

How to Finance a Business

- **Introduction**
- **Common Stock Financings**
- **Preferred Stock Financings**
- **Debt Financings**
- **Convertible Securities and Warrants**
- *Case Study: Aspen Radio, Inc.*
- **Summary of Financing Methods**
- **How to Prepare a Financing Proposal**

The Need for Capital

It's not always cash shortages, oversights, and mistakes that necessitate new financing arrangements and additional capital infusions. Very often the need for new capital stems from the success of a business. *Some examples:* A company must order additional production machinery to fill a big order; or it's selling its inventory so fast it needs capital to finance its accounts receivables, schedule additional production shifts, and build up depleted inventory; or it gets an unexpected opportunity to expand into a promising new marketing or product area.

In each instance, the goal is to get the *best financing* possible on the *best terms* through the financing method that is *most appropriate* to the business at its *current* financial position and growth stage.

The most direct and fastest method of raising capital usually is through a bank loan. But debt is not always the best choice when cash is needed. Depending on an owner's personal financial position, his or her willingness and ability to assume risk, and the company's projections and balance sheet ratios, alternate methods of raising capital may be less expensive and result in more capital availability.

Even if you're not shopping for capital right now, chances are you will down the road, maybe when an opportunity for expansion or an acquisition arises. Knowing your alternatives in raising capital and the advantages and disadvantages of each financing method will help you make the most cost-effective and comfortable choice when opportunities arise for expanding sales and profits.

That's what *How to Finance a Business* is about — it's a concise and comprehensive overview of the financing options that are available to you in raising capital — common stock, preferred stock, debt, and equity-type securities. It also includes ideas on how to deal with lenders and investors and cautions and traps you should avoid. It contains very practical information based on actual financings and draws from the author's involvement in business financings over the last 30 years.

How to Finance a Business was written to provide financing information to those individuals involved with running a business, and the professionals serving this market: accountants, insurance agents, lawyers, and financial planners.

Specifically, this Report:

- Explains the basic methods of raising capital — common stock, preferred stock, debt, and equity kickers (warrants and convertible securities).
- Establishes a framework that will help you understand how a lender or an investor looks at a business and what factors he or she considers in making a decision to lend or to invest.
- Discusses the details of raising capital: the costs, repayment terms, and the conditions involved in completing a financing.
- Helps you determine how much equity in your business you can expect to give up in exchange for any needed capital.
- Presents many ideas on how to obtain *more* capital from your existing lenders and investors.

Capital Market Environment

The capital market in which the smaller business operates should be viewed with these considerations in mind. Smaller businesses:

- #1. Employ more than half of the nation's labor force.
- #2. Represent more than 90% of all U.S. businesses.
- #3. Account for more than 50% of all business receipts.
- #4. Are recognized as the most efficient creator of new jobs.
- #5. Are the leaders in technical innovation.

Despite these contributions to our country, many balance sheets of smaller businesses are highly leveraged (high debt-to-equity ratio). Furthermore, because equity capital is virtually non-existent, debt continues to be their principal source of capital. That's why many smaller businesses are often locked into short-term bank debt and slow in paying trade debt.

Conclusion: You and your advisers must take a *persistent* and *creative* approach to raising capital for your business and be thoroughly familiar with how to do it, where to go for the capital, and how to structure the right financing.

Contents and Structure

Here is a brief preview of *How to Finance a Business*.

Section #1 is an introduction to raising capital for your business. It includes the basics of getting capital and the smart way to deal with lenders.

Sections #2 through *#5* explain the principal ways to raise capital:

- Common Stock
- Preferred Stock
- Debt Instruments
- Equity Kickers

We will take you through the steps and concepts involved in raising capital by each of the four methods, the advantages and disadvantages of each, and the short- and long-term effects of each financing alternative. You will see the mathematical calculations you must make to compare the financing methods and the judgments you must render in deciding which method is best for your business based on its current and projected financial profile. Also covered are equity kickers: *warrants* (options to buy common stock) and *convertible securities* (debt or preferred stock that can be converted into common stock). How to value these "options" to buy or convert the debt or preferred stock into common stock is explained. You also will find the analysis helpful when evaluating the prices of convertible securities traded in the public market.

Section #6 is a Case Study that puts all the financing methods into perspective, including the cost of capital and the effects of each financing alternative on a company's balance sheet and income statement.

* * *

The job of raising capital is not one that should be left solely to your advisers. You should be involved in the decision of *debt* or *equity* and the important subsequent steps in negotiating and closing a financing. Remember, it is you and your company who have to live with the terms and consequences of any financing or loan agreement.

Before we begin, keep in mind these facts: When a business is liquidated or adjudicated bankrupt, the general order of priority for payment is secured creditors, unsecured creditors, preferred stockholders, and then common stockholders. This fundamental order, referred to as the "absolute priority doctrine," establishes the framework of risk and reward for the different financing instruments.

Axiom: The greater the risk, the greater the reward (compensation) to the lender/investor, e.g., higher interest rate or percentage of the business for the greater risks associated with the financing. That knowledge is a very important consideration when making the debt or equity capital decision.

A detailed Table of Contents starts on the next page. Good luck in your search for capital and in your efforts to use it more effectively.

Thomas J. Martin, Author and President
Tricia Walsh, Publishing Director
The Business Library

Table of Contents

The Need for Capital	2
Capital Market Environment	3
Contents and Structure	4
<i>Section #1: Introduction: How to Raise Capital</i>	<i>8</i>
● What Makes You Different?	9
● The Capital Gap	9
● Basics of Getting Capital	10
● Smart Way to Deal with a Lender	11
<i>Section #2: Common Stock: What It Is, How to Use It</i>	<i>14</i>
● Business Form Applications	15
● Financing via Common Stock	16
● Common Stock Values	18
● <i>Case Study: Aspen Radio Raises \$200,000 of Capital ..</i>	<i>20</i>
<i>Exhibit: Aspen Radio: Before and After the Financing</i>	<i>23</i>
<i>Section #3: Preferred Stock: What It Is, How to Use It</i>	<i>24</i>
● Business Forms and Preferred Stock	25
● Financing via Preferred Stock	26
● Special Terms and Features	27
● Other Uses of Preferred Stock	31
<i>Section #4: Debt Financings: How to Use Them for Growth</i>	<i>32</i>
● Financing via Debt	33
● How a Lender Looks at a Company	34
● Types of Debt Instruments	35
● Debt Terms to Know and Negotiate	37

<i>Section #5:</i>	<i>Equity Kickers: How to Sweeten a Financing</i>	41
	● About Warrants	43
	● About Convertible Securities	44
	● Financing via Warrants and Convertible Securities	45
	● How to Negotiate Equity Kickers	46
	● How to Find Lenders and Investors	50
<i>Section #6:</i>	<i>Case Study: Actual Financing</i>	
	Common Stock vs. Preferred Stock vs. Debt	51
	● The Financing Alternatives	52
	● Analysis of Financing Alternatives	54
	● Calculate Ratios for Each Financing	55
	● Which Financing Was Selected?	56
	● Table 1 — <i>Earnings: Comparing the Financing Methods</i>	57
	● Table 2 — Effect on the Balance Sheet	58
	<i>Exhibit: Financing a Business: Review of Financing Methods</i>	59
<i>Section #7:</i>	How to Prepare a Financing Proposal	63
	● Know What the Lender/Investor Wants	64
	<i>Exhibit: A Brief, Effective Financing Proposal</i>	67

* * *

This **Resource Report** was written by Thomas J. Martin, publisher of *The Business Library*. Mr. Martin is an investment banker and the author of several finance and valuation books. Over the last 30 years, he has presented scores of workshops for business associations, accounting firms, banks, insurance companies and other organizations on raising capital, and valuing, buying, and selling businesses.

Section #1

Introduction: **How to Raise Capital**

- **What Makes You Different?**
- **The Capital "Gap"**
- **Basics of Getting Capital**
- **Smart Way to Deal with a Lender**

Know the lending limit of the individual handling your account; and document your loan request.

What Makes You Different?

If you are a typical business owner, you also are an employee, employer, and stockholder. There are personality differences, goal differences, and cash need differences between you and executives in large corporations when it comes to raising capital.

Unlike the treasurers of larger corporations, when you, as owner, raise capital for your business — and assume the associated risks — your actions affect *both* your business and your family because your business usually represents not only your family's primary source of income, but also your principal net worth. When you have to *sell stock*, it is your personal stock that you are parting with (i.e., less ownership percent); when you *personally guarantee* a loan or *pledge personal collateral*, it's your family's assets that are put on the line.

In addition, your personal goals have a considerable impact on *how* and *from whom* you get capital for your company. *For example:*

- Do you want the business to grow? You may be quite content staying at your current level. You are now making a comfortable living and are financially independent.
- Do you want to sell out eventually? Or go public?
- Do you want your children to eventually take over? Or, sell out to your employees through an employee stock ownership plan?

These varying goal differences *must* be accommodated when considering the best capital source for your business — and in selecting the financing instrument you will use in raising capital. Unlike big businesses, the smaller business and the individual owner are often one and the same entity and any financing decisions should consider the effect on the owner, not just the business.

The Capital Gap

A capital gap exists for the smaller business, and many mid-size family businesses, from the time initial seed money is raised, usually from personal savings, to the time when the business has grown to a sufficient size to have access

to the large, organized public and private markets that provide long-term debt and permanent equity capital. This capital gap exists because:

- Public equity and debt markets are effectively closed to the owners of smaller companies.
- Large institutions, e.g., insurance companies and pension funds, that have a great deal of investment capital are not making loans to smaller businesses.
- There is no orderly market to raise securities and there are no rating services, such as Moody's and Standard & Poor's, to appraise potential lenders and investors of the creditworthiness of smaller, privately owned companies.
- There also is no secondary market for the resale of small business securities.

Basics of Getting Capital

Most lenders operate under standard lending terms and agreements, and they don't like taking risks. But those may not be the reasons you get rejected when you apply for a loan. Many times, it's the way you approach the lender, the data you present, the form the data is in, or even the information you *fail* to give your lender.

However, there is one all-encompassing axiom: When you approach any lender, have back-up information on your company that answers the following questions about the loan you want:

- How much money do you need?
- When do you need it?
- What will it be used for?
- How are you going to repay it?
- What are the alternative methods of repayment of the loan if the initial plan fails?

The answers also should be presented in a typed *Financing Proposal* (explained

in Section #7, page 63) and in a form any lender/investor can read easily and quickly; be sure to include a brief description of your company, financial results, projections, etc. Remember, other people in the lending institution will be reviewing your request and you probably won't have the opportunity to personally "sell" your business and financing request to them. Your written presentation must do that. *Here are more ideas.*

1. *Substantiate your needs:* If the loan is for the purchase of capital equipment, itemize the costs, need for the equipment, and how it will affect your sales and profits. If the money is for general working capital, say, to finance higher accounts receivable and inventory levels, details of its use and turnover into sales and profits should be projected.

2. *Communicate:* Nothing upsets a lender more than a surprise. If you're running into trouble, let your lender know. If you wait until the last minute to tell the bad news — and by "last minute" we mean you can't make this month's installment payment — then you have a serious communications problem.

3. *Relationships:* Another common mistake is talking to your lender only when you need money. You should be cultivating your relationship on an ongoing basis. Get to know your lenders and help them get to know your company. Send information about your company from time to time. Invite the lender to lunch once or twice a year.

You would be surprised how fast lenders can act on a loan request when they already know you and your business. Even if it turns out to be a rejection, you at least found out *quickly* and can move to other sources.

Smart Way to Deal with a Lender

Lenders are institutions, but they are also individuals. You're dealing with *both*. Knowing the character and lending parameters of *each* source of capital is paramount in obtaining money, refinancing it, and maintaining credibility. This checklist of basic principles will help bridge the gap that separates you from your lender. Consider them when refinancing a loan or requesting new money.

■ Know how much you need, why you need it, and how you're going to repay the loan; then document it. Also, allow for sufficient time to get the money; don't expect a loan to be granted immediately.

■ Know the specifics of your company's financial statements. You don't want to say, "I'll have to check that out," particularly when it's a request for numbers you should have at your fingertips.

■ Be knowledgeable. There are standard loan terms. Become familiar with them, and focus on the four items of greatest importance: (1) amount to be borrowed or refinanced, (2) cost of the money, (3) collateral, and (4) repayment terms. These four items are the backbone of any financing.

■ Structure your capital needs properly. If you need three-year money, don't settle for repayment in one year. If the lender must make the loan for only one year, that may be fine; but put him or her on notice that it will have to be refinanced at that time. Again, you're building credibility.

■ Don't prepare overly optimistic projections. Provide minimum and maximum cash flow projections, and then base your capital needs on the minimum projections.

■ Communicate with your lender and live up to commitments. If at a meeting you promise certain data, follow up with a letter confirming the commitment and the date of delivery; then deliver the information by that date.

■ Know how the lender, e.g., a bank, makes its final decision on loan requests and the lending limit of the individual handling your account. If another individual will be approving your loan request, set up a meeting at your company's facilities so he or she can become familiar with you and your business. You also will have the opportunity to further "sell" your company and the need for the financing.

■ Don't misuse the proceeds. Besides the obvious violation of the loan agreement, your word and character are immediately in question.

■ Regarding the specific terms of the loan agreement, don't negotiate each and every one. People dislike being "chopped away" at. Many of the loan agreement terms are standard, so concentrate on those terms and restrictions that you really can't live with. It will show professionalism on your part and give you more latitude

to fight for the major issues, i.e., the amount of money, cost, collateral, and repayment terms.

Now to the many ways you can raise capital for your business. □

Section #2

Common Stock: **What It Is, How to Use It**

- **Financing via Common Stock**
- **Common Stock Values**
- ***Case Study: Aspen Radio, Inc.***

The idea is simply risk and reward: Common stockholders take the greatest financial risk, so they stand to reap the greatest rewards if the business succeeds.

How to Raise Capital for Your Business

Stay with us. This and the next four sections discuss the ins and outs of financing your business. The methods of financing to be discussed are:

- Common Stock
- Debt Instruments
- Preferred Stock
- Options to Buy Stock

In Section #6, there will be a Case Study — an actual financing — which will provide a comprehensive overview of all the financing options and help you compare and evaluate each option’s potential role in your business.

Thomas J. Martin, *Author*

Business Form Applications

Don’t worry about the form of your business. If it’s not a regular (C) or S corporation, the decision-making process on equity (common and preferred stock) vs. debt financings still applies. For companies who don’t have common stock, e.g., limited liability companies, partnerships, and sole proprietorships, simply substitute the words “equity” or “ownership interest” for common stock.

Size of companies: If your business is smaller or larger than the companies in our Case Studies, the financing and valuation concepts still apply. Simply adjust the numbers downward or upward.

Common stock’s biggest advantage: It brings in new money that doesn’t have to be repaid.

The three principal ways to finance a business are: common stock, preferred stock, and debt. Few business owners and executives really understand the intricacies of these three forms — the opportunities for their use and expansion, and the limitations, restrictions, and responsibilities they place on the owners of the business.

Become familiar with *all* financing options. Even if you don't need additional capital today, chances are you will, maybe when an opportunity for expansion or an acquisition arises. Being aware of your alternatives in raising capital and knowing the advantages and disadvantages of each financing method will help you make the most cost-effective choice.

This section is on common stock. The next two will be on preferred stock and debt and the fourth on equity kickers (warrants, options, and convertible securities to buy a company's common stock), the principal ways to sweeten a financing for a lender/investor. The last section will present a case study comparing *all* financing alternatives to help you determine which financing method is best for your company.

Financing via Common Stock

Without question, selling common stock is the safest and most prudent method to raise capital for your business. *Reason:* It doesn't have to be repaid.

Common stock — pure equity capital — is also important as a financing vehicle because of its leverage, i.e., the ability of a company to borrow more money on the new capital raised.

Most businesses cannot operate without a minimum of equity capital since creditors would not finance the business if there was no "cushion" under them. Common stock provides that cushion, as permanent equity capital, but it has other advantages along with disadvantages.

The primary advantages are:

- Common stock entails no required fixed charges — dividends usually do not have to be paid, and the stock does not have to be repurchased by the corporation unless there is a stock repurchase or buy-sell agreement with a stockholder.

- Common stock increases a company's equity base for *future* borrowings because creditors have a prior claim on the assets of the company — the greater the equity base, the greater the company's borrowing power. (This is usually referred to as trading on your equity or financial leverage.)
- If the buyer of the common stock is or will be part of management, the buyer has more of an incentive to help the business grow.
- Since common stock does not have to be repurchased, the company's future cash flow is better, in contrast to debt which has to be repaid and has contractual interest payments.

Those advantages are particularly important to fast-growing or young companies which need capital to finance increased accounts receivable, inventories, and equipment purchases to support higher projected levels of sales.

The major disadvantages are:

- Ownership dilution is immediate with the sale of common stock. For example, if you presently own 100,000 shares of common stock and your corporation sells 25,000 shares to an investor or company executive, your percentage ownership position decreases to 80% (100,000 divided by 125,000 shares outstanding).
- The ownership dilution can have four effects: (a) potential loss of control over operations, (b) less ownership of the company's future net income stream (earnings per share), (c) less book value per share, and (d) less money when the business is eventually sold.
- The cost of selling common stock is usually higher than that of selling debt, reflecting the fact that in today's market, equity capital is more difficult to raise than debt. Moreover, the stock of closely held businesses is illiquid (not readily saleable). This means finding potential buyers of the common stock can be more difficult.
- Dividends on common stock are not tax deductible, whereas interest on debt instruments is deductible.
- If you now own 100% of the business, the sale of common stock will result in minority owners who may want a voice in the management and overall direction of the business.

Absolute priority doctrine: When considering the method of financing a business, keep in mind one fact: When a business is reorganized, liquidated, or declared bankrupt, the general order of priority for payment is debtholders, preferred stockholders, and finally, common stockholders.

This fundamental order, referred to as the "absolute priority doctrine," establishes the framework of risk and reward for the different investment instruments. The greater the risk, the greater the potential reward.

Common Stock Values

Common stock represents the *direct* ownership in a business, in contrast to options to buy stock, e.g., warrants, convertible securities, and executive stock option agreements, which represent *potential* ownership.

Common stock can be issued or sold in exchange for cash, property, or services rendered. When a share of common stock is initially issued by a business, it is assigned a value for accounting and corporate law purposes. This value is specified by either a *par value* or a *no-par value* (stated value). Any value received in excess of the par or stated value is credited to the *capital surplus* account (i.e., capital paid in excess of the par or stated value).

For example, assume that a newly incorporated business has a \$0.10 par value common stock and receives \$5,000 in cash in exchange for 500 shares of common stock — a \$10 value per share. On this basis, \$50 (500 shares times \$0.10 par value) would be credited to the common stock account, and \$4,950 would be credited to the capital surplus account, also referred to as paid-in capital.

The common stockholders' account on the balance sheet consists of:

Common Stock — Total number of shares issued and sold multiplied by the par or stated value of the stock.

Capital Surplus — Amount paid per share in excess of the par or stated value.

Retained Earnings — Cumulative earnings and losses of the company *less* all dividends paid.

These three classifications, as a group, are called the company's *stockholders' equity account*, also referred to as a company's net worth, book value, or net assets

(assets less liabilities).

But they all mean the same: the total money invested in the business by the stockholders and the accumulated retained earnings or losses.

Two values: The owners of common stock have two overall values that reflect their stake or ownership position in the business. They are book value per share and earnings per share. To illustrate, let's assume the following financial data for *Aspen Radio, Inc.*, which has 100,000 shares of common stock outstanding.

Income Statement Data

Sales	<u>\$1,000,000</u>
Operating Profit	100,000
Interest Expense	<u>-10,000</u>
Pretax Income	90,000
Taxes	<u>-30,000</u>
Net Income	<u>\$ 60,000</u>

Balance Sheet Data

Current Assets	\$400,000
Net Plant and Equipment	150,000
Other Assets	<u>50,000</u>
Total Assets	<u>\$600,000</u>
Current Liabilities	\$250,000
Five-Year Term Loan	100,000
8% Preferred Stock	50,000
Common Stockholders' Equity	<u>200,000</u>
Total Liabilities and Stockholders' Equity	<u>\$600,000</u>

On the basis of this financial data, two values can be computed.

Book value per share (BVPS). Common stockholders' equity divided by the total number of common shares outstanding:

$$\text{BVPS} = \frac{\$200,000}{100,000} = \$2$$

Earnings per share (EPS). Net income after all preferred stock dividends divided by the total number of shares outstanding:

$$\text{EPS} = \frac{\$60,000 - \$4,000}{100,000} = \$0.56$$

The \$4,000 preferred stock dividend was calculated by multiplying the dividend rate of 8% by the \$50,000 worth of preferred stock outstanding on the balance sheet. These two per-share calculations are fundamental and essential to the understanding of common stock. Book value per share represents the company's reported stockholders' equity account (or net worth) in the business *after* all debt and preferred stock are subtracted from total assets. Earnings per share reflects an owner's share of the company's profits for each share of common stock owned. The importance of these calculations is illustrated next.

Case Study: Aspen Radio Raises \$200,000 of Capital

The capital-raising activity of a business directly impacts the book value and earnings per share. For example, consider what would happen to the earnings and book value calculations if Aspen Radio raised \$200,000 of new capital in the following forms:

- \$100,000 additional preferred stock.
- \$100,000 additional debt.

Assuming an 8% cost of capital on the debt and a 10% dividend on the new preferred stock, the adjusted income statement is shown on page 23. As computed, the net income available to Aspen's common stockholders fell from \$56,000 to \$41,200, a decline of about 26%. Based on 100,000 shares outstanding, earnings per share correspondingly declined 26%, from \$0.56 to \$0.41.

Moreover, the company now has \$350,000 of contractual commitments to eventually repay/redeem, compared to \$150,000 before the two financings (see balance sheet on page 19). Looked at another way, here is total long-term debt and

preferred stock as a percent of the company's common stockholders' equity account of \$200,000:

	Before <u>Financing</u>	After <u>Financing</u>
Long-Term Debt	\$100,000	\$200,000
Preferred Stock	<u>50,000</u>	<u>150,000</u>
Total	\$150,000	\$350,000
Stockholders' Equity	\$200,000	\$200,000
Debt Percent of Equity	75%	175%

As computed, both long-term debt and preferred stock now represent 175% of common stockholders' equity — more than double what it was *before* the \$200,000 financing.

In contrast, if Aspen raises the \$200,000 in common stock, rather than debt and preferred stock, the ratio changes dramatically. Now, the stockholders' equity account increases to \$400,000 and the combined debt and preferred stock of \$150,000 represents only 37% (not 175%) of the \$400,000 equity account. That's the type of balance sheet and equity account you need to finance growth.

And, on the other side of the coin — the income statement — let's assume Aspen has to give an investor 20% of the business, or 25,000 shares of common stock, for the \$200,000 common stock investment. Using the current \$56,000 net income in the Table on page 23, here are the adjusted earnings per share:

Net Income	\$56,000
Shares Outstanding	125,000
Earnings per Share	\$ 0.45

That \$0.45 earnings per share is greater than the \$0.41 from the debt and preferred stock financing. And, as indicated, the after-financing balance sheet is substantially stronger with the common stock financing. In addition, the book value per share greatly increased — from \$2.00 per share to \$3.20 (\$400,000 equity account divided by 125,000 shares of common stock outstanding). That's because the 25,000 shares of common stock were sold at \$8.00 per share, \$6.00 above the

current book value of \$2.00.

That's the type of balance sheet and income analysis you should do *before* deciding which method of financing is best for your business. You also might want to consider a combination financing such as breaking up the \$200,000 financing into \$100,000 debt and \$100,000 common stock.

Also very important: Project your company's profits for the next few years and recalculate the earnings per share using the format in the Table on the next page. That way, you will know the *additional* profits to be earned on each method of financing.

* * *

There is always a risk on any new financing, but presumably, the new capital will enable the business to substantially improve its earnings and thus its long-term profitability. But remember; the balance sheet you have to work with is also very important. The more equity capital you have in the business, the easier it is to raise future capital and the less cash flow you need to repay contractual obligations, including interest and dividend requirements. □

Next Section — How to Use Preferred Stock to Finance Your Business

Aspen Radio: Before and After the Financing

	<u>Before Financing</u>	<u>Additional Interest and Dividends</u>	<u>After Financing</u>
Sales	<u>\$1,000,000</u>		<u>\$1,000,000</u>
Operating Profit	100,000		100,000
Interest Expense	<u>-10,000</u>	-8,000 ¹	<u>-18,000</u>
Pretax Income	90,000		82,000
Taxes	<u>-30,000</u>		<u>-26,800</u>
Net Income	60,000		55,200
Preferred Stock Dividends	<u>-4,000</u>	-10,000 ²	<u>-14,000</u>
Net Income Available to Common Stockholders	\$ 56,000		\$ 41,200 ³
Earnings per Share	\$0.56		\$0.41 ³

#1 — 8% times \$100,000 debt financing; tax deductible.

#2 — 10% times \$100,000 new preferred financing; not tax deductible.

#3 — Assumes no additional earnings on the new capital of \$200,000.

Section #3

Preferred Stock: **What It Is, How to Use It**

- **Financing via Preferred Stock**
- **Special Terms and Features**
- **Other Uses of Preferred Stock**

Failure to pay a dividend on preferred stock usually doesn't result in a default; failure to pay interest on debt does.

Financing with Preferred Stock

You Want —

- Optional redemption
- Noncumulative dividends
- No equity kickers
- Restricted voting rights unless dividends are missed

You Don't Want —

- High dividend since it's not tax deductible
- Convertibility
- Participating
- Long period for conversion

Business Form and Preferred Stock

Regular (C) corporations can finance their businesses by using preferred stock. S corporations are restricted from using preferred stock since it is a second security; generally only common stock is allowed. For limited liability companies, S corps., partnerships, and sole proprietorships, simply substitute the word “preference securities” for preferred stock. For example, in a partnership, the general partner, who manages the partnership, could receive 20% of the profits and the limited partners 80% even though they may legally own 100% of the partnership.

Although preferred stock is usually considered *permanent* equity capital, it may contain a redemption feature, which makes it look like debt.

In the prior section, we reviewed common stock. This section is on *preferred stock* — what it is and how to use it as a financing vehicle.

Preferred stock is a hybrid security lying between common stock and debt on the balance sheet. From the point of view of a creditor, preferred stock is part of a company's equity base since, if a liquidation occurs, preferred stockholders do not receive payment until all creditors have been paid. However, from the point of view of common stockholders, preferred stock *looks like debt* since it generally:

- Carries a dividend yield.
- May require a predetermined repayment, referred to as a redemption requirement.
- Has liquidation preference ahead of the company's common stockholders, i.e., if there is a liquidation, reorganization, or bankruptcy, the preferred stockholders would be paid *before* common stockholders.

Companies issue and sell preferred stock because it is equity capital that has "leverage." That is, banks and other financial institutions usually include preferred stock in the company's equity base when determining how much money a company is "eligible" to borrow.

Although preferred stock is considered permanent equity capital, it may contain a redemption feature that requires the company to redeem, or buy back, the preferred stock over a specified period. In this regard, it is comparable to debt, which also must be repaid over a specified period of time.

However, preferred stock, unlike debt, pays dividends from corporate earnings. Failure to pay a dividend on a preferred usually does not result in a default; failure to pay interest on a debt instrument (line of credit, term loan, mortgage, etc.) *does* result in a default.

Financing via Preferred Stock

The advantages are:

- For current and future borrowing purposes, capital raised through preferred stock is considered part of the company's equity base by creditors.

- Fixed loan repayments and interest payments required by debt obligations are avoided. Thus, future cash flow is greater when financing via preferred stock.
- The ownership positions of existing common stockholders are not diluted. The increase in the value of the business goes to the common stockholders, not to the preferred stockholders (except with convertible and participating preferred stocks, which are discussed later).
- If the preferred does not have a mandatory redemption requirement, the equity capital it provides is permanent, comparable to a straight common stock financing.

The disadvantages are:

- To compensate an investor for the greater risk of buying preferred stock, the overall return on a straight preferred — if it's not participating or convertible — must be higher than the interest rate paid on debt instruments. That's because debt instruments have a priority lien on the company's assets ahead of preferred stock.
- Dividends paid on preferred stock are *not* tax deductible by the company. (This is a big negative when compared to debt financings since interest is tax deductible.)
- Many preferred stocks sold by smaller businesses require an equity kicker in the form of either a conversion feature or an option to buy common stock, i.e., a warrant agreement to buy a certain number of shares at a predetermined price.
- If the equity kicker is exercised by the preferred stockholder, that means minority ownership in the business, which most business owners prefer not to have.

Special Terms and Features

Preferred stock has special characteristics, the most common of which are the following:

Par value. The par value for a preferred stock is important for two reasons: (a) it usually states the value (price) for redeeming (buying back) the preferred shares, and (b) the dividend rate is usually set as a percentage of the par value. For

example, a company may issue a 10% preferred stock with a par value of \$100. This means that for every \$100, a purchaser of the preferred would receive one share of preferred stock with a redemption (repayment) value of \$100. In addition, the preferred stockholder would be entitled to an annual dividend of \$10 per share (10% times \$100 par value).

Cumulative dividends. The dividends on preferred stock can be either *cumulative* or *noncumulative*. Most are cumulative, which means that all *past* dividends accrued (not paid) on the preferred stock must be paid before any common stock dividends are paid.

For example, let's assume that a company has issued \$100,000 of 10% cumulative preferred stock. Each year, the preferred stockholders would be entitled to \$10,000 in dividends. If the dividend is skipped one year, it accumulates. Thus, after the second year, \$20,000 would be due and payable (\$10,000 past due and \$10,000 currently due). This total amount *must be paid* before any dividends are paid on the common stock.

If the preferred is *noncumulative*, common stock dividends can be paid in the second year without paying the previous year's preferred dividend. However, the current year's preferred dividend must be paid before current-year common stock dividends are paid. In most cases, *all* past and unpaid preferred dividends must be paid *before* any common stock dividends.

Tax consideration. Preferred stock dividends are *not* tax deductible. The annual 10% (\$10,000) cumulative dividend illustrated above is paid out of the company's after-tax income. Thus, if a business is in an overall 30% tax bracket, the effective after-tax cost of the preferred stock dividend is a full 10%. If a debt instrument paying 10% interest were issued by the company, the effective after-tax cost would be 7% (10% interest *less* overall tax rate of 30%, i.e., 10% minus 3% tax savings). That's because interest on debt instruments is a tax-deductible expense.

Looking at the preferred dividend from a *pre-tax* point of view, the effective cost is 14.3% (10% dividend divided by 70% after-tax rate). Compare that 14.3% with the 10% interest rate on the debt financing.

In terms of net cash outlay, the preferred stock is much more expensive than debt, even though the interest and dividend rates are the same.

Participating preferred. One of the benefits for common stockholders is

that preferred stockholders are usually entitled only to a fixed return (i.e., the 10% dividend). This allows common stockholders the favorable leverage of increasing earnings by more than the preferred stock dividend rate of 10%. There is no fixed limit on the annual return for common stockholders. However, preferred stock may be *participating*, which means that it participates along with common stock in the net income of the business, usually as a percentage, e.g., 15% of the company's net income above a certain level.

For example, a participating preferred stock could have the following rights: *First*, the stated preferred stock dividend is paid out of net income, say, 10% or \$10 per \$100 preferred share. *Second*, an equal dollar amount of dividends is allocated to the common stockholders. *Third*, the remaining earnings are distributed 15% to preferred stockholders and 85% to common stockholders. That's a participating preferred.

The benefits: If the company has losses and resulting cash flow problems, the dividends do not have to be paid. In addition, the formula for payment of the participating dividend can start after a certain net income level, e.g., after \$100,000. This gives the first \$100,000 of net income to the common stockholders and also provides a cushion for future cash flow problems.

Voting rights. A preferred stock may be given voting rights or the right to designate a certain number of directors if the company defaults on the dividend payments. *Recommendation:* If voting rights have to be given, try to make the rights effective *only* after the company has missed a year or two of dividends.

Redemption or repayment. Many preferred shares do not have a definite maturity date; in contrast, debt instruments do. However, preferred stock may have a "mandatory redemption provision" requiring that a certain percentage of the preferred stock be redeemed or paid back each year. For example, a flat rate of 10% may have to be redeemed each year so that at the end of ten years the entire preferred stock has been paid off.

Optional redemption. Optional redemption gives the company the right to call in and redeem (buy back) all or part of the preferred stock outstanding. If a preferred stock has a call provision, the price at which the stock can be called is normally greater than the par value per share. This additional amount is known as the *call premium* or *call penalty*.

For example, a company may be allowed to call in its preferred stock at 108% of a \$100 par value — an 8% penalty — and the call premium may be set on a sliding scale, decreasing each year over a number of years to par value (e.g., 108% in the first year, 107% in the second, etc.). That means that the company could buy back the preferred in year two for \$107 per \$100 par value.

Reason for call option: A company wants a call provision to avoid being locked into a high, non-tax-deductible preferred dividend, especially if the preferred is participating or convertible into common stock. The preferred stockholders, on the other hand, want compensation for this call option through the call premium, i.e., the 8% penalty for the company's right to "call in" the preferred stock prior to its maturity date.

Conversion rights. A preferred stockholder also may have the right to convert the preferred stock into common stock. For example, one share of preferred might be convertible into 5 shares of common. This is known as the *conversion rate*, which determines the *conversion price*. If the preferred has a par value of \$100 and if it is convertible into 5 shares of common stock, the conversion rate is 5 to 1 and the conversion price is \$20 (\$100 par value divided by 5 shares). Thus, for each \$100 of preferred stock, the preferred stockholder receives 5 shares of common stock.

The conversion feature enables the preferred stockholder to benefit from the growth of the business through increases in the future value of the company's common stock. If, for example, the common stock grows in value to \$30 per share, the preferred stockholders, with a conversion price of \$20, would have a "paper profit" of \$10 per share or 50% on the \$20.

Conversion period: Also important is the conversion period, the time during which the preferred stockholder has the right to convert the preferred into common stock. The longer the time period to convert, the more valuable the preferred stock. However, from the company's point of view, it wants to *shorten* the conversion period for the preferred. *Reasons:* On conversion, the company stops paying contractual dividends and eliminates future redemption (repayment) of the preferred stock.

Preferred terms. The rights of preferred stockholders and the terms of the preferred stock are usually expressed in the company's charter or articles of incorporation. If the preferred stock was not originally authorized by the company's common stockholders, their approval will be needed, as well as the company's board

of directors, to effect a preferred stock financing.

Other Uses of Preferred Stock

Preferred stock can be used for a variety of purposes, but is particularly appropriate when you are recapitalizing a business by replacing a debt security with preferred stock. You may be doing so because your company is in financial trouble or because you want to fix a value on a certain percentage of your common stockholders' equity account by converting some or all of your common stock into preferred stock.

Preferred stock recapitalizations also are appropriate for business owners who wish to place a value on their common stock ownership for estate purposes or to provide for management succession. Ask your advisers about this technique, particularly if you are nearing retirement. For details, refer them to Internal Revenue Code Section 2701. □

Next Section — *Debt Financings: How to Use Them for Growth*

Section #4

Debt Financings: **How to Use Them for Growth**

- **How a Lender Looks at Your Company**
- **Types of Debt Instruments**
- **Debt Terms to Know and Negotiate**
- **Convertible Debt Securities**

Debt instruments have one thing in common: A prior claim on a company's assets over common and preferred stockholders.

This section covers short-, intermediate-, and long-term debt instruments. Unlike common or preferred stock, debt capital is borrowed money. It is not considered permanent capital or part of the equity base of a business, unless the debt is specifically subordinated to other lenders, e.g., bank loans.

Debt is *very* different from investment capital in the form of common or preferred stock. The future value of the business and any dividends provide the overall yield to common and preferred stockholders. In contrast, debtholders do not share in any increased value of the business. Their annual return is measured by the interest rate they receive.

Financing via Debt

The advantages are:

- The cost of debt is known, specified by an agreed-on interest rate. The rate can be flat or variable, e.g., one that fluctuates with the prime rate.
- The cost of debt can be substantially lower than the cost of common stock because debt does not have a claim on the future earnings and growth of the business.
- Interest paid on debt instruments is tax deductible, whereas dividends paid on common and preferred stock are not deductible.
- The ownership positions of existing stockholders are not diluted when debt is issued, unless the debt has a conversion privilege or warrants (options) to buy the company's common stock.

The disadvantages are:

- Interest on debt must be paid regardless of the level of profits or even in the event of losses. Dividends on preferred and common stock can be missed or not paid at all.
- Debt carries a fixed repayment schedule and maturity date that must be met. Thus, it affects a company's future cash flow and its balance sheet, i.e., the ratio of total debt to the company's stockholders' equity (net worth) account.
- Because of the required repayment schedule, debt capital has a limited life, i.e., it is not *permanent* capital like common stock financings. If the

business has a continuing need for capital, the debt must be refinanced.

- The loan agreement covering most debt instruments will contain affirmative and negative covenants with which the company must comply. In addition, for closely held companies, debt financings usually require the personal guarantee of the owner(s).

How a Lender Looks at a Company

The various terms of the specific loan document you negotiate with your lender are based on many factors beyond the prevailing market interest rate. Among those other factors are your company's financial ratios.

Companies with strong ratios qualify for unsecured credit; highly leveraged companies with weak ratios usually are asked to secure any new loans for even small amounts of capital. Here are some guidelines.

Generally the following ratios are considered the signs of a financially *healthy* company and are prevalent in larger, better capitalized businesses:

- Long-term debt to stockholders' equity — no more than 0.75 to 1.00.
- Total debt to equity — no more than 2.0 to 1.0, preferably 1.5 to 1.0.
- Earnings before interest and taxes (EBIT) to total interest cost — 4.0 to 1.0 or even 6.0 to 1.0.

On the other hand, *weaker* companies with the following ratios should expect to make more concessions in negotiating new capital:

- Long-term debt to equity — in excess of 2.0 or 3.0 to 1.0.
- Total debt to equity — in excess of 3.0 to 1.0.
- EBIT to interest cost — less than 2.0 or 1.0 to 1.0.

Calculate these ratios for your company before you approach lenders. If your company's ratios are weak, plan to provide some collateral for the loan or raise new capital via another method such as selling common or preferred stock.

Types of Debt Instruments

Debt instruments come in a variety of forms and maturities — term, secured or unsecured, senior or junior, subordinated or not. But all have one common characteristic: The claim they have on the assets of the business on liquidation, sale, or other transfer or disposition of the business is ahead of both preferred and common stockholders.

Please refer to the next page. Note that the line of credit, term loan, and the debentures are classified as senior debt, which is correct. However, for all practical purposes, they are junior to the first- and second-mortgage notes and to the security interests (equipment chattels) because these latter debt instruments are secured by specific assets.

In terms of maturity (due date), debt instruments usually fall into the following classes:

Short-term — less than one year.

Intermediate-term — one to seven years.

Long-term — eight or more years.

Debt Instruments: Which Is Best for You?

<u>Type of Debt</u>	<u>Term</u>	<u>Security</u>	<u>Position</u>
Line of Credit	Short-term	Unsecured ¹	Senior ²
Five-Year Term Loan	Intermediate	Unsecured ¹	Senior ²
First Mortgage Note	Long-term	Secured	Senior
Second Mortgage Note	Long-term	Secured	Junior to the first mortgage
Debenture	Long-term	Unsecured	Senior ²
Security Interests	Intermediate	Secured ³	Senior
Senior Subordinated Debt	Long-term	Unsecured	Junior debt, but senior to junior subordinated debt
Junior Subordinated Debt	Long-term	Unsecured	Junior to all debt

1 Can be secured, usually by a lien on the company's accounts receivable and inventory.

2 Senior to subordinated debt but, in essence, junior to secured debt.

3 Usually secured by company-owned equipment.

Debt Terms to Know and Negotiate

Common characteristics and terms apply to all debt instruments. It should be noted that this review is limited to formalized debt instruments, not to a company's current debt, such as accounts payable, accruals, and taxes payable.

While current credit, e.g., accounts payable, represents a debt obligation, it differs from formal, fixed-income debt securities, which have legal documents that set forth the interest rate, repayment terms, negative and affirmative covenants, and other provisions.

Fixed-income debt securities, many times with a variable interest rate, are obtained from financial institutions, such as banks, insurance companies, finance companies, factors, the Small Business Administration, small business investment companies, and specialized lenders such as local and state industrial development companies.

The following terms are common to most formal debt instruments.

Acceleration Clause. This is a clause in a loan agreement whereby the outstanding balance of the debt becomes immediately due (at the election of the lender) if the borrower defaults on repayment of the loan or breaches other covenants to the loan agreement.

Note. A note is a written promise to pay unconditionally a certain sum of money on demand (no maturity date) or at some specified future time. For example, a company may borrow \$100,000 from its local commercial bank and sign a 90-day promissory note. The principal amount is to be repaid at the end of 90 days.

Bond. In contrast to short-term loans, lines of credit, and accounts receivable financings, a bond is a long-term promissory note, generally for terms of 10 to 30 years, obtained when the need is for long-term capital.

Call Provision. This provision gives the company the right to prepay the loan prior to its maturity date. Also, as in the case of preferred stock, the call provision can provide for a premium or penalty for early repayment. For example, if the outstanding loan is \$80,000 and the premium penalty is 6% (\$4,800), you can prepay the loan for \$84,800.

Debenture. A debenture is a long-term debt obligation that is *not* secured by any specific collateral. The financial strength of the company and its future earning power are the underlying security.

Funded Debt. Funded debt is simply another name for long-term debt. *Funding* is the conversion of short-term debt into long-term debt. *Refunding* is the refinancing of current long-term debt.

Maturity. The maturity or stated maturity date is the date that the final principal payment of a loan is due, regardless of how the loan is repaid over its term.

Mortgage. A mortgage is a long-term debt instrument secured by a specific piece of real property, such as land or a building, which serves as the lender's collateral. It may be a first mortgage, in which the lender has a first lien (first claim on the collateral) or a second, third, or fourth mortgage, in which the lender has a lien junior to the preceding mortgages.

Security Interests. When the collateral is personal property, such as equipment and furniture, the debt instrument is referred to as a security interest. These financings are generally intermediate-term debt (usually three to seven years). Lenders include banks, finance companies, leasing companies, and original equipment manufacturers.

Repayment Provisions. A loan can be retired over any period. The usual methods are:

Frequency: Monthly, quarterly, semi-annual, or annual payments, or one single payment at maturity.

Level payments: Principal and interest are repaid in level (equal) installments over the term of the loan. This is how mortgage payments are made.

Step-up: A repayment schedule that increases the principal amount to be repaid each year over the term of the loan, e.g., \$10,000 per month for the first year, \$12,500 per month for the second year, etc.

Balloon: A final payment at maturity, generally no more than 15% to 25% of the original loan amount.

Convertibility. A conversion privilege allows the debtholder to convert the debt into common stock. The conversion rate, i.e., the percentage of the company the lender gets to buy on conversion of the debt to common stock, is the most important consideration. An example of a convertible debt security is illustrated in the next section.

Loan Agreement. The loan agreement or indenture is the legal document that contains the terms of the transaction as agreed to by the borrower and the lender. The loan agreement will specify the interest rate, the method of repayment, and the borrower's representations regarding the business, e.g., any financial statements given to the lender.

Also included in the loan agreement are the events that trigger a default, thereby allowing the lender to “accelerate” the loan, i.e., demand immediate and full repayment. *Two principal covenant sections:*

- ***Affirmative covenants*** specify what information the borrower must periodically supply to the lender, e.g., financial statements, proof of insurance, payment of taxes, etc.
- ***Negative covenants*** define the restrictions on the business, such as a requirement to maintain agreed-to financial ratios (e.g., a minimum net working capital level or current ratio). Since the loan agreement is a legal contract and remains in force for as long as the loan is outstanding, these negative covenants should be carefully negotiated and reviewed by the company's lawyer.

Subordinated Debt. Subordinated debt is debt whose claim on the company's assets is subordinate, or junior, to another lender. This is accomplished by the subordinated lender *agreeing in writing* that its loan will be second in line to the lender, say, a bank, to whom it is being subordinated. For example, if the company has difficulties and declares bankruptcy, any monies due the subordinated debtholder are paid to the company's bank until its loan has been fully repaid. A debt may be subordinate to all outstanding debt or to a specific creditor (say, just a bank).

The subordination feature in loan agreements increases a company's

borrowing ability since a lender usually considers the subordinated loan as equity-type capital for determining how much money it will lend to a business. That's important for business owners to know since the stockholders' equity account of many closely held businesses is usually low. □

Next Section — *Equity Kickers*: How to Sweeten a Financing

Section #5

Equity Kickers: **How to Sweeten a Financing**

- **Warrants and Convertibles**
- **Value of the Business**
- **Financing Options**
- **Negotiating Equity Kickers**
- **Finding Investors**

You need to make three calculations: Your after-financing percent ownership position, the price per share, and the value placed on the company.

Review of Ways to Raise Capital

Thus far, we have presented three forms of financing a business: common stock, preferred stock, and straight debt.

This section presents the details of debt and preferred stock financings which involve equity kickers (options to buy common stock in a business). Equity kickers are principally used to encourage a lender or investor to loan money to or invest in your company.

In the next section, we will put all the financing methods in perspective with a detailed case study to help you determine which method or combination of methods is best for you and your company at its current sales, profitability, and balance sheet position.

When an interest rate does not compensate a lender or an investor for the risks associated with an investment in a business, an equity kicker may be asked for. An equity kicker offers an investor a potential ownership share in the company in exchange for the capital, usually in the form of a loan. It is, in effect, a bonus — over and above the interest rate — that encourages an investor to choose investing in a company over other investment alternatives.

There are two basic types of equity kickers: warrants and convertible securities, both of which give a lender or investor the right to own common stock in the company. Let's start with warrants to purchase common stock.

About Warrants

A warrant is an option to purchase a certain number of shares of common stock at a certain price for an agreed-on period of time.

Example of equity give-up: A \$200,000, seven-year term loan could carry with it an option to purchase 10,000 shares of common stock at \$5 per share for the seven-year period. Let's further assume that there are 100,000 shares of common stock currently outstanding. Based on these facts, two calculations should be done: potential ownership percentage and value of the business.

#1. Potential Ownership Position

If the 10,000 warrants are exercised, 110,000 shares will be outstanding. Thus, the lender's potential ownership position is:

$$\frac{\text{Number of Shares}}{\text{Total Shares Outstanding}} = \text{Percent Ownership of Investor}$$

$$\frac{10,000}{110,000} = 9.1\%$$

Thus, the lender has an option, based on shares outstanding of 110,000 after exercise of the 10,000 warrants, to purchase 9.1% of the business.

#2. Value of the Business

The value placed on the business by the investor is computed as follows:

$$\frac{\text{Total Purchase Price}}{\text{Percent Ownership}} = \text{Value of Company}$$

$$\frac{\$50,000}{0.091} = \$550,000$$

The total purchase price of \$50,000 is the number of warrants (10,000) multiplied by the exercise price per share (\$5).

Alternative method: Another way to calculate the company's value is simply to multiply the total number of shares to be outstanding by the exercise price of the warrant: 110,000 shares times \$5 equals \$550,000.

Investor's breakeven: The \$550,000 valuation is the investor's or lender's breakeven point. If the business is sold at this price, or below it, the investor will *not* exercise the warrants. However, if the business is sold for \$1 million, the investor's share will be \$91,000 (9.1% times \$1 million). The profit (capital gain) would be \$41,000 (\$91,000 less \$50,000 cost basis to purchase the shares).

Before beginning negotiations, know what your company is worth today and what it may be worth in three to five years.

About Convertible Securities

As illustrated in the prior section, a convertible loan or convertible preferred stock gives the lender/investor the right to convert all or part of the loan (or preferred stock) into the common stock of the company for a certain period of time.

Two definitions:

Conversion rate: The total number of shares obtained by converting the loan into common stock.

Conversion price: The number of shares divided into the dollar amount of the loan.

Example: A \$200,000, 10-year loan is convertible into 40,000 shares of common stock. Again, 100,000 shares are outstanding. Based on these facts:

- The conversion price is \$5: \$200,000 loan divided by 40,000 shares.
- The potential ownership position is 28.6%: 40,000 shares divided by 140,000 shares outstanding after conversion of the debt or preferred stock into the company's common stock.
- The total value placed on the business is \$700,000: \$200,000 conversion value divided by the potential ownership percentage of 0.286. *Alternate method:* 140,000 total shares outstanding times the \$5 conversion price, which also equals \$700,000.

Financing via Warrants and Convertible Securities

Business owners and executives should consider the four components of the equity kicker which affect them personally: (a) the *number of shares* to be received by the lender/investor, (b) the *percentage* of the company that the lender/investor has the option to buy, (c) the *purchase price* of the shares, and (d) the *length of time* the investor or lender has the right to exercise the warrant or to effect the conversion privilege.

All four components are subject to extensive negotiations which are explained on the next page. Equity-type investors (venture capitalists and small business investment companies) receive an equity position because the companies in which they invest do not have the solid credit rating of larger or more established firms. The company's fundamentals, primarily its net book value and earnings (both historical and projected), determine the extent of the equity participation.

Warrant or convertible? One of the key negotiating factors in an equity participation arrangement is the value placed on the business through the conversion of the debt or the exercise of the warrant. Obviously, the investor will want a low valuation in order to obtain a greater percentage of the company and the company a higher value in order to give away as little ownership as possible.

A warrant structure is particularly useful in resolving those conflicting objectives. For example, an investor may request a seven-year option to purchase 25% of the company for \$200,000. That places an \$800,000 value on the business: \$200,000 divided by 0.25. If the business is sold for \$2 million, the investor will have a profit of \$300,000 (25% of the \$2 million selling price equals \$500,000 less the investor's cost basis of \$200,000).

However, in negotiating, you can usually lower the percent given up by

negotiating a lower buy-in price. For example, consider the following alternatives:

Alternative #1. 25% of the business at a buy-in price of \$200,000. The investor's breakeven is \$800,000: \$200,000 divided by 25%.

Alternative #2. 20% of the business (not 25%) at a buy-in price of \$100,000 (not \$200,000). The breakeven for the investor is \$500,000: \$100,000 divided by 0.20.

Alternative #3. 10% of the business for only \$10,000. Here the breakeven for the investor is *only* \$100,000: \$10,000 divided by 0.10.

On the one hand, you are giving up cheap or low-priced stock; on the other, you are saving a good percent of the company (10% vs. 20% vs. 25%). That's the tradeoff. If you think your company will double or triple in value over the next five years, you should use Alternative #3 even if it hurts emotionally to give away cheap stock.

Advisory: Because an equity participation by an investor will be one of the most important aspects of your discussions, *figure out in advance what your company is worth*. Then calculate what it may be worth in three to five years. Use three projection models — conservative, most probable, and optimistic. Somewhere within these parameters, you will find the right valuation. But be realistic. Although it's natural to set a high personal value on your company, consider how the market and prospective investors view its value.

How to Negotiate Equity Kickers

Financings that involve equity kickers, warrants and convertible securities, require *special* provisions and include special rights for the investor. Here are the important ones and ideas on how to protect yourself personally *and* the company.

Registration Rights

With this provision, the investor/lender can require the company to register the shares of common stock (or shares underlying a warrant or conversion option) with the Securities and Exchange Commission and with applicable states (blue sky laws) so that they can be sold through a public offering. Generally, the borrower pays to register the shares and the investor/lender pays the selling commissions.

In many cases, one or two registration rights are given and an unlimited number of "piggyback rights," whereby the investor can sell the shares when the company or its principal stockholders sell theirs. When negotiating registration rights, be sure to:

- Set a minimum amount to be registered. You don't want to incur minimum filing and legal costs of, say, \$100,000 to sell only \$500,000 of securities. Consider setting the minimum public offering amount in the \$2 to \$3 million area. And, of course, consider selling some of your own shares in the public offering to diversify your investment in the business and generate cash and liquidity for yourself and family.
- Avoid the so-called "shelf" or delayed offering because that will require you to keep updating the prospectus at considerable expense until all of the shares are sold.

Put and Call Options

Because of the illiquid nature (not readily saleable) of owning stock in a closely held business, many investors want the option of selling ("putting") their shares back to the company at an agreed-on price or formula, e.g., 10 times net income times the percent owned by the investor.

Example: Suppose an investor has an option to buy 20,000 shares of common stock at \$1 per share and also has a *put option* at \$5 per share effective for five years. That represents a profit of \$4 per share, a cash cost to the company of \$80,000 (\$4 times 20,000 shares). In such cases, try hard to negotiate the following:

- Obtain the right to pay the \$80,000 profit over a three- to five-year period.
- Have the put option operative only if the company has a certain earnings level and/or a minimum net worth position.
- Make the put exercise price a function (e.g., 100% to 150%) of the company's book value per share at the time of execution. Exclude any increases in the company's book value that resulted from *future* sales of common stock since that will automatically increase the company's book value and thus the profit on the option.
- Get the reciprocal right to *call* the shares. *Example:* If the investor or lender doesn't exercise the right to purchase the shares, you have the right to purchase the shares for x dollars.

Subordination

Many equity-type lenders (e.g., venture firms and small business investment companies) will subordinate their loan to banks and to other senior lenders. This means that your company's equity base (net worth *plus* subordinated debt) for present and future borrowings will be increased. *What to do:* All debt with an equity kicker should be subordinated to other institutional borrowings, e.g., your bank, so you can leverage (obtain more capital) on the subordinated debt.

Right of First Refusal

Sometimes an investor will want the right of first refusal on future financings that involve the sale of stock or stock options. If you give this right to the investor, make sure you also have the right to participate *personally*. This allows you to maintain your percentage ownership position in the business.

Example: If you own 55% of a company, which represents control, and the company is selling 20% of newly issued stock — reducing your 55% ownership to 45.8% — you want the right to buy more shares at the same price so you can maintain your 55% ownership and continue to control the company.

Antidilution

Antidilution provisions assure that the investor's percent ownership in the business is maintained and that the exercise price per share and the number of shares are adjusted for stock splits, stock dividends, and low-priced stock sales and option agreements.

Be careful: The most severe restriction is a total prohibition on issuing *any* additional shares of common stock or stock options *without* the investor's prior written consent. If such permission is required, try to reserve the right to issue stock options or sell or transfer shares up to a stated small percentage of the business, say, 10%. This right protects you from having to negotiate with the investor every time the company sells some shares to others or grants stock options to key executives. The same is true for *your* stock; you want to retain some flexibility to *personally* gift or sell shares, particularly for liquidity, diversification, and estate planning purposes. *What to do:* Reserve the right to gift, transfer, or sell 10% to 20% of your current ownership position without the investor's permission.

Summary: Negotiating Basics

There are no fixed rules when negotiating an equity kicker. All closely held businesses are different in fundamentals, growth rates, values, and the personalities and goals of their owners. Of prime importance are your personal negotiating skills and your ability to market the future of your company.

However, there are some common factors which should always get special emphasis when negotiating equity kickers. They are:

1. The number of shares optioned, i.e., the percentage of the company that the investor or lender has the option to buy.
2. The price paid per share and the value of the business.
3. The term (length of time) the investor has to exercise the warrant or to effect the conversion privilege.
4. The total amount of *new* money received. You don't want to give up a good percent of the business just to repay existing debt.
5. The *additional* money available to the company because of subordination of the loan to a bank or other lender. *Example:* \$200,000 subordinated loan can equal \$200,000 additional bank line of credit, and many times the ratio of subordinated debt to bank loans can be 2.0 to 1.0.
6. The interest rate, collateral requirements, personal guarantees, and repayment terms if it's a debt instrument with an *option* to buy common stock.
7. The loan agreement, particularly *negative covenants*, which places restrictions on the business, e.g., the maintenance of a minimum net working capital level or a debt-to-equity ratio.

More information: If you need to raise equity-type capital, please see the next page for a listing of how to obtain the names of equity-type investors. □

Next Section — *Actual Financing:* How One Company Made the Decision on Common Stock vs. Preferred Stock vs. Debt.

How to Find Lenders and Investors

The most active purchasers of equity kickers (options to buy stock) via subordinated debt and preferred stock (convertibles) are small business investment companies and venture capital firms. To a lesser extent, subordinated debt with warrants to buy stock or a conversion feature is also sold through the public market. Insurance companies and pension funds are active only in larger, more established companies.

Here is how to obtain information on specific investors and lenders.

1. Small Business Administration. A *free* listing of small business investment companies (SBICs) by state is available from the SBA.

Visit — www.sba.gov. Click Local Resources to find your local SBIC.

2. National Association of SBICs. A listing of 325 SBICs and other venture firms (by state) can be obtained *free* by visiting the website below.

Visit — www.nasbic.org. Click Entrepreneur Center, Find a Member.

3. Venture Capital Association. A Membership Directory of 480 venture capital firms can be obtained by sending \$195 to: National Venture Capital Association, 1655 North Fort Myer Drive, Suite 850, Arlington, VA 22209; 703-524-2549.

Visit — www.nvca.org/pubs.html for more information and to order the Directory: Printed (\$195) or CD-Rom (\$325).

Section #6

Case Study: Actual Financing Common Stock vs. Preferred vs. Debt

- **The Financing Alternatives**
- **Analysis of Financing Methods**
- **Comparison of Financing Methods**
- **Which Financing Was Selected?**
- **Review of All Financing Methods**

Case Study: ABC Electronics, Inc.

If common stock is sold, be sure to compute the percent by which your personal ownership position in the company is diluted.

Business owners can't afford to make mistakes in raising capital. The dollar amount and the length of the commitment are such that even a small oversight in calculating the impact of a financing method can be very expensive. In the prior sections, we presented your options on raising capital through common stock, preferred stock, debt instruments, and equity kickers in the form of warrants and convertible securities to own a piece of the business. This section uses a Case Study to illustrate the basic mathematics and the personal and business considerations in comparing all these financing alternatives. We are using an actual company, but a fictitious name, *ABC Electronics, Inc.*, a manufacturer and distributor of specialized electronic components, as our Case Study subject.

Spin-off benefits: Even if you don't need to raise capital today, you will find the financing alternative exercise and decision-making process both informative and interesting. It also will help you better understand the debt and equity financings you already have in place in your company.

* * *

Your company, *ABC Electronics*, substantially increased sales over the last three years — from \$1.8 million to \$3 million. Net income also increased from \$90,000 to \$140,000. But, the increased sales have strained the capacity of the company's plant and equipment. In-house projections indicate that, with a \$400,000 investment in equipment and working capital, sales will increase to \$4.5 million in two years and pretax income to \$400,000 (\$240,000 after taxes).

Earnings per share: Currently, there are 80,000 shares outstanding. So the earnings per share on this year's net income of \$140,000 is \$1.75 (\$140,000 divided by 80,000 shares outstanding).

The Financing Alternatives

Various plans are suggested for obtaining the \$400,000 needed for expansion. The first suggestion — that the expansion be limited to \$200,000 because this amount can be raised through internal cash flow — is rejected as too conservative. You decide to raise the full \$400,000, but haven't yet decided on the method of financing. Three financing plans are being considered:

Plan A — sell \$400,000 worth of additional common stock (25,000 shares at \$16 per share).

Plan B — sell \$400,000 of 12% cumulative preferred stock (nonconvertible), due in full at the end of eight years.

Plan C — sell \$400,000 of 10%, five-year notes, repayable \$25,000 a quarter starting in year two.

Note: When reviewing this Case Study, don't be concerned about the size of the company or the level of the interest rate or preferred stock dividend; concentrate on the comparative analysis of the three financing alternatives.

Review and Get Answers to These Questions

- #1. What is the *after-tax cost of capital* for each financing instrument? Interest on the debt financing is tax deductible. Dividends paid to common and preferred stockholders are not.
- #2. For how long do you need the additional capital? Is it a permanent or interim need?
- #3. What return can you expect to earn on the *new* money? Which method gives you the greatest profit?
- #4. What are your company's present liquidity and leverage (debt-to-equity) ratios? What will the balance sheet look like after the financing?
- #5. How is your company's projected cash flow? Will you have extra monies to repay the debt or redeem (buy back) the preferred stock?
- #6. Can you live with restrictions (negative covenants) placed on you and the business?
- #7. If stock is sold, are you comfortable with additional stockholders and possibly additional board members? In contrast, how do you feel about taking on more company debt?
- #8. If the financing is a debt instrument, do you and your spouse have to *personally guarantee* the loan or provide personal collateral, e.g., a mortgage on your home?

Analysis of Financing Alternatives

Now, let's analyze and compare the three financing offers.

Using the company's projected pretax income of \$400,000, which financing alternative has the most favorable results? The first step is to compute the effect on earnings per share for the company's common stockholders. As shown in Table 1, page 57, the after-financing (pro forma) effect on net income and earnings per share is as follows:

	<u>Common Stock</u>	<u>12% Preferred</u>	<u>10% Notes</u>
Net Income	\$240,000	\$192,000	\$216,000
Earnings per Share	\$2.29	\$2.40	\$2.70

Conclusion: Financing via debt results in greater earnings per share than the sale of new common stock or preferred stock. This is considered favorable "trading on equity" or "profitable leverage." Both the debt and preferred stock financings produced a good increase in earnings per share, principally because these two financings did not involve the sale of new common stock, which would have diluted each stockholder's percentage ownership in the business. *But consider the following:*

- The debt and preferred stock have definite maturities — the debt *must* be repaid in five years and the preferred stock redeemed in full at the end of eight years. That means neither one is permanent capital as in the common stock financing.
- The debt and preferred stock carry fixed charges — interest and dividends *must* be paid.
- The preferred stock dividend is *not* tax deductible. In the debt financing, on the other hand, interest is tax deductible.
- The debt and preferred stock will have loan or investment agreements that restrict the operations of the business.

In contrast, let's look at the common stock financing:

- If you sell common stock, the earnings per share are lower — \$2.27 vs.

\$2.70 with the debt financing — but the capital is permanent. The common stock doesn't have to be redeemed (repurchased), whereas the debt must be paid, along with interest. The payment of dividends on the common stock is *optional* since a company's board of directors determines whether or not to authorize their payment each year.

- ABC now has an additional equity base of \$400,000, which increases its borrowing capacity. Based on a borrowing ratio of \$1 of debt for every \$1 of equity, the company should be able to borrow additional bank debt of at least \$400,000 on the common stock financing. If the ratio was \$2 to \$1, the company's *additional* borrowing capacity increases to \$800,000, for total available capital of \$1.2 million.

Calculate Ratios for Each Financing

When analyzing any financing instrument, all book value calculations and debt-to-equity ratios should be computed (pro forma analysis) — as they exist *both* before and after the financing methods being considered. These calculations are shown in Table 2, page 58. *Some observations:*

- With the common stock financing, book value per share increases to \$8.57. That's because shares were sold at \$16 per share (\$9.75 above the company's current book value of \$6.25).
- Financing via debt increases the company's debt-to-equity ratio to 380%, a highly leveraged balance sheet which restricts future borrowings and cash flow since the debt will have to be repaid.
- In contrast, when common or preferred stock is the method of financing, total debt represents only 167% of stockholders' equity, compared to 380% with the debt financing. That leaves plenty of room for future borrowings to meet projected working capital and equipment needs.
- With the common stock financing, earnings per share decrease to \$2.29 (see Table 1 on page 57), compared to \$2.40 and \$2.70 per share when financing via preferred stock or debt.
- The debt and preferred stock have contractual agreements to pay the interest and dividends and repay/redeem both securities. Common stock is permanent capital that doesn't require repayment.
- Financing via debt or preferred stock does *not* result in minority owners,

loss of control, or restrictions on the company's operations, i.e., the terms of the loan or preferred stock agreements.

Which Financing Was Selected?

You be the judge: This Case Study does not set forth a best solution; instead, it simply shows the major differences in earnings per share, book values, and leverage ratios for the three financing methods.

For your information, the owners of this company selected common stock to raise the \$400,000. At the same time, the company closed a \$500,000 five-year term loan at one point over the prime rate. Thus, it raised a total of \$900,000, more than sufficient capital to meet its projections.

Although the preferred stock alternative also increases the company's borrowing ability, management felt that the after-tax cost of the 12% dividend was prohibitive since the dividends are not tax deductible. Another negative was the fact that the preferred stock had to be redeemed at the end of eight years.

* * *

For a summary review of the advantages and disadvantages of each financing method, please see page 59. □

— Table 1 —

Earnings: Comparing the Financing Methods

	<u>Common Stock</u>	<u>12% Preferred</u>	<u>10% Notes</u>
Pretax Income	\$400,000	\$400,000	\$400,000
Additional Interest Expense	<u>0</u>	<u>0</u>	<u>-40,000</u>
Adjusted Pretax Income	\$400,000	\$400,000	\$360,000
Less: Income Taxes	<u>160,000</u>	<u>160,000</u>	<u>144,000</u>
Net Income	\$240,000	\$240,000	\$216,000
Less: Preferred Dividends ¹	<u>0</u>	<u>48,000</u>	<u>0</u>
Net Income Available to Common Stockholders	<u>\$240,000</u>	<u>\$192,000</u>	<u>\$216,000</u>
Shares Outstanding	105,000 ²	80,000	80,000
Earnings per Share	\$2.29	\$2.40	\$2.70

#1 — After net income since dividends are not tax deductible.

#2 — After sale of 25,000 additional shares of Common Stock at \$16 per share.

— Table 2 —

Effect on the Balance Sheet

(Dollars in Thousands)	Before <u>Financing</u>	<u>After-Financing Position</u>		
		<u>Common</u>	<u>Preferred</u>	<u>Debt</u>
Assets	<u>\$2,000</u>	<u>\$2,400</u>	<u>\$2,400</u>	<u>\$2,400</u>
Debt	\$1,500	\$1,500	\$1,500	\$1,900
Preferred Stock	0	0	400	0
Common Stock Equity ¹	<u>500</u>	<u>900</u>	<u>500</u>	<u>500</u>
Total Debt and Equity	<u>\$2,000</u>	<u>\$2,400</u>	<u>\$2,400</u>	<u>\$2,400</u>

Calculations

Book Value per Share	\$6.25 ²	\$8.57 ³	\$6.25	\$6.25
Total Debt % of Common Stockholders' Equity	300%	167%	300%	380%
Total Debt % of Total Equity	300%	167%	167% ⁴	380%

#1 — Includes retained earnings, capital surplus, i.e., total common stockholders' equity.

#2 — Actual shares outstanding: 80,000.

#3 — After-financing shares outstanding: 105,000.

#4 — Includes \$400,000 preferred stock as equity capital.

***Financing a Business:* Review of Financing Methods**

Financing via Common Stock

The primary advantages are:

- Common stock entails no required fixed charges — dividends usually do not have to be paid, and the stock does not have to be repurchased by the corporation unless there is a stock repurchase agreement with a stockholder.
- Common stock increases the equity base for *future* borrowings because creditors have a prior claim on the assets of the company — the greater the equity base, the greater the company's borrowing power.
- If the buyer of the common stock is part of management, he or she will have more of an incentive to help the business grow.
- Since common stock usually does not have to be repurchased (redeemed), the company's future cash flow is better; in contrast, debt has to be repaid and has contractual interest payments.

The major disadvantages are:

- Ownership dilution is immediate with the sale of common stock. For example, if you presently own 100,000 shares of stock and your company sells 25,000 additional shares, your percentage ownership decreases to 80% (100,000 shares divided by 125,000 outstanding).
- The ownership dilution can have four effects: (a) potential loss of control over operations, (b) less ownership of the company's future net income stream (earnings per share), (c) less book value per share, and (d) less money for you and

your family when the business is eventually sold.

- Dividends on common stock are not tax deductible, whereas interest on debt instruments is deductible.

- The cost of selling common stock is usually higher than that of selling debt, reflecting the fact that in today's market, equity capital is more difficult to raise than debt. Moreover, the stock of closely held businesses is illiquid (not readily saleable).

- If you now own 100% of the business, the sale of common stock will result in minority owners who may want a voice in the management of the business.

Financing via Preferred Stock

The advantages are:

- For current and future borrowing purposes, capital raised through preferred stock is considered part of the company's equity base by creditors.

- Fixed loan repayments and interest payments required by debt obligations are avoided. Thus, future cash flow is greater when financing via preferred stock.

- The ownership positions of existing stockholders are *not* diluted. The increase in the value of the business goes to the common stockholders, not to the preferred stockholders (except with convertible and participating preferred stocks).

- If the preferred does not have a mandatory redemption requirement, the equity capital it provides is permanent, comparable to a straight common stock financing.

The disadvantages are:

- To compensate an investor for the greater risk of buying preferred stock, the overall return on a straight preferred — if it's not participating or convertible

— must be higher than the interest rate paid on debt instruments. That's because debt instruments have a priority position on the company's assets ahead of preferred stock.

- Dividends paid on preferred stock are *not* tax deductible by the company. (This is a big negative when compared to debt financings since interest is tax deductible.)

- Many preferred stocks sold by smaller businesses require an *equity kicker* in the form of either a conversion feature or an option to buy common stock, i.e., the right to buy a certain number of shares at a predetermined price.

- If the equity kicker is exercised by the preferred stockholder, that means minority ownership in the business.

Financing via Debt

The advantages are:

- The cost of debt is known, specified by an agreed-on interest rate. The rate can be flat or a variable one that fluctuates with the prime rate.

- The cost of debt can be substantially lower than the cost of common stock because debt does not have a claim on the future earnings and growth of the business.

- Interest paid on debt instruments is tax deductible, whereas dividends paid on common and preferred stock are not deductible.

- The ownership positions of existing stockholders are not diluted when debt is issued, unless the debt has a conversion privilege or warrants (options) to buy the company's common stock.

The disadvantages are:

- Interest on debt must be paid regardless of the level of profits or even in the event of losses. Dividends on preferred and common stock can be missed or not paid at all.

- Debt carries a fixed repayment schedule and maturity date that must be met. Thus, it affects a company's future cash flow and its balance sheet, i.e., the ratio of total debt to the company's stockholders' equity account.

- Because of the required repayment schedule, debt capital has a limited life, i.e., it is not *permanent* capital like common stock financings. If the business has a continuing need for capital, the debt usually must be refinanced.

- The loan agreement covering most debt instruments will contain affirmative and negative covenants with which the company must comply. In addition, for closely held companies, debt financings usually require the personal guarantee of the owner(s).

* * *

Knowing your alternatives in raising capital and the advantages and disadvantages of each financing method will help you make the most cost-effective and psychologically comfortable choice when opportunities arise for expanding sales and/or profits. □

Section #7

How to Prepare A Financing Proposal

- **Know What the Lender/Investor Wants**
- ***Exhibit:* Sample Financing Proposal**

The proper financing proposal will save you time and money and get you an answer *fast*.

Raising capital can be a harried and confusing experience. Comparing interest rates isn't enough. You have to concentrate on getting the best overall package: the lowest interest rate, the most acceptable terms and restrictions, and a reasonable repayment schedule.

When shopping for the best loan deal, your most effective tool is a standard loan request that can be used with all potential lenders and that saves time for both you and the lenders. Here are ideas on the *best* way to obtain that needed capital.

Fact: The average lender looks at scores of loan applications each year. So there is a good chance that your financing request and proposal may be *buried in an unread pile*.

Question: How do you move your proposal to the top of the pile and get action on it? By keeping your presentation concise and targeted to the right people with the right information.

Remember, no matter what your proposal is for, people respect other people who can tell their story quickly and succinctly. Too many business owners and executives hand their bankers internal company reports and assume they can dig out the information they need to accept or reject the loan request.

Company-prepared internal plans (e.g., budgets, cash flows, and profit forecasts) are comprehensive and detailed. But they are best used as in-house management tools in looking back (judging performance) and looking forward (controlling and determining needs). Initially placing these long, tedious documents into the hands of outsiders and expecting them to serve as a request for capital usually is a big mistake. Potential lenders may *not* have the time or interest to wade through company documents to pull out the numbers they need to consider a loan request.

Know What the Lender/Investor Wants

Most prospective lenders and investors initially want no more than ten, double-spaced pages, approximately 2,000 words. Time yourself. If your financing proposal can't be read in five to ten minutes, kill it and start over.

If it can, your proposal will immediately be separated from the pile of other financing proposals.

Furthermore, write and shape the proposal to the reader for whom it is in-

tended. While banks, finance companies, small business investment companies (SBICs), and insurance companies all make loans to smaller businesses, they look for those characteristics in a financing that fit each lender's special needs.

Give them the highlights of what they want; the back-up material can follow later. For example, if you're approaching an asset-based lender, discuss the collateral (in detail); if an insurance company, historical income statements and balance sheet substance should be played up; if an SBIC or venture capital firm, your projections for growth and the value of the company's common stock or the equity kicker (warrant or convertible) should be emphasized. To summarize, it is in your best interest to:

1. find out as quickly as possible whether or not there is interest in your proposal and
2. structure the proposal so that it deals with what the reader needs to make a decision.

Here's an Example

Let's assume you currently have a \$200,000 bank loan and want to increase it to \$400,000. You also want to repay the loan on a monthly basis over a three-year period. How do you get your request accepted?

Most individuals would *verbally* try to convince their bankers, some successfully. But your odds are greatly increased if you first identify the banker's needs. In deciding whether or not to lend you an additional \$200,000, a good lender is primarily concerned with the following:

- Why do you need the additional capital?
- Why couldn't you repay the present loan?
- How will you repay the \$400,000?
- What alternative repayment sources do you have?

Step-by-step. Prepare a 10-page, double-spaced memorandum, which should:

- Explain where the company is today and why you need the money. Possibly, you can't repay the \$200,000 loan because your sales are up substantially, and consequently so are your inventory and accounts receivable levels.

- Itemize and explain any collateral that may be offered to secure the loan.
- Show how you plan to repay the loan and document the paydown with a monthly cash flow projection for one year and then annually for two to three years.

Of course, the lender also will want to see current financial statements and receivable and payable reports, but these 10 pages are sufficient for him or her to indicate an initial "yes" or "no."

The Result

This direct approach not only shows your lender that you are on top of the situation and testifies to your competence, but it also gives him or her the necessary information to make a quick decision. If other individuals will be involved in approving the request, your professional memorandum provides the necessary data they need to make a decision.

Even if your loan request is rejected, you at least have found out *quickly* and can now move rapidly to identify and pursue other financing alternatives. Also, in any proposal, candidness is essential. If you suffered some recent losses, say so upfront and provide an explanation. If your company is in a turn-around situation, explain why and document the reason with actions you have already taken or intend to take to solve the problem.

Remember, your goal is to get your proposal read so that you can take the next step. The short, factual approach will accomplish this and will separate the interested from the uninterested lender, and do it a lot sooner.

Exhibit: A Brief, Effective Financing Proposal, next page

Lenders respect owners who can present a proposal quickly and succinctly.

A Brief, Effective Financing Proposal

Here is a typical breakdown of what should be included in your 10-page request for capital.

<u>Topic</u>	<u>Number of Pages</u>	<u>What to Cover in Financing Request</u>
Introduction	2	One to two sentences each on the purpose of the report, business of the company, major customers, comparative income statement results.
The Proposal	1	Capital needed: amount, use of proceeds, and repayment.
Justification	1	List the reasons why the lender/investor should act on the proposal; in a nutshell, why it is a good loan or investment.
The Business	4	Description of the company's products, industry, marketing, customers, facilities, management, backlog, etc.
Financials	1	Show, in condensed form, a balance sheet and historical income statement data plus one to two years' projections.
The Future	1	Summary on where the company is headed.
Total Pages	10	

Presentation note: All proposals should be originally typed and professional in appearance. Enclose the material in an attractive brochure, and introduce it with a short, one-page cover letter. Also supply extra copies to the individual who is handling your request. This will speed up the review process; more than one loan officer may be reading your proposal. □

About *The Business Library*

This **Report** is part of *The Business Library* (TBL), a collection of 90 Reports and Manuals on subjects of critical importance to business owners, executives, their families, and the professionals who advise them. TBL is produced by an editorial and research staff with an *average experience* of **30** years in helping businesses and individuals manage their finances better.

The company was formed in 1974 by Thomas J. Martin. Martin has written more than 900 articles and advisories and presented *hundreds* of workshops and seminars to *thousands* of business owners and executives on many of the subjects covered in *The Business Library*. He is an Investment Banker and an expert witness in Valuation and Succession Court Cases. He has helped *hundreds* of business owners and executives raise capital, refinance debt, prepare for succession, and value and sell their businesses.

The information in *The Business Library* has helped more than 300,000 business owners, executives, entrepreneurs, investors, and individuals manage their companies and finances better, using several million copies of our reports, manuals, advisories, books, seminar workbooks, and newsletters to guide them in their business and family planning.

Tricia Walsh, Publishing Director
The Business Library
180 Melody Court, Eastport, NY 11941
631-325-1133 • Fax: 631-325-1145
E-mail: triciawalsh@yourbusinesslibrary.com

Copyright and Publishing Notice

All rights to *The Business Library* and its product lines are reserved under International and Pan American Copyright Conventions. The reproduction, sale, and distribution of this **Report: How to Finance a Business** in whole or in part (in any form) is prohibited without the prior *written* consent of Thomas J. Martin, President, MW Business Solutions, Inc., 180 Melody Court, Eastport, NY 11941, 631-325-1133. Copyright © 2009 by MW Business Solutions, Inc. and Thomas J. Martin, Author.

This Report is intended to provide general information and background in regard to the subject matter covered. It is sold and distributed with the understanding that the publisher, author, and any distributor are not engaged in rendering legal, accounting, tax, insurance, or other professional services or advice. If legal advice or other expert assistance is required, the services of a competent professional should be sought.