Short-Term Financing

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WHAT'S COVERED

In this lesson, you will learn about the types of short-term financing. Specifically, this lesson will cover:

1. Family and Friends

Short-term loans are borrowed funds used to meet obligations for just a few days or up to a year. Anything longer is not short term. With a short-term loan, you receive the cash from your lender more quickly, but it also needs to be repaid in a shorter time frame.

One of the most common ways for start-ups to get funding is the asking of families and friends. A young and energetic entrepreneur may have a great idea for a start-up but doesn't have the money in his personal savings. Friends and family may be older and have some money set aside. Parents or other family members should not risk all of their retirement savings on the start-up but they may be willing to risk a small amount to help the entrepreneur out.

Sometimes friends similar in age are willing to work for little or no wages until the cash flow turns positive. The term **sweat equity** is often used for this type of contribution. The owner rewards this type of loyalty with a small percentage of ownership of the organization in lieu of cash. A variation of this is barter or trade. This is the method where a service such as consulting or management advice is provided in return for the resources needed for the start-up.

TERM TO KNOW

Sweat Equity
A non-monetary contribution of time and labor.

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2. Peer-to-Peer Lending

After friends and family, there has been an increase in person-to-person lending, also called **peer-to-peer lending** or P2P lending. This type of lending occurs directly between individuals or peers without the intermediation of a traditional financial institution. For the most part, peer-to-peer lending is a for-profit activity that distinguishes it from charities, philanthropy, or crowdfunding.

Peer-to-peer lending saw huge growth during the economic crisis of 2007 through 2010. Peer lenders were willing to provide credit at a time when banks were not willing to lend. In P2P lending, lenders could charge below-market rates to help the borrower and lessen the risk.

One advantage to the **borrower** is that rates may be better than the rates that traditional banks can offer. The advantage to a lender is they would get a higher return than they would if they just had the money in a low-yield savings account.

TERM TO KNOW

Peer-to-Peer Lending
A type of financing which occurs directly between individuals or “peers” without the intermediation of a traditional financial institution.

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3. Commercial Banks

Commercial banks offer loans to businesses and can be secured or unsecured.

- Secured loans are when a borrower pledges some property as collateral for security to the credit being extended and then has the money lent to them. If the borrower defaults, the creditor gets possession of the assets.
- Unsecured loans include credit cards or lines of credit. These types of loans typically incur a higher interest rate because they are a higher risk to the lender.

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4. Trade Credit

When the business is a going concern, the most common type of short-term financing is the use of trade credit. **Trade credit** is a valuable source of alternative funds for personal and business loans. This is the money owed by a business to its suppliers when inventory is received and is recorded on the balance sheet as accounts payable until it is paid. Most often, a supplier will send an order to a business, issue a bill, and collect the payment later. This is an important part of the cash conversion cycle because the business has the inventory but they have not paid cash for it yet.

Sometimes the supplier will offer a discount if the bill is paid early. An example of these terms may be "2/10 Net 30." This means that the business can take a 2% discount if it pays within 10 days; otherwise, the balance due must be paid in 30 days. While the discount might seem attractive, the business must weigh that against shortening its cash conversion cycle by 20 days, as in this case.

It is also important not to abuse any trade credit extended. The business could run the risk of not having that credit available due to slow payment.

TERM TO KNOW

Trade Credit
A loan extended by suppliers who allow businesses to buy now and pay later.

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5. Factoring

A less widely used method of short-term financing is **factoring**. Here, a business sells its accounts receivable to a third party, called a factor, at a discount. This allows the business to convert a substantial part of its accounts receivable to cash. Therefore, it could pay its suppliers and other debtors more quickly.

This transaction can be negotiated with or without recourse.

- With recourse, the risk for any bad debt remains with the business.
- Without recourse, that risk goes to the factor.

TERM TO KNOW

Factoring
A financial transaction whereby a business sells its accounts receivable to a third party (called a factor) at a discount.

SUMMARY

In this lesson, you learned that the most common way for entrepreneurs to start a business is through **families and friends**. Another available option is **peer-to-peer lending**, or P2P lending, often at a lower rate than that available from financial institutions. **Commercial banks** also offer secured and unsecured loans. Secured loans require collateral but also offer a lower interest rate. Unsecured loans include credit cards and lines of credit.

For a going concern, **trade credit** is often used. A business takes advantage of this by having its vendor ship inventory to it and then paying the bill when it is received. This has a positive impact on the cash conversion cycle. A company could also consider **factoring**, involving the sale of their accounts receivable for an amount below its stated value.

Best of luck in your learning!

TERMS TO KNOW

Factoring
A financial transaction whereby a business sells its accounts receivable to a third party (called a factor) at a discount.

Peer-to-Peer Lending
A type of financing which occurs directly between individuals or “peers” without the intermediation of a traditional financial institution.

Sweat Equity
A non-monetary contribution of time and labor.

Trade Credit

A loan extended by suppliers who allow businesses to buy now and pay later.