can provide you with this in-house expertise, call us today.

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