

Sources of Financing

1. Sweat equity and owner's personal capital.
2. Friends and relatives (emotional rather than economic decision).
3. Operating Leases (Renting).
4. Large Suppliers or Customers (People with vested interest in the success of the company).
5. Trade Payables (Vendors Credit –easier to obtain, low cost).
6. Government Guaranteed Loans
 - a. Federal – SBA, FmHA, Exim Bank
 - b. State – Department of Commerce, Agriculture
 - c. Local – City of Austin (BIG Program, Enterprise Zone)
Travis County – Economic Block Grant, Tax incentives, Industrial Revenue Bonds
 - d. Special – Handicapped Loans, Veteran Loans, Minority or Women Loans.

These government agencies rarely lend money directly but rather guarantee the loan to a private lender such as a bank or S&L. Programs for financing contracts, working capital, purchasing a business, expanding, buying or improving owner occupied real estate, equipment financing, debt consolidation, etc. are available. Many may have strings attached such as employment quotas or location of the business.

7. Bank Loans (RLOC, 3-5 year term loans, mini-perm mortgages, Prime +2-4%, floating, Principal & Interest monthly loan covenants, lock box).
8. Finance Companies
 - a. Factoring – selling accounts receivable.
 - b. Floorplanning – finance inventory
 - c. Equipment Financing
 - d. Equipment Leasing (capital leases).
 - e. Sales Finance – selling retail installment contracts
9. Leasing Companies
 - a. Capital Leases
 - b. Sale/Leaseback
10. Merchant Banks – Bridge or Mezzanine Financing
11. Venture Capitalists
 - a. Business Angels
 - b. Capital Networks
 - c. SBIC or MESBIC
 - d. Independent Venture Capital Companies
 - e. Corporate Venture Capital

Terms usually include convertible debt or convertible preferred stock, exit point in 7 year period, active in management, may require controlling interest, and expect 30 to 50% required returns.
12. Foundations
13. Royalty Partnership
14. Private Placement (non-registered – Reg A or Reg D)
15. Institutional Money
 - a. Pension Funds/Retirement Funds
 - b. Insurance Companies
16. Initial Public Offering (IPO)
17. ESOP – Employee Stock Options Plans

Classification of Funds

- A. Debt Capital vs. Equity Capital
- B. Internal Sources vs. External Sources
- C. By Maturity (short-term, intermediate- and long-term sources)
- D. Permanent Capital vs. Seasonal (Temporary) Capital
- E. Primary Financing vs. Secondary Financing
- F. Source and Use Funds – Operating Cash Flows, Investment Cash Flows, Financing Cash Flows.

Debt Capital vs. Equity Capital

- ~~///~~ Debt Capital is any creditor capital which must be repaid and has a superior position to the holders of equity securities. Debt Capital includes both short-term and long-term liabilities of the company. Debt instruments include secured and unsecured creditors without regard to maturity. Examples of debt instruments include vendor credit (trade payables), short-term revolving lines of credit, term loans, mortgages, bonds, etc.
- ~~///~~ Equity Capital is owner's capital and has an inferior claim on the earnings and the assets of the company. Equity owners are the residual claimants and generally require a higher return to compensate them for higher risk. Examples of equity capital are preferred stock, common stock and retained earnings.

Sources of Funds

- A. Internal Sources
 - a. Spontaneous Liabilities – accounts payable and accrued expenses.
 - b. Retained Earnings – Profit after taxes not paid out on dividends.
- B. External Sources
 - c. Debt Sources (Including bank debt, bonds, mortgages & leases).
 - ~~///~~ short-term sources
 - ~~///~~ long-term sources
 - d. Equity Sources (including preferred & common stock)

Funds Classified By Maturity

- A. Short-term Funds – less than one year in maturity and usually debt instruments. Included in this category are accrued expenses, accrued taxes, short term bank notes, balloon notes due within one year, revolving lines of credit and trade accounts payable.
- B. Intermediate-term Funds – funds due from one to ten years, including term loans, debentures, capital leases, etc.
- C. Long-term Funds – funds with a maturity of greater than ten years. Long-term loans, mortgages, bonds, common and preferred stock as well as retained earnings are sources of long-term funds.

Permanent Capital vs. Seasonal (Temporary) Capital

- ✍ Permanent Capital is long-term capital for financing the permanent assets of the company. Equity sources of capital are generally considered permanent sources as are long-term debt instruments. Permanent capital is used to finance permanent assets, such as land, buildings, equipment and other long-term investments. Working capital (investment in inventory, receivables and cash) also has a permanent portion often times called evergreen working capital. Permanent working capital of a firm is the level of investment in current assets when sales are at their lowest point. When inventory is converted to receivables and then converted back to cash, the cash is used to replenish inventory and the cash cycle begins again, thus this level of investment stays fully invested at the given level of sales.
- ✍ Temporary Capital is used to finance temporary or seasonal needs for assets. Seasonal increases in sales generally cause an increase in inventory and receivable financing which can be financed short-term. When the seasonal sales return to normal levels, inventory and receivables decline to normal levels (a decrease in an asset is a source of funds) and frees up capital to repay the short-term loan.

Primary Financing vs. Secondary Financing

- ✍ Primary financing is raising new capital to finance the expansion of assets. Both debt or equity funds can be utilized as the source to finance the use of funds created by the increase in assets.
- ✍ Secondary financing is re-financing of existing debt or equity. Renewing maturing debt, debt consolidation, stock repurchase, debt for stock and stock for debt are all secondary financing since no new funds are injected into the firm.

Capital

Bank Underwriting Criteria for Commercial Loan Applications

The 6 “C”s

1. Cash Flow of the Borrower
 - a. Primary Source of Repayment – Cash Flow of Business. Coverage ratio of at least 1.25 times annual debt service should be demonstrated.
 - b. Secondary Source of Repayment – Personal Cash Flow of Guarantors.
 - c. Tertiary Source of Repayment – Liquidation of Collateral.

2. Credit History – A retail and business credit report will be run by the bank to determine your past repayment history. Slow pay, foreclosures, bankruptcy, judgments, tax liens or charge-offs will probably be cause for turndown of loan request.

3. Collateral – Sufficient collateral to secure the loan must be demonstrated. Typical factors applied by banks are:
 - 100% of Cash pledged to loan.
 - 75-85% of accounts receivable less than 60 days old.
 - 40-50% of inventory (as little as 15-20% depending on inventory)
 - 75-80% of recently appraised real estate.
 - 50-80% of furniture, fixtures and equipment.
 - 0% of leasehold improvements, franchise fees, tools and dyes, and other intangible assets.

Banks like loan to appraised value ratios of 75 to 80% maximum and at least 100% of the liquidation value of the collateral.

4. Capacity – The ability of the Borrower Company to handle the additional loan request from a leverage and coverage standpoint. Banks do not want to be your partner and put up all the capital and take all the risk. The measure the debt to worth ratio (borrowed money relative to your equity capital contribution). For start-ups, the maximum debt to worth ratio should be 2:1 (33% equity by owner) and for existing businesses, no more than 4:1 (20% equity in the business).

5. Character of the Borrower – Past credit history and background of the borrower, management history and experience in the industry.

6. Conditions – The anticipated effects of the economy on your company’s repayment ability. If the bank thinks the construction industry is going to have a rough time in the future, they will be less willing to finance subcontractors and real estate developers.

Loan Documentation.

1. Three years historical financial statements and tax returns on the business.
2. Personal Financial statements on the owners and three years personal tax returns. A personal cash flow statement.
3. Use of Proceeds – What is the loan request for?
4. Collateral to be used to secure the loan. Appraisals?
5. Projected cash flow of the business showing ability to repay the loan.
6. Resumes on key management personnel.
7. Your business plan, if available.

Plan on the bank taking longer to give you an answer to the request (2 to 3 weeks) and even longer to fund the loan waiting on attorneys to draw up the paper work.

~~///~~ Trade Credit (Accounts Payable)

- ~~///~~ Vendor Credit is generally used to finance inventories and/or operating expenses.
- ~~///~~ Relied on twice as much by Small Businesses.
- ~~///~~ Bootstrapping (riding payables) is common and is the first sign on cash flow problems.
- ~~///~~ Usually unsecured, this open-account credit is easy to obtain and cheap (no computable cost unless early payment discount is offered or late penalties assessed).
- ~~///~~ Cost of passing early payment discounts:

$$\frac{\% \text{ Disc.}}{100\% - \% \text{ Disc.}} \quad X \quad \frac{365 \text{ days}}{\text{Net Period} - \text{Discount Period}}$$

Revolving Line of Credit

- ~~///~~ Usually a one year note which is subject to a borrowing base calculated on the receivables and/or inventory securing the loan (blanket lien).
- ~~///~~ Borrowing base is usually 70-80% of Accts. Rec. less than 60 days old and 40-50% of inventory. Loan Agreement usually has minimum current ratio, maximum debt to worth ratio, minimum net worth and minimum cash flow coverage ratio. May have lock box provision and clean-up provision.
- ~~///~~ Good for seasonal cash needs – bad for permanent working capital requirements.

Credit vs. Cash Discount

Assumptions:

Cost of Capital is 12% annually (1% per month).

Credit terms on receivables are 2/Cash, net 30

Price per Unit is \$1.00

Cost to Produce Unit is 90¢

	<u>Cash Sale with Discount</u>	<u>Cash Sale without Discount</u>
Sales	\$1.00	\$1.00
Cost to Produce	<u>\$0.90</u>	<u>\$0.90</u>
Profit before Credit Terms	\$0.10	\$0.10
Discount	\$0.02	-----
Time Value of Money (1% Cost)	-----	<u>\$0.01</u>
NET PROFIT ON SALE	\$0.08	\$0.09

Discount is too large for cash payment, would make more money if sold on credit and financed at 12% (ignoring bad debt and other expenses). Only if you could invest the 98¢ (\$1.00 less the 2% discount) during the 30 days difference in receiving payment at a rate of greater than 12% would you offer this type of discount.

Cost of Passing the Discount

Terms: 2/10, net 30 Assume a \$10,000 invoice.

If you pay by the 10th, you deduct \$200 and pay only \$9,800. If you pay on the 30th, you owe the entire \$10,000. Thus, to hold your cash from the 10th to the 30th day (20 days difference), it cost you \$200. This represents an effective annualized rate of:

$$\frac{\$200}{\$9,800} \times \frac{365}{30 - 10} = 2.04\% \times 18.25 = 37\%$$

(net period – disc.period)

The only reason you would not take discount is that you could invest your money at greater than a 37% rate of return or you did not have the cash on the tenth to take the discount but would collect by the 30th. Since it is unlikely that you can invest at greater than 37%, then if the only reason for passing the discount is lack of cash, can't you borrow at a cheaper rate than 37%? If you miss the discount, then wait as long as possible to pay the invoice to reduce the effective cost of missing the discount.

Savings By Taking Discount	\$200.00
Cost of Loan	
Amount Borrowed \$9,800	
Interest Rate 12%	
Annual Cost \$1,176/year	
Per Diem Cost \$3.22/day	
Borrow on 10 th /repay on 30 th	
20days at \$3.22/day	(\$ 64.44)
Net Savings	<u>\$135.56</u>

Letters of Credit

- ~~///~~ Revocable and irrevocable letters of credit guarantee payment of a specified amount of money by the issuing bank if certain conditions are met by an expiration date.
- ~~///~~ Standby Letter of Credit provides for payment to the beneficiary in case of non-performance or default by the issuing party.
- ~~///~~ Often used for international trade or in lieu of bonds.
- ~~///~~ Cost is generally 1% of the amount of credit.

Term Loans

- ~~///~~ Usually three to seven year maturities with principal and interest payments made monthly (can be a balloon note).
- ~~///~~ Used to finance equipment, permanent working capital, or expansion needs.
- ~~///~~ Usually collateralized by long-term assets (furniture, fixtures, plant and equipment).
- ~~///~~ Usually a variable interest rate which floats with prime (prime plus1% or 2%). Fixed rates may be available for a fee (swap).

Factoring

- ✍ This is an effective rate of 40 to 50% since the invoice would have been paid in 60 days or less.
- ✍ Since it is purchasing rather than financing, usury is not an issue and the seller does not have to guarantee the money like a loan. However, a reserve for uncollected accounts is generally established.
- ✍ Finance Company may pre-approve the receivable and does all of the collection efforts. This may reduce the firm's credit department costs thus lowering the effective cost of factoring.
- ✍ VISA and Mastercard are, in effect, factoring.

Floorplanning

- ✍ Inventory financing. May be done by a manufacturer for its dealers (captive) or by a commercial finance company bank.
- ✍ Usually for retailers of higher priced durable goods, like car and boat dealers.
- ✍ Manufacturer may carry, or induce a third party to carry, its dealer's inventory for some specified period free of interest charges. This gives the dealer the opportunity to sell the merchandise, collect the cash and pay the floorplanner.
- ✍ After the specified interest free period, the interest meter may begin ticking at a high rate of interest.

Business Angels

- ✍ Private investors or small investment or venture capital firms who supply seed and early stage capital in exchange for an equity position in the firm.
- ✍ Capital is "patient" with the median investment periods of seven years before a return is expected.
- ✍ Texas Capital Network is a computerized "dating" service for entrepreneurs and business angels.
- ✍ Money brokers may make introductions for a fee: 1% for second debt, 3% for subordinated debt, and 5%+ for equity placements.
- ✍ Deal structure is negotiated, but may be subordinated debt or preferred stock with equity kickers.

Leases

Sources of Leases:

Independent Leasing Companies
Lease Brokers
Banks
Finance Companies
Pension Funds and Insurance Companies.

FASB 13

Accounting rules require that a lease be capitalized (i.e. the asset recorded as an asset and the lease as a liability on the balance sheet. The interest portion of each payment is then deducted and the asset is depreciated as if it were purchased) rather than expensed in the case of an operating lease if the lease meets any one or more of the following requirements:

1. Lease contains a *bargain* purchase option. If you can buy the asset for \$1 at the end of the lease, then it is a capital lease. But what if the lease says fair market value or 10% of the original purchase price? The IRS usually rules that any purchase option which is less than 20% of the original asset value is a bargain purchase price.
2. Lease contains a provision for transfer of ownership at the end of the lease (i.e. rent to own contracts).
3. The term of the lease extends at least 75% of the leased asset's estimated economic life.
4. The sum of the present values of the minimum lease payments is at least 90% of the fair market value of the leased asset.

FASB 13 was an attempt to standardized the way accountants handle the various types of leases since it was vague as to when a lessee decided to exercise the purchase option and thus accounting statements might not represent the true financial picture. As you can see with FASB 13, you might have to capitalize a leased asset if you meet either #3 or #4, even though you could never get legal title to the asset since there was no purchase option or transfer of ownership.

Operating Leases – Like renting. May be used when an asset is needed for temporary use (AVIS, U-Haul, mini-storage) or to avoid technological obsolescence (lease high technology equipment). Businesses with poor credit who cannot buy the asset may lease as the only way to acquire the asset. Operating leases usually call for the lessor to pay for maintenance taxes and insurance and thus relieves the user of service. These leases are usually characterized by the following:

- a) Lease is cancelable without substantial penalty.
- b) Lessor provides maintenance taxes and insurance
- c) Contract life is less than the economic life of the asset
- d) Lessor to receive his investment and return from multiple lessees.
- e) Lease payments are expensed by the lessee. Since the asset and the lease are not recorded on the balance sheet, no depreciation is taken and the lease payments are shown as an operating expense. Called off finance sheet financing since lessee has use of the asset, can generate income off the asset without recording the asset on the balance sheet, leading to a misleading ROA calculation. Shows up as operating leverage rather than financial leverage.
- f) Asset is depreciated by the lessor, sheltering the rental payment. At the end of the lease, the lessor retain title (no purchase option). The lessor can, release the asset, sell the asset, scrap the asset or use the asset himself. Since this is not financing, no truth in lending is required and typical required rates of return are 18% to 28%. Operating leases also cause the lessee to lose the asset at the end of the lease and may require replacement at a higher cost, loss of equity accumulation may affect future financing, loss of residual value, and may lead to inadequate valuation due to habitual leasing.

Capital Lease (Financial Lease) – Similar to purchasing with financing by a lease contract rather than a note. Capital leases provide the lessee with additional source of financing, flexibility with terms, may provide tax savings, and may free working capital by requiring a lower down payment and lower monthly payments. The lower monthly payments are usually not due to a lower interest rate but rather a longer maturity than traditional bank financing as well as not fully amortizing the purchase price. The capital lease has a purchase option or terminal value at which time the lessee can return the asset with at least the terminal value or purchase the asset for the purchase option price. Since the lessor gets a balloon payment at the end of the lease, the monthly payments are often times lower than a fully amortizing bank loan. Since the terminal value is critical, the lease will contain provisions for excessive wear (like 15¢ per mile over 15,000 miles per year).

Characteristics of a capital lease are:

- a) Asset is fully amortized to one lessee. The lessor plans to recoup his/her investment and required return from one lessee.
- b) Not cancelable without substantial penalty, usually acceleration of the remaining lease payments.
- c) Lessee is responsible for taxes, maintenance and insurance and Lessor determines liability limits.
- d) Contract life approximates the useful economic life of the asset.
- e) Lease contains a purchase option at the end of the lease.
- f) Lease does not expense the lease payments but rather records the asset on the balance sheet and the lease as a liability. The interest portion of each lease payment is deducted and then the asset is depreciated.

Sale / Leaseback – Usually employed when an asset is fully depreciated and no longer producing tax benefits or when the market value of the asset is much higher than the book value (appreciation of the asset). This type of lease does not usually involve new assets but rather a transfer of title to an existing asset. The seller simultaneously becomes the lessee and the purchaser simultaneously becomes the lesser. The seller gets the fair market value of the asset. If the FMV is greater than the book value, then the seller recognizes a gain on the sale of the asset, pays tax on the gain, leases the profits in the company which improves the net worth of the company, increases the liquidity of the company, and the seller retains use of the asset by agreeing to lease the asset back for some period of time. The lease is usually an operating lease which can be expensed by the seller. The purchaser receives rental income which he can shelter with depreciation on the stepped up basis (FMV).

Assume you purchase land for \$5,000 and build a building for \$30,000 in 1970 to house your company. Assume you have been depreciating the improvements of \$30,000 straight line over a 30 year useful life (\$1,000 per year) and thus at the end of 1993, you had taken 23 years of depreciation or \$23,000. Therefore, your depreciation schedule reflects the \$5,000 book value of the land and a net book value of \$7,000 on the building (\$30,000 less \$23,000 accumulated depreciation) or a total book value of the land and building of \$12,000. The city's expansion and new roadways has lead to your property becoming a valuable piece of real estate. A recent appraisal shows the fair market value of the real estate to be \$300,000 and since your firm is a manufacturer where location is not a key element, you have decided to sell the property and take the gain to rebuild a new larger facility further from town where property is cheaper but access to highways is still good. However, if you sell the property, you cannot afford to shut down production while you build a new facility and you cannot afford to build a new plant until the property is sold. Therefore, you enter into a sale/leaseback arrangement. You sell the property for \$300,000, pay tax on the \$288,000 gain (\$300,000 less \$12,000 basis) of \$80,000 and then take the remaining \$220,000 (\$300,000 less \$80,000 tax) to build a new plant. However, you execute a lease on the property from the purchaser for two years while you find and build a new location. The purchase needs to hire an architect and arrange financing for a new development he intends to construct on the property and is not expected to start construction for two years. The Purchaser/Lessor agrees to lease the property back to Seller/Lessee for \$2,650 per month for two years (an operating lease).

The seller has increased his net worth by \$208,000, increased cash by \$220,000, and gets to expense \$2,650 per month.

Lease vs. Buy Decisions:

In calculating a lease vs. buy decision, you need to ask three questions:

How much is the payment (expense or savings)?

Is there any tax consequence to the payment?

When does the payment occur and what is the present value?

Use the company's opportunity cost (required rate of return or hurdle rate) to compute time value of money. Solve for the after tax, present value of each alternative and select the alternative with the lowest after-tax present value cost. Factors which will affect the after-tax present value cost are:

- 1) Interest rate or Lessor's required rate of return
- 2) Tax rate
- 3) Method of repayment (time value of money)
- 4) Method of computing depreciation (straight-line vs. accelerated, economic life)
- 5) Investment tax credit (if any)
- 6) The firm's cost of capital (opportunity cost, required rate of return)
- 7) Salvage value (if any)
- 8) Purchase option (if any)

SBA LOANS

U.S. Small Business Administration (SBA) Programs, Eligibility, Requirements

I. Programs:

- A. 7(a) Loan Program – Guaranteed Loan Program – Term loans with no balloon payments and no payment penalties.
 1. Maturities:
 - a. Up to 7 years for working capital
 - b. Up to 15 years for equipment
 - c. Up to 25 years on owner occupied real estate
 2. Interest rate: New York Low Prime plus a maximum of 2¼% on maturities less than 7 years and New York Prime plus a maximum of 2¾% on maturities more than 7 years. Rate can be adjusted monthly, quarterly or annually.
 3. Guarantee Percentages
 - a. \$0 - \$100,000 – up to 85% guarantee.
 - b. \$100,000 - \$750,000 – up to 75% guarantee.
 - c. Refinancing existing debt at participating Lender – If Lender can prove it is not in a position to sustain a loss and the loan has not been more than 29 days past due.

- B. Contract Loan – Specific contract financing. Lender may advance labor and materials on a specific contract with contract draws assigned to Lender. Approval is on a contract by contract basis. One year or less maturities with guarantees to Lender as in Section A. above. On maturities less than 1 year, guarantee fee to SBA is ¼% rather than 3+%.
- C. Seasonal Line of Credit – Line of credit is guaranteed as in Section A above with one year maturities. Borrower must prove seasonality. On maturities less than 1 year, guarantee fee to SBA is ¼% rather than 3+%.
- D. Greenline – A revolving line of credit (RLOC) initiated in 1992 subject to a borrowing base (80% of A/R and 50% of inventory). Loans under \$200,000 not subject to as much administration and are called Cap Line Loans. Loans over \$200,000 are similar to asset base lending with many lender requirements on monitoring the loan. Commitment up to 5 years. Loan can be termed out at maturity. On maturities less than 1 year, guarantee fee to SBA is ¼% rather than 3+%. Over 1 year maturity, subject to 3% guarantee fee on the first \$250k, 3.5% on next \$250k and 3.875% on final \$250k.
- E. Low Doc Program. Rural Business Development and Small Loan program – Many banks will not go through the “hassles” of dealing with the SBA on loans less than \$100,000. To encourage smaller loans (\$5,000 to \$100,000), the SBA will rebate 1% of the 2% guarantee fee and allow the lender to charge 3.25% over New York Prime to encourage this program. Low Doc means low documentation and is a one page application for loans under \$50,000 and 2 pages for loans between \$50,000 and \$100,000. Is a character loan program meaning they lend more on our credit history rather than just the numbers (less collateral, higher debt ratios, etc.).
- F. Direct Loans – The SBA has programs for Handicapped Individuals (HAL Loans) and Veterans Loans but do not have programs specifically for minorities or women. These direct loans from the SBA have a maximum of \$150,000 at preferential interest rates (currently 6%), but Congress has not allocated much money to these programs and there is a long waiting list.
- G. 504 Loan Program – Expansion program administered by Certified Development Company (CDC) – In Central Texas, LCRA’S Cen-Tex CDC (Randy Cosson or Rosa Valdez) or the statewide CDC administered through the Texas Department of Commerce, (TDOC – Ed Sosa or Frank Solis).
 - 1. Loan proceeds must be used for expansion. Can only finance land, building and equipment for expansion. No refinancing (other than interim construction loans) and non working capital financing. Creation or retention of one job per \$35,000 of SBA bond money required.

2. Total project capital requirements are financed as follows:
 - a. Lender contributes 50% of project costs and receives a *first lien* on collateral. Maturity is generally 10 to 20 years if real estate is involved at market interest rate.
 - b. SBA issues debentures for 40% of the project cost and takes a *second lien* on the collateral. Debentures are for a minimum of 10 up to 20 maximum years. Borrower gets the bond interest rate (currently 6%).
 - c. Owner must contribute a minimum of 10% of project cost (33% if a start-up operation).
 - d. Appraisals, closing costs, etc. can be rolled into loan.
 - e. This is the permanent financing and can take out the interim lender.
3. Maximum debenture amount if \$750,000 (\$1 million in rural area)

II. Purposes of Using SBA Loans (Which borrowers are good candidates)

- A. Borrower lacks a good secondary source of repayment. SBA guarantee provides an excellent secondary source for small business owners who do not have personal assets, liquidity or personal cash flow to service the required debt.
- B. Maturity is longer than bank policy allows. Few lenders today are willing to make 7 year loans on receivables and inventory (evergreen working capital requests) or 25 year amortizations on real estate without balloons. The SBA guarantee allows the lender to provide longer-term capital without being criticized by examiners. Blended maturities are also made based on the nature of the collateral and the cash flow of the business.
- C. Specialty nature of collateral. Guarantee will shore up security for the loan if the building is special purpose, inventory is difficult to liquidate, etc.
- D. Start-ups and turnarounds. Lack of a long-term profitable operating history may be overcome with the guarantee. If the lender thinks the company has potential but is uncomfortable with the short track record or marginal ability to cash flow the loan historically but does so on a proforma basis, then the guarantee may allow the loan to be made. Start-ups are ineligible for Greenlines and Seasonal Lines of Credit since one year operating history is required.

III. Eligibility – Must be an Independently Owned Small Business.

1. Size - Eligibility is based on the SIC code of the business and must be verified by researching the Federal Code of Regulation's (FCR) size standards. In general, retail and service companies with average revenues in excess of \$5 million over the past three years are ineligible, (notable exceptions are car dealers, contractors, etc. which may have higher limits). Wholesale companies with fewer than 100 employees and manufacturing companies with fewer than 500 employees are eligible. If the majority owner controls more than one company, the revenues or employees are added together (affiliates) as if they were a holding company to meet this test.

For the 504 loan program, eligibility is based on net worth. The company cannot have a net worth in excess of \$6.5 million or after-tax profits in excess of \$2 million.

2. Eligible Purposes

- a. Recapitalize the Company
- b. Provide long-term working capital
- c. Purchase an existing business (no goodwill/relatives)
- d. Start-up a new business (33% equity requirement)
- e. Refinance existing debt (no personal debt)
- f. Repay accounts payable
- g. Expansion
- h. Owner Occupied real estate construction, purchase of land and building, leasehold improvements.
- i. Equipment financing
- j. Media Companies (Newspaper, Magazine, TV and Radio are now eligible).

3. Ineligible Companies / Purposes

- k. Gambling operations (unless non-gambling revenues are greater than 67% of total revenues)
- l. Speculative purposes
- m. Investment Property – must be 51% owner occupied (67% on new construction).
- n. Insurance Companies, Finance Companies or other institutions who invest money.
- o. Non-Profit Organizations.
- p. Refinancing personal debt (Alter-ego real estate loans are eligible if the ownership of the real estate is a mirror image of the company's ownership and the lease payment to the company is equal to the mortgage payment (plus taxes & insurance).

IV. Financial Criteria

1. Debt to Worth Ratio –
 - a. Start-ups (less than 18 months of operations) and change of ownership – 33% equity contribution by owner (less than 2:1 debt worth ratio).
 - b. Existing Business – Less than 4:1 debt to worth ratio or within RMA industry guidelines.
 - c. Negative net worth companies are ineligible and intangible assets such as shareholder receivables, goodwill, etc. must be netted from the net worth of the company (i.e., tangible net worth).
 - d. Owner's notes can be subordinated and a stand-by agreement executed (no principal repayment during term of SBA note) and thus these owner notes can be treated as equity.
2. Collateral – SBA is not supposed to decline a loan purely for collateral reasons.
 - a. Appraisals can be required, MAI appraisal is not necessarily required but comparables are required.
 - b. Phase I environmental site assessment required on all real estate purchases and refinancing. Pledge of real estate as additional outside collateral may not be required to have the audit.
 - c. SBA likes loan to value (LTV) to be 75 to 80% at book value and at least 100% based on liquidation values.
 - d. SBA will take second, third and fourth liens on assets. They may also ask for personal assets to be pledged to the loan.
3. Cash Flow – Historical ability to service the debt should be demonstrated.
 - a. Cash flow coverage of at least 120% should be present over the past three years. Explanation of operating losses, extraordinary expenses, etc. may receive loan approval if other factors are favorable.
4. Personal Guarantees – of all owners with more than 20% ownership and usually the President of the Corporation. Personal financial statements must be filed with all owners with more than 20% ownership, all officers and directors of the company.
 - a. Excess Liquidity – If the owners have more than \$50,000 or 25% of the loan amount, whichever is greater, in liquid assets (excluding IRA's), then the owners must contribute the excess to the corporation and reduce the loan amount.
 - b. Credit Reports/Bankruptcy/Criminal Record – Explanations must be provided but do not make the borrower intelligible unless they are on probation or under indictment or in bankruptcy court jurisdiction.

V. Fees and Costs

- A. SBA guarantee fee – ¼% on loans one year or less and paid with submission of package to SBA. On loans to \$100,000, SBA guarantee fee for over 1 year maturity is 2%. On loans over \$100,000 and one year maturity, SBA guarantee fee is 3% on the first \$250k. 3.5% on the next \$250k and 3.875% on the final \$250k. Maximum guarantee is \$750,000 so maximum fee is \$25,937, payable by the Lender at time of signing the loan authorization and commitment agreement and can be deducted from loan proceeds at closing. This fee is contingent on loan approval.

- B. Closing Costs - Borrower is responsible for appraisal fees, environmental audit fees, closing costs, title policies, UCC filing fees, attorney fees and other costs associated with closing the loan.
- C. Life Insurance – Borrower is required to pledge a life insurance policy in the loan amount.
- D. Packaging fees – Professional SBA loan packagers can be hired. Their fees are usually not contingent on loan approval and are due upon completion of the package. Fees range from \$700 to \$3,500. CFO Services charges by the hour (\$50 to \$75 per hour) and provides an itemized statement which usually ranges from \$1,000 to \$1,200 per package. CFO Services prepares all of the Lender's forms as well as the borrower's forms, credit reports, and the financial spread and analysis of the Company. SBA reviews fees for reasonableness and a compensation agreement form must be executed by the borrower, packager and signed by Lender.

Packagers can be paid a finder's fee by the Lender but the fee can not be tied to the premium received by Lender when loan is sold in the secondary market.

VI. Benefits to the Lender

- A. Good CRA loans.
- B. Meets risk-based capital requirements.
- C. Good asset/liability management tools as the loans are long-term but fully adjustable.
- D. Lender can sell the guaranteed portion of the loan, providing liquidity to the bank if needed.
- E. If loan is sold, firms such as Government Securities in Houston, Morgan Keegan, First Boston and other investment banking firms will pay a premium due to the attractive yield on the guaranteed portion. The longer the maturity and the higher the interest rate, the higher the premium, which generally range from 4 to 15% premium on face. Lender retains a 1% servicing fee on the entire loan plus earns market interest on the non-guaranteed, unsold portion of the loan. This interest income, premium for the sold portion and servicing income provides a 23% return on the retained portion of the loan.

Premiums in excess of 10% must now be shared 50/50 with the SBA effective August, 1993. Part of the servicing fee (0.4%) is also shared with SBA. Lender can sell Prime minus one for a 9% premium and keep the stripped out interest spread, thus avoiding sharing the premiums and servicing income.

VII. Advantages / Disadvantages to the Borrower.

Advantages:

1. Only way to get the loan. Only source for long-term capital.
2. Only way to get the maturity needed to match the cash flow of the company.
3. No balloon payments, prepayments penalties, and don't have to worry about refinancing if bank fails.
4. May get cheaper rate than bank would normally charge.

Disadvantages:

1. Long approval process (6 to 8 weeks minimum unless with a certified or preferred lender).
2. Substantial paperwork required (can hire packager).
3. High costs (guarantee fee, packaging fees).
4. Restrictive covenants.

Sources of Equity Capital

1. Your own personal capital or “Sweet Equity”.
2. Friends and Relatives – People you do not have to sell yourself to and who make emotional decisions rather than economic decisions.
3. Joint Ventures with suppliers/customers – People with a vested interest in your company’s success. A supplier who would benefit from selling supplies to your company might be interested in being a partner in your operation or a customer who wants the use of your product or service may be willing to inject equity to ensure your survival.
4. Business Angels – Private investors with money to invest in deals. Some are looking for a higher return for their money, some may want to help the small business person for philanthropic reasons, and some make investments which benefit society. These people are generally difficult to locate, have investment advisors which screen their deals and usually want to remain anonymous.

As a result, several capital networks have begun (Texas Capital network Austin) to match entrepreneurs with private investors. The network summarizes the business plan and capital needs and faxes the information to the investors whose profile matches those of the company. If the investor is interested, then an introduction is made and the parties work out their own financing arrangements.

5. Venture Capitalists – Can be government sponsored (SBIC or MESBIC, Texas Growth Fund), small funds made up of individual investors, large funds with institutional money, or corporate venture capital companies (arms of banks, large corporations, pension funds, retirement funds, or insurance companies). These funds have investment parameters which may be size and industry specific. They generally look for an exit point which will provide them with 5 to 10 times their initial investment within a five to seven year period. The exit point is generally provided by going public or a merger or acquisition by a larger company.

Venture capitalists will structure their investment with convertible debt instruments, convertible preferred stock, warrants, rights or options or other means of capitalizing on the upside while protecting the downside of their investment. Most venture capital firms are active in the management of the company, take board seats, and can exercise control of the company if certain performance is not met. The venture capitalist may have “put” agreements to force repurchase of their investment if the exit strategy is not met within 7 years.

6. Royalty Partnership – If no exit point is available, you might be able to attract investors by distributing cash generated by operations through a royalty partnership. A limited partnership is formed and capital injected. The limited partnership then pre-purchases product from the company giving it immediate cash injection. The company executes a royalty agreement that repays the limited partnership as units of the product are sold. Terms of the royalty agreement are negotiable and the return comes off the top (revenues) and are not subject to usury laws like lending. Thus, the company maintains ownership and control and the limited partnership gets venture capital type returns with a built in exit strategy based on a percentage of revenues.

Private Placements

- ~~☞~~ Reg D – Rule 504 (Small Corporate offering-SCOR) – State filing form U-7 can raise up to \$1 million in 12 months, interstate possible and can advertise the offering. Form D required for SEC (short form).
- ~~☞~~ Reg A – Offering statement filed with SEC and state registration. Interstate allowed with up to \$5 million offered within 12 months. Advertising allowed.
- ~~☞~~ Rule 147 Intrastate Offering – No federal limit, amount varies by state. Can only offer and sell within one state. No SEC registration, only state registration. General solicitation allowed.
- ~~☞~~ Intrastate offering to accredited investors (\$1 million net worth) is exempt from state and SEC registration.
- ~~☞~~ Intrastate offering to fewer than 35 sophisticated by unaccredited investors is exempt from registration.

SBIC and MESBIC

- Small business investment corporations and minority enterprise small business corporations raise \$2.5 to \$10+ million in private capital and can then leverage this with debentures issued by the SBA. Leverage can be from 2 to 4 times the private equity.
- Since SBA guaranteed debenture money has a lower cost, these venture capital firms may not require a big return as institutional venture capital firms.
- SBA limits the size of the firms and the size of the investment the SBIC and MESBIC can make.
- Convertible debt, debt with warrants, convertible preferred, preferred with warrants or options, and direct equity ownership are common investment structures.

Venture Capital Firms

- The venture capital industry has expanded rapidly since the late 1980's due to increased entrepreneurial activity surrounding technology advancements.
- The number of VC firms now exceeds 1,200 with a concentration in the Silicon Valley, Boston, Raleigh/Durham, Chicago and Dallas.
- Austin Ventures is the largest in Austin with 6 partners and 4 funds totaling \$900 million (down from \$1½ billion in fall of 2001). Since 1984 they have made approximately 1,000 investments, 17 have gone public and 12 merged, with approximately 40 active investments. Their portfolio is 1/3 technology, 1/3 services and 1/3 special situations.

Venture Capitalists

- Focus on young firms with high growth – high risk and high return. Industry return is 15% with a standard deviation of 32.4%
- Active participation is strategic decisions, not day-to-day management
- As of 1994, \$38 billion under management and \$2.5 billion new investments each year
- Invest in management teams, not products
- Want an exit point within 5-7 years by going public or merging the firm

Common issues in Venture Capital Financings

<u>Issue</u>	<u>Considerations</u>
Size of financing	Not all good companies are institutionally "backable". Need to get \$1 - \$2 million to work over life of deal
Control	Not a motivating factor More important where risk of capital loss is significant.
Employee ownership	Must be truly substantial below CEO level.
Valuation	Never the cheapest source of capital.

Types of Venture Capital Financing

<u>Stage</u>	<u>Purpose</u>	<u>Common "Deal Killers"</u>
Seed	Development of Concept/Business Plan	Management Experience
Start-Up	Product Design/Development	Market Size Proprietariness Capital Efficiency
Second Round	Product Rollout/Marketing	Competitive Landscape
Third Round	Fund Operations To Cash Break-Even	Pace of Market Development
Bridge/Mezzanine	Carry Through to IPO or Acquisition	Valuation

3M's – The "Management" Play

- ☞ Product under development.
- ☞ Market potentially very interesting but tea leaves not yet turned.
- ☞ QB savvy/experienced enough to read the field and call audibles.
- ☞ Short-term goal: finish product and convince someone to pay for it.
- ☞ Return if all goes well: 50% +

3 M's – The “Model Play”

- ✍ Product (essentially) finished.
- ✍ Someone has paid real money for it; others have shown genuine interest.
- ✍ Management team no longer 1-2 person show.
- ✍ Short-term goal: solid reference account base.
- ✍ Return if all goes well: 40% +

3 M's – The “Momentum” Play

- ✍ Product family exists/emerging.
- ✍ Real, forecastable revenue stream.
- ✍ Team can be envisioned in an S-1 (may still be 1-2 holes).
- ✍ Short-term goal: raise lots of cheap capital.
- ✍ Return if all goes well: 30% +

ESOP

- ✍ Employee Stock Ownership Plan.
- ✍ Company must have an independent valuation of the company's stock.
- ✍ Can contribute the value of the stock to the ESOP Trust where the employees get ownership in the company (tax deferred) and the company gets a deduction for the value of the stock.
- ✍ Leveraged ESOP can borrow money to buy the owner's stock. Bank only pays tax on 50% of the interest income, company gets to deduct principal and interest, and the owner's gain on the stock is tax deferred if he invests the proceeds in other publicly traded stock.