

Profiling and Presenting Your Company To the World

- **Presenting Your Company to Lenders, Investors, and Potential Buyers**
- **Preparing the Best Financing Proposal**
- **Using Your Company Profile for Other Business Purposes**
- **What to Include and What to Avoid**
- **Protecting Yourself from Lawsuits**
- **Negotiating the Best Deal**
- **Documenting the Health of Your Company**

Why This Report Is So Important

To present your company in the best manner.

To position your company for continued growth.

To provide sufficient information to a lender, investor, or buyer so he or she can make a decision quickly.

To separate the interested sources of capital from the uninterested.

To produce a company document that can be adapted for other purposes:

- As the basis for a company brochure or website.
- As the substance of a Business or Marketing Plan — i.e., where your company has been, where it's now, and where it's headed.
- To solicit equity capital locally from lenders or investors in your area or nationally from government agencies, venture firms, small business investment companies, and regional banks.
- To value or sell the business.

To analyze your company and identify its strengths, problems, and opportunities.

This Report will help you accomplish those objectives.

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You want your financing request and company report read, acted on quickly, and adaptable for other company purposes, such as a company brochure or website.

How to Finance Your Business

There are two parts to this Report. **Part One** presents many ideas on how to best present your company to potential lenders and investors. It covers the following introductory subjects:

- How to Get That Needed Capital
- What the Lender/Investor Wants
- How to Protect Yourself in Making Representations

Part Two will help you better understand your own business — its strengths, problems, and growth opportunities. It presents an *actual* Financing Plan and Proposal (referred to as the “Report”) prepared by a company seeking \$1.2 million bank debt to be repaid over eight years. The subjects discussed include the company’s history, form of business, financial statements, products, industry, marketing, management and employees, condensed financial statements, projections, and many other topics to help you prepare your own financing plan and proposal.

There is basic information every lender or investor needs to make a financing decision, so prepare it in advance. Don’t waste weeks answering questions and tracking down information you know would be needed and that should have been provided from day one.

Become familiar with the Report’s format, presentation, and the type of information required by perspective lenders or investors. Once collected, the same information can be adapted for company reports, brochures, or website, etc.

Observations

Throughout this Report, we make observations on the concepts, standard ratios and terms, and overall presentation of this specific company to guide you in preparing a report on your own company.

Applications, Size, Length, and Definitions

Applications: Although we refer to shares in a corporation in this Report, the concepts and presentation apply to *all* forms of business and ownership positions, including C and S corporations, partnerships, sole proprietorships, joint ventures, and limited liability companies (LLC). For example, you can simply insert the words “ownership position” for the words “shares” or “stock” in the case of partnerships, LLCs, and sole proprietorships.

Size: If your company is larger or smaller than this actual financing proposal, don’t worry about it. Again, it’s the presentation and analysis that are important.

Length of Report: We intentionally included information in the Report to make it applicable to as many businesses as possible. You will find much of this additional material informative, useful, and adaptable to your own business.

Definition: The term “stockholder’s equity” as used in this Report is the same as a company’s net worth, net book value, or book value.

Addenda Information

To help you analyze your own business and negotiate the best terms, we have included the following addenda.

Addendum A — *Loan Agreements: Negotiating Strategies*, page 37

Addendum B — *Sample Spread Sheets*, page 40

Addendum C — *How to Analyze and Value Your Business*, page 41

Confidentiality: We have changed the names, addresses, etc., as well as some of the numbers, to protect confidentiality and to make the Report on *Hargrave Technology Corp.* more easily read and understood.

Now to Part One — How to Get That Needed Capital

Part One — How to Get That Needed Capital

Borrowing money can be a harried and time-consuming 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 plan.

When shopping for the best loan deal, your most effective tool is a *standard financing proposal* or report on the company that can be submitted to *all* potential lenders and that saves time for both you and the lenders.

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, lenders respect business people who can tell their story quickly and succinctly. Too many owners and executives hand their bankers a pile of 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). 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 nor interest to wade through these 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 10 to 15 pages, approximately 2,000 to 3,000 words. Time yourself. If your financing

proposal can't be read in 15 to 30 minutes, start cutting unnecessary words and surplus information.

If you do, your proposal will immediately be separated from the pile of other financial proposals.

Although the basic content is the same for all loan requests, you should customize the proposal to the specific lender you are approaching. While banks, finance companies, small business investment companies (SBICs), and insurance companies all make loans to smaller and mid-sized businesses, emphasize those characteristics in a financing that fit each lender's special needs.

Give them the highlights of what they want; the backup 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, your projections for growth and the value of the equity kicker (warrant or convertible) should be emphasized. (A sample *Highlights of the Company* is shown on pages 10 and 11.)

This approach not only shows your lender/investor 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 your request, your professional report also 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, candidness is essential. If you suffered recent losses, say so upfront and provide an explanation. If your company is in a turnaround situation, explain why and document the reason with actions you've already taken or intend to take.

Remember, your goal is to get your proposal read, separate the interested from the uninterested, and do it as quickly as possible.

How to Protect Yourself in Making Representations

You will be making representations on your company which open you up to potential lawsuits from lenders and investors if that information turns out to be incorrect, misrepresented, or even fraudulent.

You want to protect yourself personally and the business. Here are some ideas

on how to do that. (References to the actual financing report are indicated so you can discuss the wording with your lawyer.)

- Number and date each copy of the Report to control its distribution and copying. Record who received the Report and when. For Date and Copy Number, please see bottom of page 5.
- Have your lawyer, consultant, and accountant review the Report for mistakes, inconsistencies, and terminology, e.g., the use of the word “may” rather than “will”.
- Indicate you are the *sole* owner of the Report. See page 8. This will give you complete protection to reuse the material in a website, other company brochure, or an Offering Document to sell your business.
- Don’t include information that is *not* applicable to the special purpose of the proposal. That’s a waste of your and the lender’s time.
- Inform the recipients of the Report that you welcome their questions, requests for more information and documentation, and are available to meet with them to discuss your company. See letter on page 6.
- Sign all correspondence and communications as president of the company, and always use company stationery.
- Talk to your lawyer about the federal and state security laws, particularly if the lender or investor is an individual who is not both sophisticated and wealthy.
- Use the Confidential Notice on page 8.
- Delays kill deals. Manage the follow-up personally. Never use “please call me after reviewing....” Alert the lender/investor that you will call next week. See letter on page 6.
- Inform the lender/investor of the special risks of your company, e.g., your top sales person resigned recently and now works for your competitor or three customers account for 65% of your company’s sales.
- Discuss with your lawyer a Confidentiality Agreement to be signed by each recipient of the Report.
- Disclaim all company projections. You and the company *can’t* represent to their achievement. No matter how carefully projections are prepared, the actual results could differ substantially. See page 8.
- Indicate that the Supplemental Information accompanying the proposal, e.g., financial statements, is an integral part of the proposal. See page 7 for a listing.

- Get expert advice if you are selling common stock or options to buy the company's common stock, e.g., warrants and convertible securities, since their sale by the company may be deemed "securities" under the Securities Act of 1933, as amended, or state law.

Don't forget to request the return of all the information from a potential lender or investor if he or she is not interested in the financing. There are exceptions for existing lenders/investors and large financial institutions; check with your lawyer.

If you are not familiar with balance sheet, income statement, and cash flow analysis and the computation of basic ratios and values, review Addendum C starting on page 41. Through a case study, it presents 37 financial ratios to help you evaluate your own business or one you want to acquire or invest in.

* * *

Final comments: Work hard on your company's report. Once it's done, you can easily update it each year, as well as adapt the information to a company brochure, website, valuation report, or other purpose.

Now to Part Two — The Financing Proposal.

Part Two

Confidential Financing Proposal

Hargrave Technology Corp.

- I. Highlights of the Company**
- II. About the Company**
- III. Review of Financial Data**
- IV. About the Financing**

Hargrave Technology Corp.

James K. Hargrave, President

Established 1986

1800 Broadway Avenue • Allstate, NY 11800 • 989-681-2000 • Fax: 989-681-2001

William Baurer
Senior Vice President
All-America Bank Corp.
125 Main Street
Aspen, NY 11806

Dear Bill:

It was nice talking with you. As promised, enclosed is our Financing Proposal for a \$1,200,000 Term Loan to be repaid quarterly over eight years.

The loan would be used to retire the existing bank loan (\$450,000), pay trade debt (\$200,000), purchase equipment (\$80,000), and provide cash for working capital (\$470,000) to finance higher sales, receivables, and inventory levels.

Our 2006 results showed a significant increase in sales (9%) and pretax profits (78%). We also are on target to meet our 2007 projections for sales: \$5,400,000 and pretax profits: \$580,000. Our quarterly results support our achieving the 2007 projections.

Also enclosed is other company information (listed on the next page) to help you move forward on this proposal. If you need extra copies of the proposal for other bank executives, please contact me.

We are available at any time to meet and answer your questions. I will call you next week to set up a meeting date. Best regards and thank you for your time in reviewing this proposal.

Sincerely,

James K. Hargrave, President
Hargrave Technology Corp.

Supplemental Information —

Enclosed are the following Company documents:

- Financing Proposal
- Financial Statements — December 31, 2004, 2005, and 2006
- Financial Statement — March 31, 2007, which contains the March 31, 2006 results
- Breakdown and agings of accounts receivable and payables as of March 31, 2007
- Facilities and Equipment Listing — Current and to Purchase
- Product Literature

Observations

#1 — Do not inundate the lender with detailed information which doesn't address the primary question: Is the lender interested in lending money to your company and on what terms?

#2 — Note that in the letter on the prior page, Hargrave will call the bank. You want to control response to your proposal.

#3 — Also note in the letter: "If you need extra copies of the proposal...." That gives Hargrave control over who receives the proposal and when. Remember, you're numbering each report and any copies.

#4 — If the bank has difficulty with an eight-year loan, the term loan can be structured as a five-year loan with an eight-year repayment schedule. That provides the same repayment schedule as an eight-year loan but the maturity of the loan would be five years. Another alternative is to keep the \$450,000 loan outstanding and raise \$750,000 from other sources of capital.

#5 — We would recommend against Mr. Hargrave and his spouse personally guaranteeing the term loan. It shouldn't be necessary. The Company has good fundamentals, a solid balance sheet, and consistent growth.

Confidential Notice

The information contained in this Financing Proposal (Report) is prepared for potential lenders/investors in Hargrave Technology Corp. (the “Company”).

Its *sole* purpose is to give a general overview of the Company. The Report is furnished on a confidential basis and is the sole property of the Company.

The Report cannot be reproduced, in any form, without the *prior* written consent of James K. Hargrave, president of the Company, and it must be returned to the undersigned within 15 days of written request.

Management cannot represent to its achievement of the projections cited in this Report.

Any future transaction must comply with all security laws, including the Securities and Exchange Commission and applicable state laws.

The Company’s management is available to meet with prospective lenders and investors to answer questions, provide additional information, and discuss the Company’s operations.

James K. Hargrave, *President*
Hargrave Technology Corp.
1800 Broadway Avenue
Allstate, NY 11800
989-681-2000 • Fax: 989-681-2001

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I. Highlights of the Company

- Hargrave Technology Corp. was formed in 1986 and has been in business for 21 years. The Company manufactures and distributes a broad line of high-quality industrial transformers and related products.
- The Company was founded by and is 100% owned by Jim Hargrave. He is president of the Company and is supported by an excellent management team, which is capable of handling substantial increases in sales.
- For the year ended 2006, the Company had sales of \$4.7 million, pretax income of \$492,000, and net income of \$320,000.
- As of March 31, 2007, the Company's backlog was \$1.4 million compared to \$1.1 million for the comparable period last year, a 27% increase.
- For the year 2007, management is projecting sales of \$5.4 million and pretax profits of \$580,000, which is supported by the backlog data above.
- Profitability is strong and consistent. For the last five years, the Company had average annual sales of \$3.8 million and pretax income of \$366,000, a 9.6% average return on sales.
- The balance sheet is strong. As of March 31, 2007:

Assets	<u>\$3,085,000</u>	
Total Debt	1,584,000	51%
Stockholder's Equity	<u>1,501,000</u>	<u>49</u>
Debt and Equity	<u>\$3,085,000</u>	<u>100%</u>

The debt-to-equity ratio is 1.1 to 1.0, leaving substantial opportunity for growth financings.

- The Company has 289 customers, none of which account for more than 8% of sales. About 90% of the customers have been customers for the last three years. The top 10 customers account for 35% of sales.
- The Company has 70 employees and leases its facilities in Allstate, New York, consisting of 17,500 square feet. The facilities can support an increase to about 100 employees and sales of approximately \$8 million.
- The adjusted net book value (stockholder's equity) of the Company is \$2,658,000,

compared to the accountant's reported position of \$1,501,000 as of March 31, 2007. (The adjustments are explained on pages 27 and 28.)

Financing Request

The Company represents an excellent financing opportunity for the following reasons:

1. The in-place management team is capable of managing a much larger company.
2. Growth projections are supported by a substantial backlog of firm orders.
3. Many of the products are proprietary, state-of-the-art with patents, UL approval, and approved vendor status.
4. The groundwork has been completed to achieve substantial sales and profits for 2007 and subsequent years.
5. The balance sheet is strong, easily allowing for debt repayment, interest, and future growth.

* * *

The Company is proposing a \$1,200,000, Eight-Year Term Loan. The proceeds will be used for the following:

- \$450,000 to repay an existing bank loan.
- \$200,000 to bring trade debt current.
- \$80,000 for equipment purchases.
- \$470,000 for working capital to support higher sales, accounts receivable, and inventory levels.

The \$1,200,000 loan would be repaid over eight years with quarterly principal repayments of \$37,500 (\$150,000 a year). Interest would be paid monthly.

II. About the Company

- Introduction
- Income Statement Results
- Backlog
- Income Projections
- Balance Sheet Position
- Management
- Employees and Benefits
- Facilities and Lease Agreement
- Equipment
- Customers
- Competition and Industry
- Financial and Other Factors
- Lawsuits and Compliance
- Ownership and Common Stock

Introduction

The Company manufactures and distributes a broad line of high-quality industrial transformers and related products. For the year ended December 31, 2006, the Company showed sales of \$4.7 million, pretax income of \$492,000, and net income of \$172,000.

Distribution: Product application and end users are: industrial (62%), distributors (33%), export (4%), and government (1%). The line of products consists of both catalog items (60%) and modified catalog and custom-made electronic transformers (40%). The SIC No. for the Company's line of products is #2179.

Formation: On January 16, 1986, the Company was incorporated in New York State. On December 29, 1999, the Company and its stockholders elected to be taxed as an S Corporation under Section 1362 of the Internal Revenue Code. The S Corporate election started with the 2000 tax year.

Ownership: The Company is owned by Jim Hargrave, who owns 100% of the 125,000 shares of Common Stock outstanding. There are 1,000,000 shares authorized. There are no outstanding warrants, convertible securities, or other options to buy stock, except for a Stock Option Plan for key executives, explained on page 16.

Accounting: The Company reports on a calendar-year basis. Inventory is valued at the lower of cost or market determined by the first-in, first-out method. The Company's financial statements are audited by the accounting firm, Muller, Johnson, and Weiss, 1850 Broadway Avenue, Allstate, NY 11806; the telephone number is 989-681-2179.

Executive Offices: The Company's executive offices and manufacturing facilities are located at 1800 Broadway Avenue, Allstate, NY 11800. The telephone number is 989-681-2000 (fax: 989-681-2001). The website is www.hargravecorp.org.

Income Statement Results

The Company showed the following sales, pretax income, and net income:

(Thousands)

	— Year Ended December 31 —			
	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Sales	<u>\$3,250</u>	<u>\$3,850</u>	<u>\$4,360</u>	<u>\$4,740</u>
Pretax Income	\$ 323	\$ 477	\$ 277	\$ 492
Less: Taxes	<u>113</u>	<u>167</u>	<u>97</u>	<u>172</u>
Net Income	<u>\$ 210</u>	<u>\$ 310</u>	<u>\$ 180</u>	<u>\$ 320</u>
Return on Sales	6.5%	8.1%	4.1%	6.8%

An analysis of the 2005 profit decline is explained later on page 24.

Interim results: For the quarter ended March 31, 2006 and 2007, the Company reported the following results:

	<u>2006</u>	<u>2007</u>	<u>Annualized</u>
Sales	\$1,180,000	\$1,360,000	\$5,440,000
Net Income	\$ 88,000	\$ 104,000	\$ 416,000
Return on Sales	7.5%	7.6%	7.6%

Backlog

As of March 31, 2006 and 2007, the Company had the following backlog:

	<u>2006</u>	<u>2007</u>	<u>Increase</u>
Backlog	\$1,100,000	\$1,400,000	27%

Income Projections

For the three years to end December 31, 2009, the Company is projecting the following:

(Thousands)

	<u>2007</u>	<u>2008</u>	<u>2009</u>
Sales	\$5,400	\$6,200	\$7,100
Net Income	\$ 377	\$ 429	\$ 505

Balance Sheet Position

Here's a condensed balance sheet position as of March 31, 2007:

(Thousands)

Current Assets	\$1,990	Current Liabilities	\$1,502
Net Fixed Assets	943	Capitalized Leases	82
Other Assets	<u>152</u>	Stockholder's Equity	<u>1,501</u>
Total Assets	<u>\$3,085</u>	Total Debt and Equity	<u>\$3,085</u>

Comments: Current liabilities include a \$450,000 bank loan. A detailed balance sheet is presented on page 26.

Management

The officers and Board of Directors are as follows:

<u>Name</u>	<u>Age</u>	<u>Salary</u>	<u>Position</u>
James Hargrave *	58	\$160,000	President, Chairman of the Board
David Johnson *	52	\$120,000	Chief Operating Officer
Gail Hargrave *	56	\$ 48,000	Vice President, Secretary
John Michael *	48	\$ 80,000	Vice President, Marketing
Robert Tower	41	\$ 80,000	Treasurer, Assistant Secretary
James Smiley	58	\$ 80,000	Vice President, Production
Robert Collins *	60	\$ 0	Local Businessman

* The directors of the Company have been noted with an asterisk.

Gail Hargrave is the wife of James Hargrave. Robert Collins, a successful local real estate builder and investor, has been on the board for seven years. He is paid \$6,000 annually to attend board meetings.

Other particulars:

- Overall compensation and benefits are reasonable.
- There are no management agreements or employment contracts with anyone except David Johnson, COO. His employment contract is for the five years to end December 31, 2012, and it stipulates that his annual salary will increase 4% a year.
- Through the year 2010, Messrs. Johnson, Michael, Tower, and Smiley have the right to purchase a total of 20,000 shares (5,000 each) of Common Stock at \$15 per share, which is 125% of the Company's current book value per share of \$12 (\$1,501,000 stockholder's equity divided by 125,000 shares outstanding) as of December 31, 2006. Upon exercise of the options, the four executives will own 13.8% of the Company's Common Stock (20,000 shares divided by 145,000 shares).
- All executives and select employees have signed noncompete and confidentiality agreements.
- Bonuses are paid at the discretion of the Board of Directors. The annual amount is usually no more than 10% of profits.
- The Company does not have a deferred compensation or wage continuation plan in effect. There is a disability plan covering all employees.
- There is no buy-sell or any other agreement to purchase Mr. Hargrave's stock. However, in the Stock Option Plan above, Mr. Hargrave can elect to sell 20,000 shares of his stock rather than have the Company issue new shares.

Employees and Benefits

The Company has 70 employees, of whom 45 are represented by the Consolidated Union Local #1, an independent union. *Other particulars:*

- There have been no work stoppages during the last three years.
- The Company provides group health, dental, and life insurance for its full-time, non-union employees. For its union employees, the Company

contributes to a Union Financial Trust, which provides benefits similar to those provided to its non-union employees.

- Eligible non-union employees can participate in the Company's profit-sharing and 401(k) plans. The Company is fully funded in its pension plans.

Facilities and Lease Agreement

The Company leases its facilities located at 1800 Broadway Avenue, Allstate, New York. The building is in good condition, properly maintained, and has more than adequate parking space. The total square footage, including mezzanines, is approximately 17,500. Manufacturing space represents 12,000 square feet (69% of the total area).

The building is leased from Hargrave Real Estate Co., which is a partnership owned by James Hargrave and his wife, Gail. The annual rental is \$80,000 a year (\$4.57 per-square foot). The company pays maintenance, utilities, insurance and taxes, totaling about \$25,000 a year.

The lease expires in the year 2013 with a renewal option for an additional five or 10 years, the Company's option. The annual rental increase is tied to the Consumer Price Index but, in no event, can it increase more than 3% a year. *Other particulars:*

- The rental amount is comparable to rental rates in the area the Company is located.
- The building complies with all federal, state, and local laws, including zoning requirements.
- There is no option to buy the facilities, but the Company can assign the lease or sublet space to another company.
- Management believes sales could increase to about \$8 million before additional facilities would be needed. This would represent a growth of about 70%, based on 2006 sales of \$4.7 million. (In addition, there is space available to expand the building another 7,500 square feet.)

With respect to the facilities, there have never been any state or local violations or any serious accidents. In 1995, the Company had a minor OSHA violation, which was corrected immediately. There was no penalty assessed by OSHA.

Equipment

The Company owns most of its production equipment for winding, finishing, laminating, wiring, encapsulating, sealing, and painting. The Company also has machine and sheet metal equipment, as well as quality control, inspection, design, laboratory, and drafting equipment.

In management's opinion, the equipment capacity is about 160% of current sales of \$4.7 million. Thus, sales could increase to about \$7.5 million with only minor increases in equipment purchases.

Customers

The Company's major customers include: Able Technologies Inc., Buycom Inc., Gale Electronics, National Electric, Babson Manufacturing, Tone Industries, Electric Corp., Marcus Corp., Core Corporation, and Barclay Manufacturing. Please note the following:

- These 10 customers represent 35% of the Company's sales.
- No one customer among the Company's entire customer list represents more than 8% of sales.
- About 90% of the Company's customers have been customers for the last three years.

Competition and Industry

The Company is in an industry which is fragmented and which represents approximately \$1.3 billion in annual sales. According to management, the annual growth rate of the base industry is 3% to 5%. Major competitors include Hopkins Electronics, Baskin Controls, Victor Computer, and Marshall Technology.

Financial and Other Factors

- The Company's tax returns generally conform to its financial statements, including the K-1 Form distributed to the Company's owner.
- Sources of supply are adequate.
- The Company has never been in default on any loan agreements.
- Agings of inventories and accounts receivable are current.

- Accounts payable will be current on completion of this financing.
- Bad debt is nominal, less than 0.50% of sales.
- Adequate property, casualty, and liability insurance is maintained on the Company's facilities and its operations.
- The Company is current on its payroll, sales, and property taxes.
- Except for the lease and rental agreements, there are no material contingent liabilities which were not disclosed in the financial statements for the year ended Dec. 31, 2006.
- Corporate minutes are current.
- The Dun and Bradstreet report on the Company does not contain any adverse information not reflected in this Report or the financial statements.
- The last examination by the IRS of the Company's tax returns was in 2000 for the tax years 1995 through 1998. The examination resulted in additional taxes of \$6,500.

Lawsuits and Compliance

The Company has never had a major lawsuit and, in management's opinion, it is in compliance with all federal and state laws regarding taxes, employment, discrimination, health and safety standards, EPA, OSHA, etc.

Ownership and Common Stock

The Common Stock was authorized and issued under the laws of the State of New York. All shares of the Common Stock are fully paid for and are non-assessable. The 125,000 total shares currently outstanding are owned by James Hargrave, President of the Company.

The Certificate of Incorporation was amended on January 8, 1997 to allow for voting by simple majority for both the Company's stockholders and Board of Directors. The number of directors was set at five. As previously indicated, the Company elected S Corporate status on December 29, 1999 for the tax year beginning January 1, 2000.

Other Particulars on Ownership:

- There are no outstanding stock options, warrants, convertible securities, or other options to purchase the Company's Common Stock, except the Stock Option Plan explained on page 16.
- There are no shares of Preferred Stock authorized or outstanding.
- There are no cumulative voting rights.
- There are preemptive rights.

Voting: The common stockholders are entitled to receive dividends if and when declared by the Board of Directors. The payment of dividends on the Common Stock is not required by the Company's Articles of Incorporation, Bylaws, or any other agreement. Except as expressly required by law, all rights to vote and all voting power are vested exclusively with the holders of the Common Stock. Each share of Common Stock is entitled to one vote.

Dividends: Since the Company is an S Corporation, it does not pay dividends.

III. Review of Financial Data

- A. Business Form Adjustments and Tax Rates**
- B. Historical Income Statements**
- C. Interim Results**
- D. Projected Income Statements**
- E. Balance Sheet Position**

A. Business Form Adjustments and Tax Rates

In S corporations, the Company's profits are passed through to their owners in relation to their percentage ownership of the business. For example, if you own 80% of an S corporation which reports \$80,000 taxable income (after owner salaries), you must report \$64,000 of additional income on Form K-1 in your tax return. That *personal* taxation of business profits also applies to partnerships, limited liability companies, and sole proprietorships.

In contrast, a C corporation pays taxes on its profits directly to the IRS since its taxable income is *not* passed through to its owners. When profits *are* passed through to the C corporate owners in the form of dividends, they are considered personal taxable income and are taxed at rates up to 35% for 2007.

For your use, here are select corporate and personal tax rates for 2007.

C Corporate Tax Rates

<u>Taxable Income</u>	<u>Tax Rate</u>	<u>Taxes Payable</u>	<u>Cumulative Taxes Payable</u>	<u>Overall Tax Rate</u>
First \$50,000	15%	\$ 7,500	\$ 7,500	15.00%
Next \$25,000	25%	6,250	\$13,750	18.33%
Next \$25,000	34%	<u>8,500</u>	\$22,250	22.25%
Taxes Paid on \$100,000		<u><u>\$22,250</u></u>		

On corporate taxable income between \$100,000 and \$335,000, the corporate tax rate is 39% and then it drops to 34% on income up to \$10 million.

Personal Tax Rates — Married, Filing Jointly

<u>Taxable Income</u>	<u>Marginal Tax Rate</u>	<u>Taxes Payable</u>	<u>Cumulative Taxes Payable</u>	<u>Overall Tax Rate</u>
First \$15,650	10%	\$ 1,565	\$ 1,565	10.0%
Next \$48,050	15%	\$ 7,208	\$ 8,773	13.8%
Next \$64,800	25%	\$16,200	\$24,973	19.4%
Next \$67,350	28%	\$18,858	\$43,831	22.4%
Next \$153,850	33%	\$50,770	\$94,601	27.1%

On taxable income above \$349,700, the personal tax rate is 35%.

B. Historical Income Statements

Shown below are the Company's audited results for the five years ended December 31, 2006. Pretax income, taxes, and net income were adjusted to a regular C corporation using an *overall* 35% federal and state tax rate.

(Thousands)

<u>Year</u>	<u>Sales</u>	<u>Depreciation</u>	<u>Pretax Income</u>	<u>Less Taxes</u>	<u>Net Income</u>
2006	\$ 4,740	\$ 128	\$ 492	\$172	\$ 320
2005	4,360	115	277	97	180
2004	3,850	85	477	167	310
2003	3,250	95	323	113	210
2002	<u>2,820</u>	<u>61</u>	<u>262</u>	<u>92</u>	<u>170</u>
	<u>\$19,020</u>	<u>\$484</u>	<u>\$1,831</u>	<u>\$641</u>	<u>\$1,190</u>

Averages: Last Five Years

<u>\$3,804</u>	<u>\$97</u>	<u>\$366</u>	<u>\$128</u>	<u>\$238</u>
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Comments on Results

1. The average pretax return on sales was 9.6% and on net income 6.3%.
2. The compounded annual growth rate for the years 2002 through 2006 was as follows: 14% for sales, 17% for pretax income, and 17% for net income.
3. Annual depreciation includes about \$20,000 amortization expense, principally capitalized computer and research expenses.

4. The Company expenses all research and development costs of approximately \$80,000 a year.

5. The Company's pretax profits declined from \$477,000 in 2004 to \$277,000 in 2005. As a percent of sales, pretax profits dropped from 12.4% in 2004 to 6.4% in 2005, a difference of 6.0 percentage points. The decline is due to the introduction of a new product line and the following *added* expenses for 2005.

<u>Expense Category</u>	<u>Amount</u>
Engineering Expense	\$132,000
Manufacturing	84,000
Sales and Marketing	31,000
Other Expenses	<u>28,000</u>
Total Increased Expenses	<u>\$275,000</u>

Without that \$275,000 increase in expenses, the Company's reported pretax income of \$277,000 would have been \$552,000 or 12.7% of 2005 sales of \$4,360,000.

C. Interim Results

For the quarter ended March 31, 2006 and 2007, the Company reported the following unaudited results:

	<u>Mar. 31, 2006</u>	<u>Mar. 31, 2007</u>	<u>Increase</u>
Sales	<u>\$1,180,000</u>	<u>\$1,360,000</u>	+15.3%
Pretax Income	\$ 131,000	\$ 155,000	
<i>Less:</i> Taxes	<u>43,000</u>	<u>51,000</u>	
Net Income	<u>\$ 88,000</u>	<u>\$ 104,000</u>	+18.2%

D. Projected Income Statements

The Company is projecting the following sales and profits for the next three years:

(Thousands)

	<u>Income Projections</u>		
	<u>2007</u>	<u>2008</u>	<u>2009</u>
Sales	<u>\$5,400</u>	<u>\$6,200</u>	<u>\$7,100</u>
Pretax Income	\$ 580	\$ 660	\$ 776
<i>Less: Taxes (35%)</i>	<u>203</u>	<u>231</u>	<u>271</u>
Net Income	<u>\$ 377</u>	<u>\$ 429</u>	<u>\$ 505</u>

Comments on Projections

1. The Company's results for the first quarter of 2007 (see prior page) support its 2007 sales and profit projections. Here are the *annualized* results, computed simply by multiplying the first quarter's reported results by four:

	<u>Mar. 31, 2007</u>	<u>Annualized</u>
Sales	\$1,360,000	\$5,440,000
Net Income	\$ 104,000	\$ 416,000

Compare these annualized results with the above 2007 projected sales of \$5,400,000 and net income of \$377,000.

2. The Company's current backlog also supports the 2007 projections. As of March 31, 2007, the backlog was \$1.4 million versus \$1.1 million last year, an increase of 27%.

3. For the next five years, depreciation and amortization expenses are projected at \$140,000 a year, of which \$80,000 can be used for debt repayment and

\$60,000 for capital expenditures and leasehold improvements.

E. Balance Sheet Position

Shown below is a condensed balance sheet of the Company as of March 31, 2007.

(Thousands)

Cash and Securities	\$ 122	Accounts Payable	\$ 818
Accounts Receivable	885	Accrued Expenses/Taxes	184
Inventory	948	Stockholder Loan	50
Prepaid Expenses	<u>35</u>	Bank Loan	<u>450</u>
Current Assets	\$1,990	Current Liabilities	\$1,502
Net Fixed Assets	943	Capitalized Leases	<u>82</u>
Capitalized Expenses	88	Total Liabilities	\$1,584
Other Assets	<u>64</u>	Stockholder's Equity	<u>1,501</u>
Total Assets	<u>\$3,085</u>	Total Liabilities and Stockholder's Equity	<u>\$3,085</u>

Comments on Balance Sheet Position

1. *Bank Loan of \$450,000:* Represents a Demand Note on a \$600,000 line of credit; interest is payable at the prime rate plus one point. Mr. Hargrave, including his spouse, personally guaranteed the loan. The lender is All-America Bank Corp., Aspen, New York.

2. *Inventory of \$948,000:* The inventory is valued at the lower of cost or market, with cost being determined by the first-in, first-out method.

3. *Capitalized Expenses of \$88,000:* Represents select computer and other development expenses which were capitalized as an asset to be written off over five to seven years.

4. *Other Assets of \$64,000:* Principally represents the cash value (\$52,000) of a \$600,000 split-dollar insurance policy on the life of Mr. Hargrave.

5. *Stockholder Loan of \$50,000:* Payable to Mr. Hargrave. Repayment in full is due December 31, 2007 with interest at 7%.

6. *Net Fixed Assets of \$943,000:* The breakdown, including its fair market value (FMV), is as follows (in thousands):

	<u>Reported Value</u>	<u>Fair Market Value (FMV)</u>
Machinery and Equipment	\$1,210	\$1,600
Autos, Trucks, and Vans	246	300
Leasehold Improvements	82	0
Office and Computers	<u>56</u>	<u>200</u>
Total Gross Assets	\$1,594	<u>\$2,100</u>
<i>Less:</i> Accumulated Depreciation	<u>651</u>	
Net Book Value	<u>\$ 943</u>	
		<u>\$1,157</u>

The fair market value of \$2,100,000 — \$1,157,000 above the Company's *reported* net book value of \$943,000 — is management's best estimate of the current value of these assets. Although it's an estimate, the value does approximate the specific values indicated in an Appraisal Report prepared in 2005.

No allowance was made for leasehold improvements of \$82,000 since these expenses are technically the property of the landlord.

Adjustment to FMV: Based on the data above, here is the Company's adjusted equity account:

Adjusted Stockholder's Equity:

Reported as of March 31, 2007	\$1,501,000
Plus: Adjustments to FMV	<u>1,157,000</u>
Adjusted Stockholder's Equity	<u>\$2,658,000</u>

Observation — It is important to show that \$2,658,000 amount to any perspective lender, particularly asset-based lenders who are interested in the percentage by which a company's assets cover the loaned amount. For example, on a \$1.2 million loan, stockholders' equity of \$1.5 million covers the loan by 1.25 (125%). Using the *adjusted* equity value of \$2,658,000, the coverage increases to 2.22 (222%).

Select Ratios and Positions

Based on the balance sheet on page 26, here are select ratios and positions as of March 31, 2007. The pro forma column is the after-financing balance sheet, as detailed on page 32. (Select ratios are defined on page 40.)

	<u>Actual</u>	<u>Pro Forma</u>
Cash and Securities % Current Liabilities	8%	59%
Net Working Capital	\$ 488,000	\$1,458,000
Net Quick Assets (actual is negative)	\$-495,000	\$ 475,000
Current Ratio	1.3 to 1.0	2.5 to 1.0
Net Quick Ratio	0.7 to 1.0	1.5 to 1.0
Long-Term Debt % Stockholders' Equity	5%	75%
Total Debt % Stockholder's Equity	106%	142%

Observations

1. Net working capital is current assets (cash, receivables, inventory, and prepaid expenses) less current liabilities, i.e., those assets and liabilities which are expected to generate cash or be paid *within* one year.

2. A current ratio (current assets divided by current liabilities) of 2.0 to 1.0 is considered excellent for most businesses.

3. A net quick ratio (cash, securities, and receivables divided by current liabilities) of 1.0 to 1.0 is also considered excellent. That's because these "quick assets" alone cover *all* liabilities due within one year. Inventory and prepaid expenses are not included in the net quick ratio. That means the company doesn't have to rely on the turnover and sale of inventory to pay its current liabilities, i.e., debt due within one year.

IV. About the Financing

- A. Use of Proceeds**
- B. After-Financing Balance Sheet**
- C. Debt Service Coverage**
- D. Closing**

A. Use of Proceeds

The \$1,200,000 loan will be used for the following purposes:

Use of Proceeds

Repayment of Bank Debt	\$ 450,000
Payment of Trade Debt	200,000
Capital Expenditures	80,000
Cash for Working Capital	<u>470,000</u>
Total Amount	<u><u>\$1,200,000</u></u>

Comments —

1. The loan will pay off the existing bank loan of \$450,000, which will result in new capital of \$750,000.

2. The \$200,000 for trade debt payments represents those suppliers and amounts which are 45 days or more past due, as listed on the Company's account payable aging.

3. The capital expenditures of \$80,000 are detailed in the enclosed listing of equipment to purchase.

4. The \$470,000 additional working capital is to finance higher projected sales, inventory, and accounts receivable levels.

For a pro forma (after financing) balance sheet position reflecting the use of proceeds, please see the next page.

B. After-Financing Balance Sheet

(Thousands)

	Actual <u>Mar. 31, 2007</u>	Use of <u>Proceeds</u>	Pro <u>Forma</u>
Cash and Securities	\$ 122	+ 470	\$ 592
Accounts Receivable	885		885
Inventory	948		948
Prepaid Expenses	<u>35</u>		<u>35</u>
Current Assets	\$1,990		\$2,460
Net Fixed Assets	943	+ 80	1,023
Capitalized Expenses	88		88
Other Assets	<u>64</u>		<u>64</u>
Total Assets	<u>\$3,085</u>	<u>+ 550</u>	<u>\$3,635</u>
Accounts Payable	\$ 818	- 200	\$ 618
Accrued Expenses/Taxes	184		184
Stockholder Loan	50		50
Bank Loan	450	- 450	0
Current Portion (L-T Debt)	<u>0</u>	+ 150	<u>150</u>
Current Liabilities	\$1,502		\$1,002
Eight-Year Bank Loan	0	+1,050	1,050
Capitalized Leases	<u>82</u>		<u>82</u>
Total Liabilities	\$1,584		\$2,134
Stockholder's Equity	<u>1,501</u>		<u>1,501</u>
Total Debt and Equity	<u>\$3,085</u>	<u>+ 550</u>	<u>\$3,635</u>

The after-financing balance sheet is very strong. Consider the following positions and ratios:

- *Net Working Capital* — increased from \$488,000 to \$1,458,000, an increase of \$970,000.
- *Current Ratio* — increased from 1.3 to 2.5.

- *Net Quick Assets* — was a negative \$495,000; it increased to a positive \$475,000, a difference of \$970,000.
- *Net Quick Ratio* — increased from 0.3 to 1.5.

The debt-to-equity ratios are within acceptable lending ratios. Long-term debt is 75% of stockholder's equity and total debt is 142%.

Observations

As a general rule, most banks will lend dollar-for-dollar (many times \$2.00 to \$1.00) on a company's equity account. In the case of *Hargrave Technology Corp.*, the proposed total bank loan of \$1,200,000, including the \$150,000 repayable in one year, represents only 0.80 to 1.00 (80%) of the equity account of \$1,501,000.

If that debt-to-equity relationship was seriously out of proportion, e.g., a 4.0 to 1.0 ratio, a lender usually requires collateral, such as a security interest in the company's accounts receivable, inventory, or equipment. In some cases, a blanket lien covering *all* of a company's assets is required.

In contrast, *unsecured*, long-term loans from life insurance companies generally require the following ratios and coverage:

- Long-term debt to 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) divided by the after-financing interest cost — no less than 3.0 to 4.0.

That's more evidence why borrowers should pursue several sources of capital. You may not meet one lender's credit criteria but look fine to another lender.

Debt Service Coverage — please see next page

C. Debt Service Coverage

Interest Coverage: Based on a bank loan of \$1,200,000 at an 8% interest rate (\$96,000 annual interest), here are the loan's coverage ratios for the last three years (in thousands):

	<u>2004</u>	<u>2005</u>	<u>2006</u>
Pretax Income (see page 23)	\$477	\$277	\$492
<i>Add Back:</i> Interest Paid	<u>32</u>	<u>27</u>	<u>25</u>
Pretax Income before Interest	<u>\$509</u>	<u>\$304</u>	<u>\$517</u>
\$96,000 Interest Coverage	5.3	3.2	5.4

Average Annual Interest Coverage is 4.6

Principal and Interest Coverage (P + I): Based on a principal repayment of \$150,000 a year over 8 years, the Company shows the ability to make both the loan repayment and \$96,000 interest, a total of \$246,000.

Average Pretax Income before Interest	\$443,333
Maximum Fixed Charges — P + I	\$246,000
Coverage of Principal and Interest	1.8

Observation

The above average interest coverage of 4.6 does not include \$140,000 additional cash flow from depreciation since management believes that \$60,000 of this cash flow will be needed for future capital expenditures. As previously indicated on the bottom of page 25, \$80,000 of the \$140,000 depreciation can be used for debt repayment. Thus, the coverage ratios, as computed above, are conservative.

D. Closing

Hargrave Technology Corp. is a solid company with good and consistent growth over the years.

- Management is in place to substantially increase sales and profits.
- For the last five years, the *average* sales and profits were \$3.8 million and \$366,000, respectively.
- The Company is on target to meet its 2007 projections of \$5.4 million in sales and \$580,000 in pretax profits.
- The backlog of orders has increased 27%.
- The number of employees and existing facilities are adequate to reach \$8 million in sales — 69% above 2006 sales of \$4,740,000.
- The balance sheet is very strong, easily allowing for debt repayment, interest payments, and future growth.

If you have any questions on this Financing Proposal and the enclosures, or need additional information on the Company, please contact Robert Tower, Treasurer, or James K. Hargrave, at 989-681-2000. □

Addenda Information — please see next page.

Addenda Information

Addendum A — *Loan Agreements: Negotiating Strategies*

Addendum B — Sample Spread Sheets

Addendum C — How to Analyze and Value Your Business

Loan Agreements: Negotiating Strategies

Once you've identified a willing lender, it's time to review and negotiate the offer and terms. Initially, you want to focus on the four items of greatest importance: amount to be borrowed, cost of the money, collateral, and repayment terms. You then want to focus on the loan agreement.

Your negotiating strength in dealing with a specific lender will principally depend on your current balance sheet, historical and projected income statements, collateral, and the alternatives you have to finance the business. But do recognize that each capital source has its own terms and conditions. Although the loan agreements used by banks and insurance companies are usually standard from borrower to borrower, there are negotiating tips and cautions you will be able to use to your benefit — no matter which capital source you select.

Here are two sections in a loan agreement on which you should focus your attention and negotiate carefully.

Negative covenants in a loan agreement are restrictions on the business, e.g., you must maintain a minimum net working capital position *or* total debt can't exceed two times the company's net worth. *Affirmative covenants* specify what information you must provide the lender, e.g., financial statements, and other requirements you must meet, such as adequate fire insurance, prompt payment of taxes, etc. Your non-compliance with *any* covenant can result in a default, which means the loan can be called by the lender with the full amount due.

Here is a list of terms you should try to avoid or at least negotiate aggressively.

- 1. *Restriction on payments to owners:*** If there is a restriction on paying dividends or acquiring company stock (called treasury stock) or a limitation on owner/officer salaries, many lenders will permit the company to effect any of the above to the extent of a certain percentage of aftertax (or pretax) profits. A formula of 25% of profits should give you plenty of latitude.

- 2. *Prepayment of the loan:*** If the negative covenants restrict management

prerogatives in critical areas — e.g., by limiting your ability to raise additional debt or preventing you from selling or merging your business — get the right to pay off your loan at par (without penalty) if the lender does not consent to your request.

3. *Pledge of stock:* Stay away from pledging the stock you own in your company as collateral. On default, this gives the lender/investor effective control of the company since it will have the right to elect a new board of directors and new management. However, expect *personally* to guarantee institutional borrowings (e.g., bank debt) if the company is reliant on your continuance in the business.

4. *Additional debt:* If there are limitations on the incurrence of additional debt, this also can be made a function of future increases in the company's net worth or stockholder's equity. For example, for every dollar increase in net worth, you can borrow another 50 cents. In addition, when setting the amount of allowable or additional short- and long-term debt, build in a cushion of at least 25% more than what you think your capital needs are.

5. *Capital expenditures:* If there is a limit on annual capital expenditures, make the amount cumulative, just in case you don't use the maximum each year. *Example:* If you are limited to \$20,000 a year and use only \$4,000 in year one, you can carry forward \$16,000 to year two (a total of \$36,000 to be used in year two).

6. *Clean-downs of short-term debt:* Most lenders will consent to a few "exception periods." For example, some lenders, particularly insurance companies who lend long term, want you to clean up (retire) bank debt for 30 to 60 consecutive days each year. If a problem arises, ask them to allow you to *pay down* the debt to a certain level (called a clean-down).

7. *Ratio tests:* With respect to liquidity ratios, try to stay with a basic net working capital level, usually 80% to 85% of the after-financing amount.

Try to avoid a net quick test or ratio. Many liquidity problems surround inventory and, since inventory is *excluded* from a company's current assets when computing the net quick test or ratio, the company may go into technical default.

8. *Tough negative covenant:* Be careful of a debt-to-net worth test. An operating loss has a *double effect* on a company's balance sheet: Net worth decreases and the loss must be financed, usually with increased debt and/or extended trade payables. That results in a high debt-to-net worth ratio and a possible default.

9. Define what "substantial" means: For example, if the sale of a "substantial" part of the company's assets is prohibited, spell out in the loan agreement what substantial means — 10% usually is acceptable to most lenders.

10. Management continuance: If a management clause is required on certain key individuals, restrict it to the company's major stockholders/employees. You don't want a loan callable simply because your controller or a minority owner leaves your employ.

11. Sale or transfer of stock: If the terms of the loan prohibit you from selling or transferring your personal stock in the business, make an exception for family gifts. You don't want to restrict your estate-planning options.

12. Cash at closing: In closing any financing, try to walk away from the table with cash for your company, particularly refinancings and in equity-type financings where you are giving away a piece of the business.

* * *

The most important stage of any negotiation is *before* you begin active negotiations. Know in advance what is going to be required and you will enhance your chances of successfully negotiating the loan agreement or a specific covenant.

Most lenders will give you the necessary latitude to live within their restrictions *plus* a reasonable cushion. Your ability to document your objections to any restrictions will go a long way toward structuring the right loan agreement.

Remember, arranging financings costs time and money. Money raised *only* to pay off creditors is not considered an efficient use of capital. When new money is coming into the business, use that opportunity to restructure or refinance other company debt. □

Addendum B — Sample Spread Sheets — see next page

Spread Sheets for Financial Statement Analysis

Historical Income Statement Data							Historical Balance Sheet Data			
(Dollars in thousands)	2004		2005		2006		(Dollars in thousands)	2004	2005	2006
	\$	%	\$	%	\$	%				
Net sales	—	—	—	—	—	—	Cash and marketable securities	—	—	—
Cost of goods sold	—	—	—	—	—	—	Accounts receivable	—	—	—
General, selling and administrative expense ...	—	—	—	—	—	—	Inventories	—	—	—
Operating income	—	—	—	—	—	—	Prepaid expenses	—	—	—
Other income (expense)	—	—	—	—	—	—	Current assets	—	—	—
Pretax income	—	—	—	—	—	—	Gross plant and property	—	—	—
Taxes payable	—	—	—	—	—	—	<i>Less:</i> Depreciation	—	—	—
Net income	—	—	—	—	—	—	Net plant and property	—	—	—
Return Analysis							Investments, loans, and advances	—	—	—
Net income % sales	—	—	—	—	—	—	Other assets	—	—	—
Net income % net worth	—	—	—	—	—	—	Total assets	—	—	—
Net income % assets	—	—	—	—	—	—	Notes payable	—	—	—
Gross profit margin	—	—	—	—	—	—	Accounts payable/Accruals	—	—	—
Operating profit margin	—	—	—	—	—	—	Current portion of long-term debt	—	—	—
Turnover Ratios (in days)							Current liabilities	—	—	—
Average collection period ...	—	—	—	—	—	—	Long-term debt	—	—	—
Inventory turnover	—	—	—	—	—	—	Preferred stock	—	—	—
Accounts payable turnover ..	—	—	—	—	—	—	Common stock	—	—	—
							Capital surplus	—	—	—
							Retained earnings	—	—	—
							<i>Less:</i> Treasury stock	—	—	—
							Stockholders' equity	—	—	—
							Total liabilities and equity	—	—	—
							Liquidity Ratios			
							Net working capital	—	—	—
							Current ratio	—	—	—
							Net quick assets	—	—	—
							Net quick ratio	—	—	—
							Cash ratio	—	—	—
							Leverage Ratios			
							Long-term debt as a % of			
							stockholders' equity	—	—	—
							Total debt as a % of stockholders' equity ..	—	—	—

Important Definitions

#1. *Net working capital* is current assets *less* current liabilities. *Current ratio* is current assets *divided* by current liabilities.

#2. *Net quick assets* are cash items and accounts receivable *less* current liabilities. *Net quick ratio* is cash items and accounts receivable *divided* by current liabilities.

#3. *Average collection period* is accounts receivable *divided* by daily credit sales.

#4. *Inventory turnover* is average inventory (beginning and end-of-year position) *divided* into cost of sales (or into sales).

#5. *Accounts payable aging* (days) is accounts payable *divided* by daily purchases of goods and supplies.

Case Study: SDI, Inc.
How to Analyze and Value Your Business

Author's Note

If you are unfamiliar with balance sheet, income statement, and cash flow analysis, this Addendum C will tell you everything you need to know to assess the health and value of your own business or one you want to acquire.

If your company is larger or smaller than the one in the case study, don't worry about it. The numbers can be adjusted easily; it's the formulas and analysis that are important.

Know Your Company's Current Position and Where It Is Headed

There are many times and many reasons you will need to compute various ratios and values for your company. The request may come from outside the company: from prospective lenders, potential buyers or investors, or even an executive candidate.

But the same calculations can be very useful and valuable internally. You and your advisers can use them to identify emerging trends, pinpoint problem areas, or alert you to recent changes that could be costly if not addressed quickly. *Examples:* a dramatic increase in accounts payable levels or a sudden slowing in inventory turnover.

We have designed this Addendum C as a catalog of both the formulas and calculations you will need to compute almost any ratio or value for just about any purpose. Work your way through the entire list and you will end up with a very revealing report card on your company's financial stability, position, trouble spots, trends, and potential.

The payoff is considerable: You get detailed, accurate insights into where your company is now and where it is headed.

Once the analysis is completed, it can be easily updated annually and compared to the results in prior years.

Financial Computations

Following are certain balance sheet and income statement data on *SDI, Inc.* for the years ended Dec. 31, 2005 and 2006 that should be used in computing the returns, values, turnovers, and other ratios in this case study.

SDI, Inc. **Comparative Balance Sheet Data**

(In Thousands)	<u>2005</u>	<u>2006</u>
Cash	\$ 75	\$ 100
Accounts receivable	150	200
Inventory	200	250
Prepaid expenses	<u>55</u>	<u>50</u>
Current assets	\$480	\$ 600
Gross: Plant and equipment	320	500
Accumulated depreciation	<u>-100</u>	<u>-200</u>
Net plant and equipment	220	300
Other assets (tangible)	<u>100</u>	<u>100</u>
Total assets	<u>\$800</u>	<u>\$1,000</u>
Short-term bank notes	\$320	\$ 100
Accounts payable	80	100
Accruals	50	50
Taxes payable	<u>50</u>	<u>50</u>
Current liabilities	\$500	\$ 300
8% Five-year note	<u>0</u>	<u>300</u>
Total debt	\$500	\$ 600
10% Convertible preferred stock	100	100
Common stock (\$1 par value)	100	100
Capital surplus	25	25
Retained earnings	<u>75</u>	<u>175</u>
Total liabilities and stockholders' equity	<u>\$800</u>	<u>\$1,000</u>

SDI, Inc.
Comparative Income Statement Data

(In Thousands)	<u>2005</u>	<u>2006</u>
Net sales	\$1,500	\$2,000
Cost of goods sold	<u>900</u>	<u>1,200</u>
Gross profit	\$ 600	\$ 800
General, selling and administrative expenses	<u>350</u>	<u>450</u>
Operating profit	\$ 250	\$ 350
<i>Less:</i> Interest expense	30	40
<i>Less:</i> Other items (net)	<u>10</u>	<u>10</u>
Pretax income	\$ 210	\$ 300
Income taxes	<u>100</u>	<u>140</u>
Net income	\$ 110	\$ 160
<i>Less:</i> Preferred stock dividend	<u>10</u>	<u>10</u>
Net income available to common stock	<u>\$ 100</u>	<u>\$ 150</u>

Other Facts —

1. 100,000 shares of common stock are outstanding — \$100,000 common stock account divided by the \$1 par value on the prior page.
2. Common stock cash dividends paid in 2006 were 50 cents per share, a total of \$50,000 (100,000 shares times 50 cents).
3. The preferred dividends are \$10,000 annually — 10% times \$100,000 preferred stock.
4. The preferred stock of \$100,000 is convertible into 10,000 shares of common stock. The par value of the preferred stock is \$100.
5. The common stock is valued at a price-earning's (p/e) multiple of 10.
6. Depreciation in 2005 and 2006 was \$75,000 and \$100,000.
7. When we refer to *common* stockholders' equity, we do not include preferred stock; *total* stockholders' equity does include it.

Ratios and Values to Compute

Remember, we are using the comparative financial data on the prior two pages to compute the following ratios and values:

1. Liquidity Ratios
 - a. Net working capital and current ratio
 - b. Net quick assets and net quick ratio
 - c. Cash ratio
 - d. Percentage composition of current assets
2. Leverage Ratios
 - a. Long-term debt percent of tangible net worth
 - b. Total debt percent of tangible net worth
 - c. Total capitalization — all long-term capital
3. Profitability Ratios
 - a. Return on sales
 - b. Return on capitalization
 - c. Return on assets
 - d. Return on common stockholders' equity
 - e. Gross profit margin
 - f. Operating profit margin
 - g. Earning power
4. Basic Values
 - a. Par value
 - b. Book value
 - c. Market value
5. Turnover (Activity) Ratios
 - a. Accounts payable
 - b. Accounts receivable
 - c. Inventory
 - d. Assets
 - e. Agings
6. Cost of Capital
 - a. Debt
 - b. Preferred stock
 - c. Common stock
 - d. Retained earnings
7. Common Stock Analysis
 - a. Earnings per share
 - b. Price-earning's multiple
 - c. Capitalization rate
 - d. EBIT
 - e. Yield
8. Dividends
 - a. Payout ratio
 - b. Yield
9. Dilution
 - a. Convertible securities
 - b. Warrants/stock options
10. Source and Application of Funds
11. Cash Flow Analysis

Definition: Stockholders' Equity = Net Worth = Net Book Value

Computation of Select Ratios

Using the balance sheet, income statement, and other data on pages 43 and 44, here are the computations for the year ended Dec. 31, 2006.

1. *Liquidity Ratios*

A. Net working capital = Current assets – Current liabilities

\$300,000 = \$600,000 – \$300,000

Current ratio = $\frac{\text{Current assets}}{\text{Current liabilities}}$

2.0 = $\frac{\$600,000}{\$300,000}$

B. Quick assets = Cash + Accounts receivable

Net quick assets = Quick assets – Current liabilities

\$-0- = \$300,000 – \$300,000

Net quick ratio = $\frac{\text{Quick assets}}{\text{Current liabilities}}$

1.0 = $\frac{\$300,000}{\$300,000}$

C. Cash ratio = Cash ÷ Current liabilities

0.333 = \$100,000 ÷ \$300,000

D. Percentage composition of current assets

	<u>Amount</u>	<u>%</u>
Cash	\$100,000	17
Accounts receivable	200,000	34
Inventory	250,000	41
Prepaid expenses	<u>50,000</u>	<u>8</u>
Current assets	<u>\$600,000</u>	<u>100</u>

2. Leverage Ratios

A. Long-term debt = \$300,000

Tangible net worth = Stockholders' equity less intangible assets

$$\frac{\text{Long-term debt}}{\text{Tangible net worth}} = \frac{\$300,000}{\$400,000} = 75\%$$

B. $\frac{\text{Total debt}}{\text{Tangible net worth}} = \frac{\$600,000}{\$400,000} = 150\%$ (1.5 to 1.0)

C. Capitalization (all long-term capital)

	<u>Amount</u>	<u>%</u>
8% Five-year note	\$300,000	43
10% Preferred stock	100,000	14
Common stockholders' equity	<u>300,000</u>	<u>43</u>
Capitalization	<u>\$700,000</u>	<u>100</u>

3. Profitability Ratios

A. Return on sales = $\frac{\text{Net income}}{\text{Sales}} = \frac{\$ 160,000}{\$2,000,000} = 8\%$

B. Return on capitalization = $\frac{\text{Net income}}{\text{Capitalization}} = \frac{\$160,000}{\$700,000} = 23\%$

C. Return on assets = $\frac{\text{Net income}}{\text{Assets}} = \frac{\$ 160,000}{\$1,000,000} = 16\%$

$$D. \text{ Return on equity} = \frac{\text{Net income} - \text{preferred dividend}}{\text{Common stockholders' equity}} = \frac{\$150,000}{\$300,000} = 50\%$$

$$E. \text{ Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales}}$$

$$\frac{\$800,000}{\$2,000,000} = 40\% \text{ Gross profit margin}$$

$$F. \text{ Operating profit margin} = \frac{\text{Operating profit}}{\text{Sales}}$$

$$\frac{\$350,000}{\$2,000,000} = 17.5\% \text{ Operating profit margin}$$

$$G. \text{ Earning power} = \text{Operating profit margin times asset turnover}$$

$$\text{Operating margin} = \frac{\text{Operating profit}}{\text{Sales}} = \frac{\$350,000}{\$2,000,000} = 17.5\%$$

$$\text{Asset turnover} = \frac{\text{Sales}}{\text{Average assets}} = \frac{\$2,000,000}{\$900,000} = 2.2 \text{ times}$$

$$17.5\% \times 2.2 = 38.5\% \text{ earning power on assets}$$

4. *Basic Values*

A. Par value = \$1 (see balance sheet on page 43). The par value is simply the stated value of common stock for accounting and legal purposes.

$$B. \text{ Book value} = \frac{\text{Common stockholders' equity}}{\text{Shares outstanding}}$$

$$= \frac{\$300,000}{100,000} = \$3 \text{ per share}$$

Note: Compute the shares outstanding by dividing \$1 par value per share into the common stock account of \$100,000 on page 43.

C. Market value = Earnings per share (EPS) times the price-earning's multiple (p/e)

Earnings per share = $\frac{\text{Net income less preferred stock dividend}}{\text{Shares outstanding}}$

Earnings per share = $\$160,000 - \$10,000 = \frac{\$150,000}{100,000} = \1.50 EPS

Market value = Earnings per share x price-earning's multiple

Market value = $\$1.50 \times 10 \text{ p/e}$

Market value = $\$15 \text{ per share}$

5. Turnover (Activity) Ratios

A. Accounts payable

Average payable period = $\frac{\text{Accounts payable} \times 365 \text{ days}}{\text{Annual purchases}}$

= $\frac{\$100,000 \times 365}{\$800,000}$

= 46 average payables (in days)

Note: Annual purchases of \$800,000 represents two-thirds of the company's cost of goods sold of \$1.2 million (see page 44).

B. Accounts receivable

Average collection period = $\frac{\text{Accounts receivable} \times 365 \text{ days}}{\text{Annual credit sales}}$

= $\frac{\$200,000 \times 365}{\$2,000,000}$

= 37 average collection period (in days)

Note: It is assumed that all sales were made on a credit basis.

C. Inventory

$$\begin{aligned}\text{Inventory turnover} &= \frac{\text{Cost of goods sold}}{\text{Average ending inventory}} \\ &= \frac{\$1,200,000}{\$225,000} = 5.3 \text{ times a year}\end{aligned}$$

D. Assets

$$\begin{aligned}\text{Asset turnover} &= \frac{\text{Sales}}{\text{Average assets}} \\ &= \frac{\$2,000,000}{\$900,000} = 2.2 \text{ times a year}\end{aligned}$$

E. Agings

For further analysis of select asset accounts, prepare agings for accounts receivable, accounts payable, and inventories. Here is an example based on the accounts receivable level of \$200,000 as of Dec. 31, 2006:

<u>Days Outstanding</u>	<u>Amount</u>	<u>%</u>
0 - 30 days	\$ 92,000	46
31 - 60 days	56,000	28
61 - 90 days	38,000	19
91 days and over	<u>14,000</u>	<u>7</u>
	<u>\$200,000</u>	<u>100</u>

6. Cost of Capital

- A. Debt: All interest on debt is tax deductible.
- B. Preferred stock: Dividends are *not* tax deductible by the corporation but are taxable income to the preferred stockholder.
- C. Common stock: The cost of capital on the common stock dividends is the "opportunity cost" of paying the dividends. It is presumed that this money, if not paid in dividends, can be used by the company for growth, resulting in increased net income and earnings per share.

There is also an added cost of capital when new shares of common stock are issued and sold by a company. This cost reflects itself in potential dilution of earnings per share, book value per share, and the percentage ownership held by each stockholder. Basically, the company's net income and value — if and when the business is sold — must now be shared with the stockholders who acquired the new shares.

- D. Retained earnings: This account represents the accumulated earnings (net of any losses) retained in the business. The company's return on the accumulated retained earnings is compared to the potential return on that money by the company's stockholders. If the company can earn more money on the capital than its stockholders can earn on the received dividends, earnings should be retained in the business.

7. Common Stock Analysis

- A. Earnings per share: Net income available to common stockholders divided by the number of shares outstanding: \$150,000 divided by 100,000 equals \$1.50 EPS.
- B. Price-earning's multiple: The price of the common stock divided by the earnings per share: \$15 assumed market value divided by \$1.50 EPS equals 10 p/e. See top of page 49.
- C. Capitalization rate: This is the reciprocal of the price-earning's multiple, which is assumed to be 10.

$$\text{Capitalization rate} = \frac{1}{10 \text{ p/e}} = 10\%$$

The 10% reflects the *total* return to the company's common stockholders. *Example:* \$150,000 net income divided by the total market value of \$1,500,000 (\$150,000 times 10 p/e) equals 10%, the same as above.

- D. Earnings before interest and taxes (EBIT): \$350,000 times a typical multiple of 4 places a \$1.4 million value on the company.
- E. Yield: Dividends paid per share divided by the market value.

$$\text{Yield} = \frac{\text{Dividends per share}}{\text{Price per share}}$$

$$\text{Yield} = \frac{\$0.50}{\$15.00} = 3.33\%$$

8. Dividends

A. Payout ratio: The percent of dividends paid out to common stockholders.

$$\text{Payout ratio} = \frac{\text{Total common stock dividends paid}}{\text{Total net income available to common stockholders}}$$

$$\text{Payout ratio} = \frac{\$ 50,000}{\$150,000} = 33.3\%$$

B. Yield: See prior page.

9. Dilution

A. Convertible securities: The par value of the preferred stock is \$100 and it is convertible into 10 shares of common stock. There are 1,000 preferred shares outstanding (\$100,000 total preferred stock divided by the \$100 par value).

Since each share of preferred stock is convertible into 10 shares of common stock, the potential dilution is 10,000 shares (1,000 preferred times 10 shares of common stock). If all of the preferred stock was converted into the 10,000 shares of common stock, 110,000 shares of common stock would be outstanding. Thus, the potential dilution to the company's common stockholders would be 9.1%, computed as follows:

$$\text{Percent dilution} = \frac{\text{Shares to be issued}}{\text{Shares outstanding after conversion}}$$

$$\text{Percent dilution} = \frac{10,000}{100,000 + 10,000}$$

$$\text{Percent dilution} = 9.1\%$$

Author's note: If the preferred stock is converted into common stock, earnings per share and the market price of the common stock also must be adjusted. Now, the net income available to common stockholders is \$160,000, since the annual \$10,000 preferred stock dividend no longer has to be paid. Thus, the *new* EPS is computed as follows:

$$\text{EPS} = \frac{\$160,000}{110,000} = \$1.45$$

Dilution: The conversion of the preferred stock into 10,000 shares of common stock represented real dilution to the common stockholders of 5 cents per share. As illustrated on page 49, the EPS was \$1.50; it's now \$1.45 — \$160,000 net income divided by 110,000 shares outstanding. However, with the conversion, the company now *doesn't* have to pay an annual contractual preferred dividend of \$10,000 nor does it have to redeem (buy back) the \$100,000 preferred stock.

Note that conversion of the \$100,000 preferred stock has a very positive effect on the company's common stockholders' equity account of \$300,000. It increases to \$400,000 and the book value per share also correspondingly increases to \$3.64, not the \$3 on page 48.

- B. Warrants/stock options. A warrant or other stock option carries the right to purchase a certain number of shares of common stock at a certain price for a certain period. These equity-type instruments (like the convertible preferred explained above) are issued to sweeten a financing or provide incentives to company employees. The same dilution mathematics described directly above are applicable to any option to purchase a company's common stock.

10. Source and Application of Funds

A source and application of funds schedule reconciles the balance sheet and the income and cash flow statements. It reflects where capital came from, both internal and external sources, and how the money was used by the company. Using the financial statements on pages 43 and 44, the following is its source and application of funds for the year ended Dec. 31, 2006.

Sources of Capital:

Net income	\$160,000
Depreciation	100,000
8% Five-year notes	<u>300,000</u>
Total sources	<u><u>\$560,000</u></u>

Uses of Cash:

Capital expenditures	\$180,000
Cash dividends:	
Preferred stock	10,000
Common stock	50,000
Increase in working capital	<u>320,000</u>
Total uses	<u><u>\$560,000</u></u>

The company's net working capital position, as defined on page 46, increased from a negative position of \$20,000 in 2005 to a positive position of \$300,000 in 2006, an increase of \$320,000. Note that the \$320,000 can be further analyzed to reflect the net changes in each working capital component. Here's the breakdown:

Increase in cash	\$ 25,000
Increase in accounts receivable	50,000
Increase in inventory	50,000
Decrease in prepaid expenses	-5,000
Decrease in notes payable	220,000
Increase in accounts payable	<u>-20,000</u>
Net change in working capital	<u><u>\$320,000</u></u>

11. *Cash Flow Analysis*

The company's cash flow from operations is computed as follows for the year ended Dec. 31, 2006:

Net income before dividends	\$160,000
Depreciation	100,000
Amortization expense	<u>0</u>
Cash flow	<u><u>\$260,000</u></u>
Cash flow per share	<u><u>\$ 2.60</u></u>

Valuation note: Some valuation experts prefer not to add back depreciation to operating profits since many companies need the cash flow from depreciation to fund future capital expenditures. But amortization expenses, e.g., start-up and research and development costs, are a different story. The cash has already been expended and this capitalized asset is simply an accounting entry, so feel free to add it back.

* * *

We know that working through these ratios can be time-consuming. We also know that working with balance sheets is not nearly as much fun as working in your real business. But this is time well-spent. There's gold in the numbers you are calculating. Keep in mind that these are the same ratios professional consultants use to diagnose problems in companies and get them back on track to profitability.

Trouble in a single area — slow-moving inventory or a slow-paying customer — can slow cash flow and dampen profits. But pinpoint the problem early enough and you can fix it before it causes real damage.

Our advice: Apply these ratios on a routine, regular basis to see where your company is headed before it's too late to turn it around. □

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