Finding sources of capital

BUSINESS COACH SERIES

- Secured and unsecured borrowing
- Selling equity
- Government programs
- Frequently overlooked sources

BMO Bank of Montreal
The fundamentals of finance

The situation

As a business owner, you may eventually find yourself in need of money. You may require additional capital to tide you over on a short-term basis; or you may need fairly long-term financing to help you build and strengthen your business. Or, you may seek permanent capital.

The solution

At BMO Bank of Montreal®, we are committed to helping Canadian businesses develop and succeed. The purpose of this Business Coach is to outline a wide variety of conventional and non-traditional financing sources and how they can work for you.

In seeking capital, you have to take into consideration numerous factors that will direct you to a solution appropriate for your needs. As your company matures and your assets and cash flow build, the possible sources of capital expand. We suggest that you first discuss your needs with your banker. Since your banker already knows you and your business, it’s a logical and inexpensive starting point.

Before you look to outside sources, take a close look at your own company. Often more efficient management can lead to dollars saved and lessen the need for additional funds.

Keep in mind that money seeks rewards in relation to the risk involved. If you have assets to pledge, you may find borrowing money is easier. Without assets you may need to seek an equity investment. But, take note: small amounts of equity (less than $100,000) are frequently more difficult to raise than large ones.

Start early. It could take from several weeks to six months to define your real needs and arrange a loan, a grant from a government agency or equity funds from a (new) shareholder. Suppliers of funds will investigate you thoroughly before they make a commitment. Be prepared. The best way to forecast your needs is through the preparation of a cash flow budget (See Business Coach Planning your Cash Flow at bmo.com/business-resources).
Private sources

Business owners often approach individuals for money, including:

- friends
- relatives/spouse/partner
- business contacts
- employees
- private investors

Consider:

- Individuals are rarely “silent” and may offer management or policy assistance, contacts or help with special assignments.
- Individuals tend to want equity – the right to participate in the future. Is the financial gain worth the loss of ownership?
- Individual investors can create a highly personal relationship.
- If you set up a partnership, supplement areas of weakness with strong and complementary experience.
- Always have a written shareholder/partnership agreement with backers/partners, with a “buy-sell” clause. If it’s a syndicate, try to deal with only one representative.
- Review all agreements with your legal counsel.

Tips

Seek individuals at clubs, Chambers of Commerce, and so on. As well, your lawyer, accountant or banker can sometimes make an introduction to a potential backer.

If you seek capital from employees:

- Every dollar invested is a highly committed dollar.
- Always have a written buy-back provision.
- Unless part of an eventual plan to sell control to employees, it’s desirable to keep employees’ percentage below the 20% mark.

Banks

Although Canadian Chartered Banks are primarily concerned with short-term, day-to-day lending, they also often provide term loans, leasing, mortgages, factoring, wholesale floor planning, support services such as payroll, letters of credit, credit references, and more.

What banks want from you:

- Facts and figures from statements, records and projections.
- Stability of your company and commitment of the owners. They will look at your past and present performance, future potential, the amount you have invested, the amount you have left (equity and retained earnings), the way you run the company.
- Information on how you will be investing the money in your business.
- The ability to service the debt; that is, to pay the interest and retire the loan on time.
- Security or collateral that usually involves the pledging of accounts receivable, inventory, and personal guarantee of principal. Term loans often require fixed or other tangible assets as security.
Consider:

• Be open. Tell your banker in advance if there’s bad news coming. The bank’s confidence in you will remain strong if you’re straightforward.
• Prepare a cash flow budget and go over it with your banker. Keep your banker up to date each month, even when you’re not borrowing.
• To establish a credit record, borrow from your bank early in your business cycle.
• Work your loan down and if need be, let it go up again. Don’t leave it sitting.
• Use your banker as a valuable contact. Bankers are well aware of economic conditions in their areas and potential in other areas, through their divisional offices. They can introduce you to potential customers and suppliers and help you with credit checks.
• Your banker can be your best business friend. Discuss future financing needs with your banker and take the time to nurture a good business relationship.

Ensure your banker visits your premises occasionally to get to know your operation.

Term lenders

With assets to pledge as security, you may wish to approach financial institutions that specialize in term lending. These include:

• Insurance companies, trust companies, mortgage companies and banks:
  – mortgage lending on land and buildings
  – usually longer-term (15 years and more)
  – up to 60% of recent valuation

• Commercial term lenders such as banks, acceptance companies, finance companies, Schedule 2 banks and a small group of specialist companies:
  – lending on commercial assets including land, buildings, and equipment
  – most terms are 10 years and longer
  – amortizations up to 25 years with floating interest rates
  – up to 60% of recent valuations of land and buildings; and 50% or more of equipment

Leasing

Leasing costs can frequently be deducted as a business expense, as opposed to depreciation if you own.

There are three basic types of leasing:

• Direct. For computers, cars, trucks, business equipment, and so on, the leasing company looks after the entire transaction.

• Indirect. A three-way transaction. The supplier obtains the customer’s signature on the lease and hands it to the leasing company that bills the user.
• **Leveraged.** This is a partial equity investment situation on the part of the user, say 20% to 40%, with the remainder being financed through leasing.

Consult with your accountant regarding tax implications.

### Suppliers

Major suppliers are an often overlooked source of capital, provided you can negotiate special terms with them. For instance, you may be able to develop a new market for a supplier’s materials or semi-finished goods and save the supplier money.

**Possible advantages**

- Special terms during seasonal peaks and valleys could be 120 days or longer with or without an interest charge.
- Consignment deals, where you pay only for goods sold.
- Right to return unsold goods for full credit.
- A supplier who provides you with financing wants you to succeed and may lend technical, marketing and other assistance.

**Potential disadvantages**

- Over-dependence on one supplier.
- Less room to negotiate on price/discounts.

### Customers

Customers may be able to help finance your business, particularly if you can offer on-the-spot, reliable follow-up and service, including a supply of components or parts.

**Consider:**

- Cash payment instead of credit terms (your customer may want a discount, but not necessarily).
- Deposits on orders and progress payments against work completed.
- Equalized billings, especially for service businesses with long-term customers who use services occasionally or at cyclical peaks.

### Venture capital

In five years, would you prefer to own 70% of a big company or 100% of a small one? Venture capital firms will invest directly in a company if they believe that a business will be profitable and grow substantially. Almost all deals are equity based or based on some form of subordinated debt with conversion or option rights. (This means that in case of bankruptcy, their loans rank behind all other secured creditors but ahead of other shareholder loans.)

- Venture capital companies expect high returns and usually want substantial minority positions – 20% to 40%, or even control of startups.
- They expect management shareholders to be fully committed financially, providing an efficient, balanced management team.

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**Tips**

Sometimes capital can be freed up for operating purposes by selling real estate to a development company, then leasing it back with a right to purchase at the end of five or 10 years.
Venture capital companies frequently can help in:
- planning and policy
- finance and control
- arranging mergers and acquisitions
- arranging an Initial Public Offering (IPO)

They probably will require:
- a seat on the board
- regular board meetings
- monthly statements
- insurance on the owner
- involvement in the budgeting process
- a buy-sell agreement covering your shares and their shares

Most venture investments require further funds. Ensure the venture capital company has a good reputation and is well financed.

Venture capital firms may be located through the federal government’s web site.

Tips

Check with your provincial Industry/Commerce Department to see what’s available for you. Most provinces or regions have some form of venture capital program providing relatively small amounts of money to startups.

Governments

Federal and provincial governments have loan, guarantee or grant programs for any or all of the following:
- creating jobs
- increasing capacity
- training
- replacing imports
- exporting
- creating or upgrading technology

For federal government assistance, check:
- Enterprise Development Program (EDP), which combines several previous government programs. This is a very active loan and guarantee program administered by local boards.
Franchises

Are you buying a franchise?
As a franchisee (associate or dealer), you start a new business or move into an established one. You pay a fee, but reduce your risks. Before you put your money down:

• Make sure the front-end fee provides you with value: a name, a system, a product, access to suppliers, a guarantee on a lease, training, etc.
• Check with other franchisees in the same group.
• Ensure the franchisor makes money on royalties from sales, rather than on fees.
• Check the reputation and track record of the franchise.
• Check the markets you’ll be allocated and ensure that continuing research and product help, training, and so on are available.

Are you a franchisor?
As a franchisor, you promote and build an existing business in new areas, partly on other people’s money (their fees). Before you accept money:

• Ensure you can get franchises back if franchisees don’t perform (specify minimum targets).
• Make sure franchisees have a sufficiently high financial stake to ensure they are committed.

Tips
Before you sign, read the fine print on the contract and ensure your lawyer checks it over (make sure the franchise can’t be taken from you arbitrarily).
• Consider asking for minimum royalties/fees.

For more information, booklets are available from the federal government, Better Business Bureau and Canadian Franchise Association. And follow the Business Opportunity columns in national and local papers.

**Wholesale floor planning**

For businesses that require expensive floor samples such as car and recreational vehicle dealers.

- Allows you to buy product for display prior to the beginning of the season.
- Interest rates vary and frequently escalate with length of the loan.
- Many banks provide this service as well as some industry specialists.

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**Factoring**

A traditional method of financing, factoring allows you to get cash from your receivables.

- Used by the garment and floor-covering trades, sporting goods, appliances, wholesale jobbing, building supplies, and many other areas.

**Types of factoring**

- Non-borrowing. The factor collects the accounts and pays them over to you.
- Borrowing. The factor purchases your receivables and advances a specified portion of the total, perhaps 80%.

**Consider:**

- Credit approval must come from the factor.
- Factors are an excellent source of credit reports.
- Invoices are usually stamped “Pay... Factors.”
- Costs include both management fee and cost of borrowing. Be sure to inquire about the actual fee structure.
- Factors handle all the accounts receivable associated with the issue of the original invoice.
- Factors may guarantee loans for their clients.
- Factoring can affect your normal bank lines of credit. Check with your banker before proceeding: your bank may be able to offer you similar options.
Credit unions
Credit Unions and Caisses Populaires, governed by provincial legislation and usually having a central provincial member organization, may offer:
- mortgages on land and buildings
- term loans
- working capital
- revolving lines of credit

Asset-based lending
Asset-Based Lending (ABL) is a specialized form of secured lending based on the tangible assets of a company (inventory, equipment).
ABL may be viable alternative when:
- additional funds are needed to finance growth or acquisition, or
- your business has suffered a setback

Consider:
- Interest rates and fees are higher than traditional loans; however borrowing availability is generally higher.
- Lenders usually require an independent appraisal to determine net value of assets.

- Advance rates are based on the net realizable value of assets as they relate to inventory, machinery and equipment.
- Monitoring is at a higher level in order to manage collateral positions and company performance.

Confirming houses
Confirming is the financing of your payables.
- Can be used for financing of raw materials and semifinished goods.
- Revolving accounts with specified customers and letters of credit can often be arranged.
- Several companies specialize in this field; most are international but familiar with overseas conditions, markets, suppliers and trade practices.

How it works
Confirming house takes over the supplier’s bill.
You pay the confirming house.
Interest rate can be favorable if confirming house has funds available in country of origin.

Warehouse receipts financing
A form of finished goods inventory financing.
- The lenders keep a close tab on your stock after assignment to them.
- May advance up to 80% of the value of the stock from time to time (i.e., a higher proportion than under normal borrowing). Can vary up and down according to circumstances.
**Private placement**

Mature companies use private placements to obtain debt or equity financing from a small group of investors (such as pension funds, trust companies, wealthy individuals, venture capital companies). The placement is usually made by an underwriter or lead investor.

- Generally for amounts of more than $1 million.
- Often in the form of debt or preferred shares which are subsequently convertible to common shares.
- Investors generally expect a realization on their investment within three years.

**Initial public offering**

This is the goal of many entrepreneurs: cashing in, partially or completely. It generally means selling stock to the public through the stock exchanges, but could also involve selling to a “listed” company in exchange for stock.

- Usually IPOs involve issues of $8 million or more. Less is possible, but it can be unwise and expensive due to legal fees, prospectus and underwriting costs.
- Generally, you won’t want to sell control of your company to the public.
- The issue price is likely based on the earnings of your company; the multiple used will vary depending on the market conditions and your industry.

**Consider:**

- Shares are usually higher priced when widely held, but not necessarily in poor markets.
- The stock markets aren’t easy to predict, even for the professionals.
- There are times when it isn’t possible to go public, i.e., in a weak market.
- Some or all of your stock may be subject to restrictions on when you can sell it.
- It’s often difficult to go to the public a second time for more funds.
- There are strict regulations for public companies, covering timely disclosure, insider trading, publishing financial statements, and so on.
- Public offerings are an expensive proposition when you take into account legal fees, prospectus and underwriting costs.
- Choose your underwriter carefully.

**Tips**

Be aware that raising capital through an IPO may result in some loss of control of your company.
At BMO Bank of Montreal, we are committed to helping Canadian businesses develop and succeed. To this end, we’ve created a Business Coach Series that provides information and knowledge that can optimize the value of your company’s financial resources. The booklets that make up the Series focus on essential areas of financial management allowing you to focus on operating your business more effectively.

For more information on how BMO Bank of Montreal can help your business:

• talk to your Commercial Account Manager
• call us directly at 1-877-262-5907 or
• log on to bmo.com/business-resources

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