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Need Funding for Your Business? Debt or Equity? Lender vs Investor?

Here is What you Need to Know!

By: Adrian Isaacs, CPA, CA, Founder & Managing Director at Isaacs Advisory

Many business owners I connect with are often frustrated when their bank cannot accommodate their financing needs. As I delve into their situation, I often see that their expectations regarding the role of a bank (and the level of risk they expect a bank to take) is often confused with the role and risk that would be more appropriate for that of an investor.

I have therefore prepared this article to give business owners and entrepreneurs some insight on the key differences between lenders vs. investors, and hopefully save them time (and some frustration) from calling banks with an expectation that the bank would provide them a solution in a situation that is more suited for an equity investor.

Here are the key factors to note:

Debt vs Equity:

At the outset, it is important to understand that investors buy shares or stocks in a business, i.e. they make an investment in a business. As a shareholder, they have an ownership interest in the business, albeit on a very fractional basis in the case of large public companies, such as Amazon or Apple. And as business owners, they participate in the increase (and decrease) in the value of the business they have invested in, which for public companies, is primarily reflected in the movement of the stock price. Investors typically make money "buying low & selling high".

In contrast, a lender lends (not invests) money to a business with the expectation of earning a certain fixed return on the funds provided over its term and with an expectation that the loan will be repaid.

In addition, lenders typically require collateral to secure a loan so if there is an unexpected problem in the business, they can sell off the collateral to recoup their loan. Lenders also generally require business owners to provide personal guarantees of the loan which would not be the case for an investor.

Investors, by contrast, don't lend money to the business, but rather invest (or give) their capital to the business in return for ownership (i.e. they buy in). There is no requirement to repay it and there is no collateral provided.

In addition, investors typically earn their returns by way of dividends and share price appreciation, whereas lenders generally earn interest on the loans they provide customers as well as bank service charges.

It can get confusing as some loans have features that allow them to be converted to equity at some point. But they start out as loans and can be converted to shares at some later date or at the occurrence of a certain event.

Risk vs. Return:

Investors (that buy equity in a business) seek a much higher rate of return on their investment over time and the investment return is typically proportional to the amount of risk taken on. For example, investing in a start-up business or business that is pre-revenue or losing money are typically more risky investments than investing in large established public companies, such as Procter & Gamble, Microsoft or Manulife Financial. As a result, earlier stage investors, sometimes called Angel Investors, seek a higher return than those investing in large, global, profitable, and established businesses.

On the other hand, lenders earn their return based on the spread being the difference between the interest they charge customers and the interest they pay, which for traditional banks is the interest paid on savings accounts, GIC's and other types of interest-bearing assets. Lenders want a clearly defined rate of return and don't want to lose their capital. They take on less risk and therefore make lower returns than what an investor requires.

At the time of writing this article, the bank prime interest rate is 2.45%. As such, traditional banks that ***lend*** money are only making a modest return on their capital and therefore only take on a level of risk commensurate with the interest they are receiving.

Unfortunately, a high percentage of start-up and early stage businesses do not survive their first few years of operations. This risk of loss means investors need to earn a return on their capital quite a bit higher than bank prime. This is the core reason why banks typically only lend to profitable businesses as they do not earn a sufficient return on their capital to warrant lending to a business with a higher risk of default.

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Bank financing solutions don't fund losses:

Traditional banks conceptually offer two types of financing solutions which are typically used for either timing issues or to fund growth, but not operating or startup losses. They are:

Revolving Lines of Credit – designed to bridge the timing gap between the time it takes a customer to pay vs. the business needing to pay its day-to-day costs. The solution is just the "oil" used to keep the engine running smoothly. However, many start-up or earlier stage businesses may be generating revenues but are still operating at a loss and these businesses need capital to cover the operating losses, which is a different need than the timing issue between collecting money from customers and having to pay the bills.

Term Loans – typically used to finance things like machinery and equipment, or fund acquisitions. They do not provide financing to cover the operating losses as they don't take on the "equity risk" of the business failing. Earning 2.45% is not a big enough return for an investor when investing in a start-up or early stage business and banks are lenders, not investors.

So, in conclusion, when thinking about your business's funding needs, step back and consider: Based on where my business is at today in its life cycle, is getting a bank loan realistic or should I focus my efforts on looking for an investor? And save yourself the time of approaching lenders and expecting them to take on equity like risk.

At Isaacs Advisory, we have extensive experience in advising, structuring, and sourcing a wide range of traditional and non-traditional financing solutions for small & medium sized businesses.

For more information on raising financing solutions for start-up, early stage, growth, in-transition, or business in distress, please contact Adrian Isaacs at 416-835-4511 or aisaacs@isaacsadvisory.ca.