



Development Finance

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Elements Of Business Financing

- Blending of Sources
 - Conventional Lending Philosophy
 - Collateral
 - Lender Risk



Business Financing Needs

- Long Term Financing
- Low Down Payment
- Reasonable Rate Financing
- Fixed Rate If Possible



Capital Availability

- Types of Funds Used by Small Business
- Equity - Near Equity Capital
- Loan Guarantees
- Limitations of Near Equity and Guarantees




Businesses Have Four Types Of Credit

- Trade
- Short Term
- Long Term
- Equity

Finance Sources

- Banks, Insurance Companies, Pension Funds
- Traditional, Very Conservative.
- SBIC/MEDSBIC - Quasi-venture Like Collateral.
- Venture Capital/public Sector - Very, Very Selective %, Like Technology Companies.
- Public Offerings - Stock Market Need to Venture or Other Sources to Get Their Return.
- ESOT/ESOP - In Stock Situation, Tax Advantage Way for Company Pension Benefits to Buy Ownership of a Company.



Sources of Long-term Financing

- Long Term Financing Gap

Long Term Financing Gap

- A Business wants to finance a new single story building.
- A new efficient building will save the firm \$20,000 annually in material handling costs.
- The new building will cost \$1.3 million and provide space for 50 new jobs over next 3 years.
- The firm can, after disposing of its current building and dipping into working capital, make a \$300,000 down payment.
- The company also feels existing cash flow will support annual debt service of \$130,000. By adding the efficiency savings, debt service can go to \$150,000.
- A commercial bank offers a \$1.0 million loan at 12% for 7 years.
- Annual debt service on the loan is \$211,000 which is \$61,000 more than the firm can afford, so the company decides to postpone or cancel the expansion.

Long Term Financing Gap (cont'd)

- If the bank had offered a loan which better matched sources and use of funds, the decision would have been different.
- A 25 year, 12% interest loan would have cost only \$126,000 annually and the company could have expanded.
- The 7 year loan (sources of funds) offered by the bank poorly matched the life (30-40 years) of the asset purchased (use of funds).



Incentive Financing

- Examples

- State Loans/grants
- Federal Loans/grants

- Affect

- 0% Up Rate - Lower Than Private
- Up to 30 Yrs Term - Longer Than Private
- Up to 100 % Lev. - Greater Than Private



Why Banks Can't Afford to Lend to High Risk Businesses

- Why Can't Banks Lend to High Risk Businesses?
 - Income Vs. Default
- Why Can Venture Capitalists Invest in High Risk Businesses?
 - The 33% Rule



Leveraging

- How Public Sector Programs Help the Private Sector Lender Make Loans



Understanding the Regulatory Rules

■ Private Sector Constraints

- Credit
- Collateral
- Maturity
- Regulatory

■ Sources

- A Bank Has 3 Primary Sources for Funds



Growth Requires Increase in A/R and Inventory.

Company Must Be Able to Support
Increases.

In 'Fast Growth' Company Will Run Out of
Working Capital, I.E., **Cash**

CASH IS KING
CASH PAYS BILLS

If Company Looks Good but No Cash...
Big Problem!!



The Financial Spectrum



Focus

- Current Trends in Development Financing
 - Banking
 - Venture Capital
 - Economic Development
- Benchmarks for Financing
- Current Status of Economic Development Programs



Banking and Other Private Sector Lending: Current Trends in Banking

- Merger and Acquisitions
- Federal Reserve Board
- Greater Credit Risk
- Niche Lenders
- Non Bank Lenders



Bank Lending 101: What a Bank Looks for in a Loan

- Primary Collateral
- Secondary Collateral
- Primary Cash Flow
- Secondary Cash Flow
- Character

Credit: ID The Vocabulary Of The Lending Industry

■ Capital formation

- Project Costs are paid through a combination of **debt** and **equity** – *paid just once*; generally both are needed; it's the amount and cost of each that's important.

■ Debt Service

- Amount of cash the business uses to repay the principal amount of the loan, with interest, over the term the bank agreed to lend it; includes principal repayment and interest.

What's The Difference Between Debt And Equity?

■ Debt Is Funding Which:

- Is paid back on a predetermined schedule calculated when the loan is made
- Assumes the ability of the business to generate future cash flow
- Does not involve management control
- Is typically secured by the assets being financed. If liquidation is necessary to repay the debt, lender has control over the assets of the business through the filing of liens, mortgages and guarantees
- Does not provide management control
- Is repaid using cash flow of the business

What's The Difference Between Debt And Equity? (continued)

- Equity Is Funding Which:
 - May never get paid back – is at risk
 - Gets paid back, if at all, based upon performance
 - More expensive than debt; high rate of return due to risk
 - May include some management control
 - May have some management control of the business and its assets through stock ownership
 - Is paid after all debts are paid



Benchmarks for Bank Financing of Business

- Loan to Value Ratio Not Exceeding 75%
Collateral Cushion
- 1.20 Cash Flow Coverage Ratio Based Upon Business Operations (Cash Flow Cushion)
- Multiple Purpose Assets
- Three Year History of Performance
- Clear Personal Credit Report

What They Want

- Bank, Pension, Insurance - P + Return;
Collateral; CF>D/S
- MESBIC/SBIC - Collateral; Potential 15 - 20%
Return; CF>D/S
- Venture Capital - Potential 50 - 70% Return;
Public Offering Potential
- Public Offering - Potential 30 - 49% Returns
- Sizeable Company Established Sales Product
Established Management



What Are the Toughest Deals for Banks to Finance?

- Service Businesses
- Rural Businesses
- Inner City Deals
- Business Acquisitions
- Single Purpose Collateral



Are All Banks the Same?

- Banks Have Different Kinds of Products
- A Bank's Lending Decision Is Unrelated to Credit Quality
- Banks Have Different Personalities
- Banks Are Profit Making Businesses
- Banks Are NOT Venture Capital

Where Does A Business Get Money?

■ Debt

Lending Institutions, ie:

- Banks
- Leasing Companies
- Insurance Companies
- Pension Funds
- Investment Banking Cos.

Sometimes Also From:

- Individuals
- Shareholders
- Officers

■ Equity

Individuals And Institutions:

- “Angels”
- Venture Capital Corporations (VCC)
- Investment Firms
- Home Mortgages
- Personal Lines of Credit
- Credit Cards
- Personal Savings
- Sale of Another Asset
- Investment from Relatives
- Investment from Business Partners and/or Key Management
- Investment from Former Employers/Customers



Investors And Lenders Have Similar Views On Financial Investment

- Investors and Lenders are money managers, just like individuals
- Their goals will be: to obtain a “return” on their investment (interest payments and/or dividends) which brings income (and wealth) to their owners
- The level of return (reward) that they desire will generally guide the level of risk that they will take. Higher risk requires higher rates.
- They will evaluate four factors:
 - 1. Their own source of funds (amount, stability and cost)
 - 2. The amount of return they desire
 - 3. The stability over time of the return
 - 4. The level of risk to obtain the return and stability they desire
- The higher the risk, the higher the return and less stable the return
- The lower the risk, the lower the return and more stable the return



How Does a Business Know What Bank to Approach for Financing?

- Always Approach the “Bank of Account” First
- Be Prepared to Go up the Line
- Contact Other Lenders
- Look for Banks Interested in the Type of Project Being Financed
- Instability in Lending Officers



Benchmarks for Bank Financing of Business

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- 1.20 Cash Flow Coverage
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Business And Bank Needs Are Different Their “Ideal” Type Of Loan Depends On Their Perspectives And Needs

■ Bank Financing Needs

□ Short Term Financing

- Assume the collateral will deteriorate
- Reduces the number of unknowns; helps manage collateral risk, maturity risk, rate risk, credit risk
- Flexibility depends on source of bank funds

□ Floating Rate Financing

- Flexibility depends on source of bank funds
- Vary repayment rate with the bank’s cost of money

Understanding Private Lenders

- Is There A Difference Between Small And Larger Banks?
 - Small Banks
 - May be able to make decisions more quickly
 - May have lower legal lending limits, that in turn may limit the total amount the business can borrow
 - May have greater flexibility in terms and conditions
 - Large Banks
 - May have greater resources and more products to offer
 - May take longer to make a decision, depending upon where the decision is made
 - May be able to meet your needs as your business continues to grow and expand its requirements for financing



Know What Your Bank Wants

- Is It Collateral
 - OR
 - Cash Flow?
- They All Want Both But Sometimes One Is More Important Than The Other



Benchmarks for Financing of Real Estate

- Sufficient Rental Cash Flow
- A Stable Location
- Multiple Tenant Buildings
- Multiple Purpose Buildings
- A Financially Stable and Experienced Developer



Are There Alternatives to the Local Lender?

- Non-bank Lenders
- Insurance Company
- Pension Funds
- Some Non-local Banks Specialize in SBA or RDA Guaranteed Financing Projects
- Many Large Finance Companies Provide Variety of Financing Tools



Why Some Lenders DON'T Like Public Programs

- In some cases, the requirements of the public sector programs may cause lenders to proceed without the public funds
- They may perceive that the paperwork is an unnecessary burden
- Project requirements may add time and cost:
 - Environmental assessments
 - Prevailing usage
 - Public comment period
 - Historic preservation
- The timetable to get the public sector financing may be too long
- The lender may not have had any experience with public sector programs.



Venture Capital

Current Trends in Venture Capital Financing

- Venture Capitalists Continue to Invest Primarily in Technology Based Businesses
- The Federal Small Business Investment Company (SBIC) Program Has Been Changed to Be More Responsive to the Typical Structure of Venture Investment
- The Centers of Venture Financing Continue to Be in the Large Financial Centers and in East and West Coast Technology Centers
- There Are Some Venture Financing Centers Being Created in Non-coastal Communities As a Result of University - Business - Government Partnerships (Philadelphia; Madison, Wisconsin; Lansing and Ann Arbor, Michigan)
- The Primary Investors in Venture Funds Continue to Be Large Corporate Funds, Wealthy Individuals and Pension Funds

What Is the Role Between Venture Capital and the Economic Development System?

- Venture Capital Is Rarely Appropriate for the Small Business
- A “Technology Commercialization Infrastructure” Is Necessary for an Ongoing Venture Capital Presence in the Community
- Venture Capitalists Do Not Invest Because of Job Creation
- Venture Capital Funds Needs to START With at Least \$10-\$20 Million
- Economic Development Professionals Serve an Important Intermediary Role



Benchmarks for Venture Capital Financing

- 35% Compounded Annual Rate of Return
- Demonstrated “Exit Strategy”
- Opportunity for Staged Investments
- All Critical Management Skills in Place
- Potential for Partnering



Venture Lending – New Concept

- Combines venture capital participation with conventional amortization with warrants which can be converted to royalties or stock tied to increased revenue



Rules For Packaging

- Understand the Company
- Understand the Project
- Understand the Private Lending Options
- Understand the Public Lending Options
- Analyze the Gap and Structure Options
- Close the Deal or Walk Away

Steps In Packaging - A Simple Six Step Process

- Meeting and Interviewing the Applicant to Gain an Understanding of the Project and Its Parameters, the Principals, and the Potential Structure of the Deal.
- Determine the Legal Regulatory and Policy Eligibility of the Deal.
- Determine the Credit Feasibility of the Project.
- Finding a Lender
- Packaging and Submitting the Loan Documents.
- Follow-up to Obtain Approvals. (Usually Where Deal Falls Apart).



Ratios - Credit Analysis

Ratios

Information obtained from the balance sheet and income (P&L) statement

$$\text{Current Ratio: } \frac{\text{Current Assets}}{\text{Current Liabilities}} \quad 1.5:1$$

Balance sheet should show total current asset and current liability amounts.

Current assets are cash, accounts receivable, and inventory.

Current liabilities are accounts payable plus other current (less than 1 year) items such as accrued taxes and wages, estimated income taxes, etc.

Ratios

Quick Ratio:
$$\frac{\text{Cash \& Accounts Receivable}}{\text{Current Liabilities}} \quad 1:1$$

A better test of liquidity because it eliminates inventories which require two transactions to become cash.

From the income statement is another important ratio:

$$\frac{\text{Cost of Goods Sold (COGS)}}{\text{Sales}} = \text{Stable over time}$$

AND...

From the balance sheet - Working Capital

$$\text{\$Current Assets} - \text{\$Current Liabilities} = \text{\$Cash King}$$

9 Key Ratios

- Many Ratios but 9 Key Ones
 - Current Ratio
 - Quick Ratio
 - Debt to Net Worth
 - Receivable Days
 - Payable Days
 - Inventory Days
 - Net Profit to Net Sales
 - Net Profit to Net Worth (ROI)
 - Working Capital



Calculations of Ratios for Small Business Co., Inc.

Small Business Company Combined Balance Sheets January 1 and December 31, XXXX

	December 31, XXXX		January 1, XXXX	
ASSETS				
<i>Current Assets:</i>				
Cash	\$30,000		\$30,000	
Accounts Receivable	\$42,000		\$32,000	
Less Allowance for Bad Debts	<u>\$2,000</u>	\$40,000	<u>\$2,000</u>	\$30,000
Merchandise Inventory		\$60,000		\$50,000
Prepaid Expenses		<u>\$10,000</u>		<u>\$10,000</u>
TOTAL CURRENT ASSETS		\$140,000		\$120,000
<i>Fixed Assets</i>				
Buildings and Equipment	\$120,000		\$120,000	
Less Accumulated Depreciation	<u>\$70,000</u>	\$50,000	<u>\$60,000</u>	\$60,000
Land		<u>\$30,000</u>		<u>\$30,000</u>
<i>Total Fixed Assets</i>		\$80,000		\$90,000
<i>Other Assets</i>				
Goodwill and Patents		\$10,000		
TOTAL ASSETS		<u>\$230,000</u>		<u>\$210,000</u>
LIABILITIES				
<i>Current Liabilities</i>				
Accounts Payable	\$30,000		\$25,000	
Accrued Wages and Taxes	\$10,000		\$10,000	
Est. Income Taxes Payable	<u>\$20,000</u>		<u>\$15,000</u>	
TOTAL CURRENT LIABILITIES		\$60,000		\$50,000
<i>Fixed Liabilities</i>				
Mortgage Bonds, 4 percent		<u>\$40,000</u>		<u>\$40,000</u>
TOTAL LIABILITIES		\$100,000		\$90,000
EQUITY				
Common Stock (5,000 shares outstanding)		\$60,000		\$60,000
Retained Earnings		<u>\$70,000</u>		<u>\$60,000</u>
TOTAL OWNER EQUITY		\$130,000		\$120,000
TOTAL LIABILITIES AND EQUITY		<u>\$230,000</u>		<u>\$210,000</u>

Income Statement

For the Year Ended December 31, XXXX

Gross Sales	\$303,000		
Less Returns and Allowances	<u>3,000</u>		
Net Sales		\$300,000	
Cost of Goods Sold		<u>180,000</u>	
Gross Margin			\$120,000
Operating Expenses			<u>78,000</u>
Operating Profit			42,000
Interest Expense			<u>2,000</u>
Income Before Taxes			40,000
Estimated Income Tax			<u>20,000</u>
Net Profit (EAT)			\$20,000

WHAT TO LOOK FOR

- Is company growing? Sales up
- Is company profitable? Profits up
- Are COGS ÷ Sales stable over time?
- Are COGS ÷ Sales stable or declining over time?
- Is current ratio 1:1?
- Is quick ratio 1:1?
- Is working capital positive?
- Are days receivable constant with industry terms?
- Are days payable constant with industry terms?
- Are retained earnings positive?

Summary

- Demand for Capital Involves Its Accessibility, Cost, Terms and Type of Capital.
- The Public Sector Role Has Been to Increase Capital's Availability, Decrease Its Cost, and Fill Gaps in the Private Credit Market in Pursuit of Policy Goals.
- The Capital Needs Are Determined by Factors Such As Firms' Industry, Size, Market and Competition, and by Its Stage of Development.
- Business Capital Can Take the Form of Equity, Debt, or Working Capital.



Summary Cont'd

Equity Capital Is Used Most Often for Business Start-up, Building Sales and Manufacturing, Working Capital Prior to Profitability, and for Major Expansion.

The Sources of Equity Capital Include Personal Savings, Private Investors, Venture Capital Firms, and Other Business.

Debt Capital Is Generally Used to Purchase Durable Assets (Long Term), Finance Market Expansions (Medium Term), and Smooth Out Seasonal Fluctuations in Working Capital (Short Term).