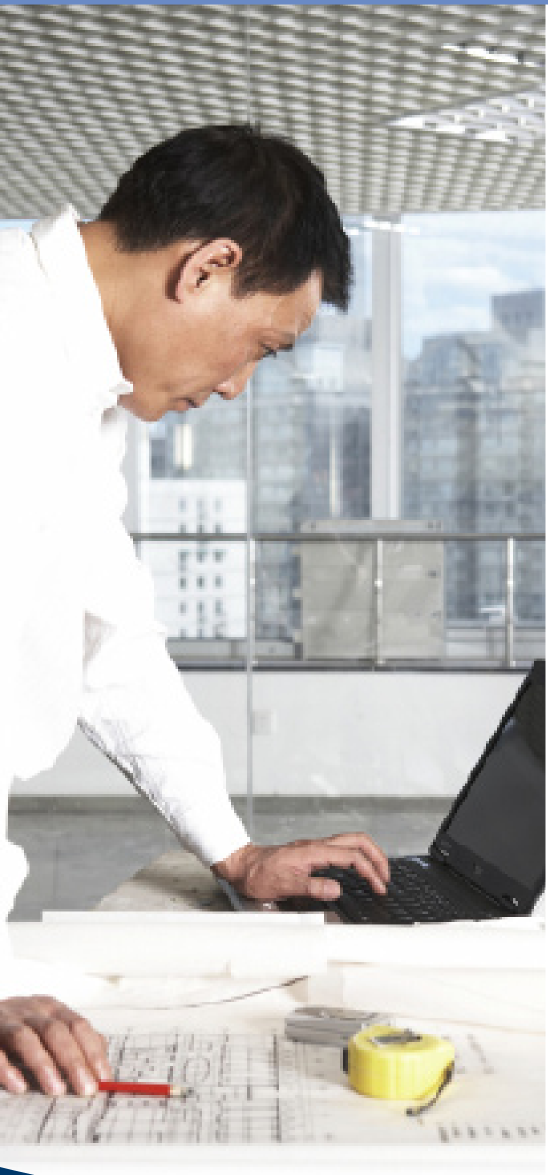
Commercial Financial Services

Understanding and managing short- and long-term debt



Smart borrowing has allowed thousands of business owners to expand and develop their operation and make it a success. These people approached their debt the same way they approached all of their investments: objectively, with a willingness to research and weigh their options until the best opportunity presented itself.

As their businesses have grown, they have continually reassessed their investments and employed debt where necessary to achieve financial freedom.

This could be your story too. All you have to do is take the time to understand debt, know when and why you need it, and how to keep it under control.

Debt as a management tool

Almost all medium to large businesses require financing, regardless of whether it's a new venture or an existing business. If you're unsure of what amount and type of financing might be required for your circumstances, your advisor can provide guidance. In addition, seek advice from your accountant, as well as owners of non-competitor businesses with needs similar to your own.

There are many situations in which taking on debt is a valid business decision that can help your firm prosper over the long term. For example, you might need to borrow to purchase property so you can expand, acquire a complementary organization, take over a competitor's firm or upgrade your computer equipment so you can operate more efficiently.

Short-term debt

Short-term debt (also called "revolving debt") is used to fund short-term financial commitments, such as funding payroll and managing regular, reccurring expenses like utilities and rent.

Though these commitments vary widely, they are all considered short-term because money borrowed to pay for them generally takes less than one year to repay.

All firms have some sort of short-term debt because there is often a gap between the date you need to pay your expenses and the times you receive payment from your clients. Even in stable operations, cash flow can be variable.

Minimize your short-term debt

Though your firm may always have some short-term debt, cash-flow issues should never be taken lightly. Poor cash-flow management is detrimental to any business. Your goal should not be to eliminate short-term debt but rather to manage it appropriately.

For example, you may want to re-examine the credit terms offered by your suppliers. Will they allow you 60 or 90 days to pay them after receipt of goods, instead of the standard 30 days? This may be an option, particularly if you are a client in good standing. However, be aware of the interest suppliers may charge — depending on the terms, it may not be the most economical way to manage cash flow.

Credit options

You have a number of options for dealing with short-term debt. Working with your advisor, you can review these options and determine what is best for your business. Your advisor may also be able to recommend some alternative cash-flow management solutions to reduce your reliance on short-term financing.

Advisors commonly recommend an operating line of credit. This can be accessed at any time, usually with minimal or no cost, should you find yourself short of funds. It lets you extend your cash resources when required and can be paid down at any time. You pay interest only on the amount that is outstanding.

Another option is to use your business credit card for smaller purchases, such as office supplies or travel expenses. Most advisors will recommend that you pay down your credit card balance in full every month to avoid additional interest charges. If that's not possible, you may wish to transfer funds from your operating line of credit to reduce the interest cost.

Long-term debt

Long-term debt covers purchases that usually take more than one year to repay, such as real estate, equipment and leasehold improvements. By using long-term financing to fund long-term asset investments, you can preserve your cash and liquid business assets to fund day-to-day expenses.

Unlike short-term debt, long-term debt is typically paid off according to well-defined repayment terms. You will likely have a fixed-payment date every month.

Minimize your long-term debt

Some firms limit their long-term debt by leasing or renting real estate and equipment instead of buying it. You do not own the property you lease, but generally, the regular payments are lower

than mortgage and other payments from the purchase of property. Leasing equipment offers you many options, including, in some cases, the option to purchase when the lease is finished.

Lease financing can offer tax advantages and simplify your budget by structuring your payments to match the cash flows generated by the asset financed. However, you will also be committed for a certain time; and should your circumstances change — for example, you need to upgrade equipment prior to the expiry of your lease — it may be more difficult to exit from some lease agreements. Your banker can explain the different types of leases and will help you make your choice.

Another way to lower your long-term debt is to commit more equity from your personal savings to your business. You may wish to use some of your accumulated equity to pay down debt. However, be wary of using up all of your capital in case you encounter an unexpected cash-flow shortfall.

Not all firms can maintain the same level of long-term debt. How much you can safely incur depends on a number of factors, including the life expectancy of the assets being financed, the cash flow available from operations and your personal equity in the firm.

Types of long-term debt

You have several alternatives for long-term financing, depending on your needs. If you are buying real estate, consider a term loan or a commercial mortgage, which will allow you to spread your payment over several years. Your advisor can provide you with competitive terms and rates as well as a repayment schedule that meets your needs.

If you are simply purchasing equipment, you may wish to consider a term loan. Term loans require you to make regular payments over a fixed time period, at a set or variable interest rate. The interest rate is based on the bank's prime lending rate.

Your bottom line

Borrowing wisely can help your business grow and fulfill its full potential. An RBC commercial account manager can help you find the solutions that are best suited to your situation. To locate an account manager in your area, call 1-800 ROYAL® 2-0 or visit us online at **www.rbcroyalbank.com/commercial.**

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