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Financing your business; Management series

Christopher R. Malburg

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Financing Your Business

Edited by Christopher R. Malburg, CPA

Issued by the Management of an Accounting Practice Committee

American Institute of Certified Public Accountants
Foreword

This booklet is one of a series on management concepts and skills issued by the Management of an Accounting Practice Committee of the American Institute of Certified Public Accountants. Written for CPA firms’ clients, these booklets are easy to read and have a practical emphasis throughout. They provide today’s managers with a short course in management techniques that are used to operate successful businesses.

For further reference, a list of relevant books and articles is included in Appendix D.
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Chapter 1

Fundamentals of Financing

The variety of financing options available to small businesses can be daunting. However, many managers still clutch at the first offer without considering the consequences or even being aware of the alternatives. Financing Your Business takes you through the many options facing borrowers. In particular, we will highlight the importance of using the right source of funds to match your needs.

Before securing additional funds, the owners of the enterprise must understand and agree upon its overall purpose. Generally, there are two types of small businesses: entrepreneurial and proprietary.

Entrepreneurial companies seize opportunities to capture a greater market share or enter new markets. For entrepreneurs the business objective and, therefore, the purpose of any financing is to amass greater wealth. This requires a willingness to take risks by entering new and often untested ventures. Generally, capital raised by such aggressive firms costs more in terms of interest and gives away a larger position in the company to the investor.

Entrepreneurs see their companies as having rapid growth potential. To realize this potential, they are willing to exchange some of their ownership interest for the needed capital. Successful high-growth companies will create greater value for their owners at a faster rate. Investors dealing with entrepreneurs are concerned with the value of the company and their participation in its appreciation.

Proprietary companies are less aggressive and refuse to take the risks borne by entrepreneurs. Often the owners aim just to provide a living for their families. This type of company may be passed on from a parent to a son or daughter. The risks are less and so is the pace of development. The owners of proprietary firms are unlikely to share control with an outside investor. They usually employ additional capital sources only to help pay off their debts. Lenders to proprietary companies worry that profits and cash flow may not be sufficient to service their debts.

Over time, business objectives often shift as management changes its priorities and new opportunities are exploited. You should identify your own reasons for raising capital. Determine how much of the company you are willing to give up and where you think it can afford to take on risk.

Most companies require several layers and types of capital sources depending on their stage of development. Usually these are distinguished between short-term and long-term financing. Short-term financing includes—

- **Internal funds.** Funds may be generated internally by cash generated from profitable operations or by a reduction in the required working capital. (Chapter 4, “Internal Funding,” deals with squeezing working capital out of the company to reduce borrowing.)
- **Short-term borrowing.** Temporary credit facilities such as a revolving line of credit can fulfill working capital requirements. Cash shortfalls during the off-season are often funded by revolving lines of credit. These funds are typically repaid within twelve months, usually during the busy season. (Chapter 5, “Debt,” discusses the mechanics of credit lines.)
Long-term financing includes—

- **Medium- and long-term debt.** Usually this includes mortgage debt and installment loans. It is used for acquisition of fixed assets and for financing large purchases such as real estate or capital equipment. The asset being purchased often becomes the collateral for the funds advanced. (Chapter 5, “Debt,” addresses the long-term core financing of a company.)

- **Bonds.** Debt issued in the form of bonds, debentures, notes, and other such instruments requires regular payments of interest and sometimes of principal. (Chapter 5 addresses the fundamentals of issuing bonds.)

- **Government loans or guarantees.** Many small businesses are able to qualify for government grants or loans under a variety of special programs. (Chapter 5 presents some of the potential sources of public-agency financing.)

- **Equity capital.** This includes common as well as preferred stock. Equity is used to finance the risk element within the company. Issuing equity shares in the company provides a large potential source of additional funds. This method is usually used for large amounts of capital, since it requires the involvement of lawyers, accountants, and investment bankers and often requires Securities and Exchange Commission (SEC) registration. (Equity financing is discussed in Chapter 6, “Equity.”)

Most companies employ a combination of these financing vehicles to form their capital structure.
Chapter 2

Transition and Growth of the Business

If you are the owner of a small business and are looking for additional capital, determine—

1. What you want out of the business.
2. How you will realize your wealth. Some call this cashing out. Do you want cash or some other form of payment in order to defer payment of taxes?
3. The amount of responsibility (and reporting requirements) you are willing to take on.
4. Your strengths and weaknesses. How do they fit with the added risks and decision making requirements involved in profitably employing additional capital?

Businesses, like people, change and develop throughout their lives. The transition from infancy to adulthood, middle age, and maturity is a series of steps rather than a smooth process. Each step requires critical management decisions and, more often than not, additional funding.

Before attempting to raise funds, consider whether you actually want the business to take the next step. Growth creates its own challenges, just as it can provide distinct rewards. In addition, as your base of lenders and investors grows, more requirements will be placed on the business in terms of reporting, record keeping, profitability targets, and disclosure. Entrepreneurs who once ran a company with singular authority over major decisions may suddenly find themselves confronted with a group of investors who can overrule them.

Each time operations reach capacity, management will likely be faced with the decision to either restrict demand by raising prices or expand the business to meet it. If you decide to expand, chances are the business will require more capital. As the demand for funding grows at each stage of business development, the financing arrangements change and become more complex. Not all types of financing are equally suited to all the stages of a company’s life cycle. The financing must match the company’s stage of development.

For new businesses, seed capital is often especially critical. It incorporates elements of venture funds, equity, and borrowing. A new company’s lack of a track record makes seed capital the most difficult to raise. Often, entrepreneurs use personal funds to begin a small prototype operation to confirm the merits of their idea. This puts them in a much stronger position when seeking a larger organization to fund the actual start-up.

At this stage, the entrepreneur with a proven idea who has used his or her own funds for seed money has several options:

- Seek venture funding and relinquish a part of the firm’s ownership.
- Enter into a joint venture with a larger organization.
- Sell a license to either market, sell, distribute, or manufacture the product.
- Sell the idea to a larger company, cash out, and walk away from the firm.

Many potential lenders and investors are merely curious about start-up companies. Most will actually fund only established businesses with proven
track records. The lower risk involved in this type of investment reduces the cost of funds but increases the probability of repayment and return on the investment.

There are six DOs to remember about financing:

— Do consider your objectives for the business honestly.

— Do look carefully at the strengths and weaknesses of your management team. Assess its ability to guide the firm on its chosen course.

— Do determine how much of the required funding can be raised internally by managing working capital requirements.

— Do identify the needs of the business and match them with the most appropriate type of financing.

— Do prepare a realistic business plan.

— Do anticipate your firm’s capital requirements far enough in advance to obtain the best deal.

There is one DON’T:

— Don’t be misled into the belief that growth is your only alternative. Periods of consolidation can be essential to the success of a business. This is especially true during periods of uncertainty when the competition is making decisions that may impair its ability to survive a business downturn.
Chapter 3

Presenting Your Case

The planning of capital requirements is just as important as the overall planning of the business. In some ways it is even more important, since an investor or lender from outside the company is being asked to share in the risks as well as the rewards.

THE BUSINESS PLAN

Both bankers and equity investors must be convinced of the company's viability. Accomplishing this depends on two things: sales and management. When presenting your plan for the use of additional capital, you should make the case that—

1. A sustained market for the product or service exists and the company has the ability to exploit it.
2. Management is experienced and capable. Describe its background and record of success.

Next, provide the financial details that illustrate—

1. Where the funds will be invested.
2. How profitability will be enhanced.
3. The company's ability to either service the debt or provide its investors with the expected return.

Investors and lenders have different concerns. In assessing the merits of your proposal, investors seeking an equity position will look for capital gain and a way to get their money out later on (this is often called the exit route). The risk they are willing to take is proportional to the return they expect.

Lenders, in contrast, are less inclined to assume the same degree of risk. As a result, their expected level of return is correspondingly lower. Further, lenders require that their funds be secured by collateral sufficient to repay the loan in the event of the company's inability to do so out of cash flow. The greater the collateral, the less risk to the lender and the lower the interest paid on the loan.

Every investor and lender needs to know the answers to the following questions:

1. What is the purpose, amount, and timing of the funding?
2. What proportion of the total project or asset being purchased does the funding represent? Most lenders do not want to be on the hook for the total cost of a risky enterprise. Often the risk will be spread among a group of lenders and the owner.
3. How will the company repay the loan? Does it have sufficient cash flow to ensure payment? What contingencies can be foreseen that might create a repayment risk?

Both equity participants and lenders will demand to see a cash flow forecast. The investor wants proof of the level of funds required and the company's ability to sustain itself. The lender wants assurance that enough money will be available to repay the loan. For small companies, the cash-flow forecast is the most vital part of the business plan.

Weak assumptions or unsupportable, overly optimistic sales projections will only damage your presentation. Investors and bankers see many
proposals, and most analysts are astute about distinguishing resourceful business people from dreamers. If your business plan errs, make sure it errs on the conservative side. You do not have to present a picture of doom, but do not ignore the plan's weaknesses. Identify them, explain how you will overcome them, and then move on.

When an assumption affects the company's ability to repay its borrowings, provide a sensitivity analysis showing the risk of default at various levels of the assumption. Many computer spreadsheets have built-in sensitivity analysis programs that make this an easy task.

Resist the temptation to burden your audience with too much detail. Everything about your company does not have to be explained at this stage. Be brief. Do not ramble on about the virtues of your plan. If they exist, they will come through. If necessary, provide facts that support your assertions.

The following essential elements should be part of your business plan:

1. An executive summary including the nature of the business, its financial requirements, the purpose of the funds, and the projected returns
2. A description of the business and the market, including the history and current status of the territory covered by each market segment
3. An introduction to the management team, including resumes for all senior executives and an organization chart showing the responsibilities of each
4. A description and analysis of the product or service, explaining its competitive advantage and place in the market
5. An assessment of the competition and its impact on your firm, including barriers to entry and stability of competing firms
6. An analysis of the industry, with a description of your marketing strategy in light of that analysis
7. A description of the company's operations and production facilities, including current and future capital requirements of the proposed expansion and management control procedures that ensure profitable operations
8. A description of your research and development programs (if they are important to the company and its position in the marketplace)
9. A description of the status of industrial relations, including unions, contract provisions, and renegotiations
10. Potential risks and planned responses
11. A description of provisions made to guarantee investors a preferred return before payment of bonuses or other management performance incentives and lenders repayment of their loan.

Historical financial statements for at least the previous three years should be provided along with financial projections. Projections should cover the term of the loan or, if you are seeking equity capital, about three years. Make sure the format of the projections is consistent with that of historical financial statements to facilitate comparison. Balance sheets, income statements, and statements of changes in financial position should be included. Include sensitivity analyses and interpretations if these are important in assessing the risk to which your projections are subject.

To assess potential risk, lenders will investigate—

1. Credit history. If you are already a customer, the bank will analyze your present loans and their balances, your history of repayment, and any delinquencies. They will want to know if current borrowings are indeed short-term in nature or whether they have become part of the core financing of the company.
2. Related party accounts. The bank will investigate the accounts of owners, partners, and major shareholders to determine how the money flows back and forth.
3. Owner's equity. Banks want owners to have a material stake in the company—the more equity, the better. Banks are reluctant to lend into a highly leveraged situation from which management can walk away when the going gets tough.
4. Liquidity and working capital. The criteria and critical ratios used to judge liquidity will
vary according to the nature of your business. Usually the bank will have pre-established benchmarks for these ratios. They will lend beyond these only in certain situations, when other evidence of creditworthiness has been established.

5. Changes in accounting policies. Bankers want to see a clean historical progression in the company’s finances. They will question changes to accounting policies—such as depreciation or inventory valuation methods—that make the presentation inconsistent. If the customer is important enough, they may demand that the financial statements be reconciled to achieve a consistent format.

Your business plan should answer the questions most likely to be asked by your audience. It must demonstrate not only your deal-making capability, but also the presence of a solid management team able to run the company and employ the funds in a manner that will realize your projections.

OUTSIDE ASSISTANCE

Excellent as they may be in their chosen fields, few entrepreneurs are equally expert in financial management and dealing with bankers and investors. If this is true of you, seek the assistance of someone skilled in the preparation of financial plans and funding proposals.

DISTRIBUTING THE FUNDING PROPOSAL

Do not send out your funding proposal to everyone you can think of who might wish to lend or invest. Instead, limit distribution to a very few. Solicit their reactions and incorporate their suggestions into the proposal. The involvement of lenders and investors gives them a personal stake in your success. If necessary, you can increase the distribution of the package later on.

SELLING THE FUNDING PROPOSAL

There are four steps to follow once you have prepared your proposal:

1. If you employ professional advisers, use their contacts and working relationships with the investment community.
2. Make sure the proposal is complete enough that it sells itself. The presentation should be eye-catching and should convey its message using a minimum amount of text while hitting the hot buttons of your audience so that they want to meet you.
3. Once the written presentation has been delivered, follow up with a telephone call and arrange for a meeting between your management team and the potential money source. This gives you an opportunity to sell the idea and demonstrate your ability, as well as allowing both sides to get to know each other.
4. Address any unresolved questions or issues. If the money source demands that different assumptions be used in your financial projections, make them promptly and provide the results.

TIMING

Raising funds takes time. You want to have a choice among sources and the leverage to negotiate the best deal. Your potential money sources need to get to know you, to solicit the opinions of their colleagues, and to do their own research. They also need time to prove to their satisfaction the accuracy of your claims.

MAINTAINING CONTACT WITH LENDERS AND INVESTORS

It is a good idea to maintain contact with a number of potential lenders and investors even after you have obtained the funds you need. This could shorten the time involved the next time you require funding and provide you with several potential sources.
Chapter 4

Internal Funding

REDUCING WORKING CAPITAL

We have already stated in chapter 1 that firms should first look internally for additional working capital. The Management Series booklet, Management of Working Capital tackles the management of day-to-day operations in detail. Broadly speaking, the business can generate valuable funds internally by reducing the accounts receivable, inventory, and accounts payable components of working capital.

Accounts receivable can be reduced by—

• Collecting from major accounts before they have a chance to become delinquent.
• Invoicing customers as soon after the sale as possible.
• Asking for payments in advance, deposits, and progress payments.
• Making sure the receivables system highlights delinquent debts and initiates collection procedures promptly.
• Paying the sales force on collected balances rather than gross sales.

Inventory can be reduced by—

• Keeping stock on hand to a minimum.
• Using economic order-quantity computations to determine the optimum order size.
• Keeping safety stocks (inventory kept on hand to prevent running short) to a minimum.

Accounts payable can be reduced by—

• Negotiating extended credit terms. This can be particularly effective when your supplier depends on your business and you can easily switch to a competitor.
• Assessing the possibility of purchasing some of your raw materials in bulk. Often, however, the price discount does not outweigh the additional capital and storage costs of overstock.

SALE OF RECEIVABLES—FACTORIZING AND INVOICE DISCOUNTING

Factoring is usually the first method managers employ to accelerate the cash flow from receivables. It involves the purchase of accounts receivable by a factoring company. This provides short-term funding—usually for no more than 180 days. The following are some of the terms common to factoring agreements.

• The factor becomes responsible for collection of accounts receivable.
• Invoices direct the customer to pay the factor.
• The factor advances a percentage of the receivables to the company. The difference between the receivables purchased and the advance (less fees and other charges) is paid when the accounts are collected.
• Accounts may be purchased with recourse, meaning that you are responsible for any bad debts. The amount lost by the factor will be charged against your account. Arrangements in which the receivables are purchased without recourse require the factor to bear the cost of bad debts. The factor’s assessment of your customer’s creditworthiness, then, deter-
mines the percentage of receivables it is prepared to advance.

Invoice discounting is similar to factoring except that the customer is not aware that the receivable has been sold. Since the seller retains responsibility for collection, the continued need for a collections department makes this method more costly than factoring. However, it does advance funds on the receivables portfolio faster than would the collections process.

Both factoring and invoice discounting are offered by a wide variety of companies, many of which are subsidiaries of financial institutions. Both techniques accelerate the flow of cash into the firm. Funds generated by selling receivables are used, like any such cash flow, to pay the current bills of the company. Selling receivables tends to be costly and only temporarily closes the gap between available cash and bills due immediately. Most firms, if their cash flow allows it, prefer to retain ownership of their accounts receivable.

TIPS FOR SELLING RECEIVABLES

First, compare the cost of the factoring agreement with other forms of short-term financing such as a line of credit.

Next, assess the impact that knowledge of this action will have on your customer base. For example, a prestigious law firm will probably not want clients to know that its financial situation required it to sell its accounts receivable to survive.

Finally, find out if factoring receivables is prohibited by covenants and restrictions on other debt carried by the company. Frequently, accounts receivable are used as collateral for loans and therefore cannot be sold or otherwise encumbered.
Chapter 5
Debt

LEVERAGE

Most companies measure their leverage (the amount of debt they carry) by the debt-to-equity ratio. This is easily computed as follows:

\[
\text{Debt} \div \text{Owner's equity}
\]

The higher the ratio, the more debt encumbers the firm. Lenders consider companies with excessive debt-to-equity ratios to be greater risks and therefore charge those companies higher interest rates on their loans.

As interest rates rise, lenders become choosier about the leveraged companies they fund. They reason that owners with a major stake in a company will be less inclined to walk away from a problem and leave the lender holding the bag.

Leverage ratios vary from firm to firm and among industries. Companies that are asset-intensive (especially those with assets that are readily marketable) can support a higher debt-to-equity ratio than service companies whose assets walk out the door every day at quitting time. In addition, established companies with solid, dependable cash flows can support a greater proportion of debt.

LOAN ELEMENTS

Lenders and borrowers form a partnership of sorts. The borrower is obligated to disclose the firm’s progress toward realizing the business plan on which the decision to make the loan was based. Continuing financial information will be provided to the lender so that it may monitor the company’s performance in light of the plan.

Security

The firm’s ability to repay the loan is the most important element in a lender’s decision. A financial plan that merely establishes the existence of cash flow is usually not enough. The lender will require security in the form of hard assets that can be sold to repay the loan in the event of default. However, the company’s assets may not provide sufficient collateral for a loan. The owners may then be required to pledge their personal assets—preferably liquid assets such as stocks, bonds, and other securities, along with real estate.

Similarly, partnerships are required to contribute their assets to the collateral. Limited partners, however—because of their limited liability—do not provide collateral. To do so would change their status as limited partners—something they may not wish to do. In fact, limited partners protect their limited status precisely to restrict their investment liability. Therefore, the general partner is often required to pledge his or her personal assets instead.

Corporations are legal entities separate from their shareholders. As such, they may incur debts on their own behalf. When a corporation’s assets are insufficient to cover the required collateral, key executives and directors are often asked to provide personal guarantees to cover the shortfall.

When the managers of a small business determine that internal sources of capital have been exhausted, usually they will turn first to their bank. Unlike the issuing of equity stock, bank loans do not dilute ownership of the company. This is important to firms that will grow and
become more profitable as a result of the loan. When assets are insufficient to provide the bank with adequate security, third-party collateral is often provided in the form of pledges of personal assets from family, friends, or—in the case of government-secured loans—the government.

Personal guarantees are a serious matter. Smart business people rarely give a personal guarantee without first obtaining legal advice. If you are asked to give a guarantee, make sure the conditions for its activation and termination are clear and in accordance with your wishes.

**Fees**

A loan involves other fees besides the interest paid monthly or quarterly. The most common loan fees include—

- **Origination fees.** These are usually computed in percentage points of the total loan value. For many real-estate loans, origination fees run between 1 and 2 percent of the total loan. These fees are used to cover the underwriting and administrative expenses involved in evaluating and setting up the loan. The origination fee paid at the beginning of the transaction also makes up a portion of the lender’s profits.

- **Commitment fees.** These are most common in lines of credit, in which a portion of the funds allocated may not be drawn on for a period of time. Commitment fees are computed as a percentage (for example, one quarter of a point) of the available line.

- **Escrow fees.** These are usually split fifty-fifty or negotiated between buyer and seller.

- **Appraisal fees.** Loans that require hard assets as collateral usually involve appraisal fees. The lender will hire an independent appraiser to place a value on the assets being pledged. The borrower is usually charged for this service.

- **Broker and legal fees.** Complex loan documents require the advice of an attorney. Banks often use outside attorneys for this purpose, and charge their fees to the customer. If the services of a loan broker are used, the borrower must pay those fees as well.

Different lenders quote different rates for each fee. Make sure you are aware of all the costs involved and be prepared to negotiate.

**Interest**

Each bank sets its own interest-rate policies. Base rates are changed as a function of money-market interest rates, the bank’s requirement for additional loans, and what the market for funds will bear. Interest rates are typically quick to rise and slow to fall. Depending on the credit risk, credit lines are charged between 2 percent and 4 percent above the prime rate of the bank. Normally, higher rates will be charged on installment loans to reflect the longer-term nature of the bank’s commitment.

Interest can be fixed or float with an index—either the prime or some other rate on which the bank bases its cost of funds. The amount by which a loan rate exceeds the index is called the spread. The spread is measured in terms of basis points. One hundred basis points are equivalent to one percentage point. The bank’s profitability on index-related loans can come under pressure when short-term interest rates fluctuate. This affects supply and demand and will translate into the rate spreads offered.

**LOAN TYPES**

**Lines of Credit**

Lines of credit (LOCs) are ideal for funding short-term working capital requirements. Credit lines require that interest be paid only on the amount outstanding. The interest rates charged on LOCs float on a spread, usually over the prime interest rate. The spread can be anywhere from no points to four points or more over prime, depending on how the lender perceives the risk of the transaction. Usually only larger, more established companies command rates at the low end of the LOC spread.

LOCs are easy to draw on. Usually only a telephone call to the banker followed by a letter of confirmation are all it takes to draw down the required funds on a pre-established credit line. However, for many financing requirements, lines of credit are not the answer. If business changes for the worse, an LOC may not be renewed. This can mean trouble if the business was using the credit line for core borrowing—a use for which LOCs were not intended.

The amount of the facility (or line) is usually reviewed annually unless the bank has cause for
concern. Many credit-line agreements have an annual clean-up provision that requires the borrower to repay the entire line and not draw on it for a period of one month. In between reviews, monitoring usually takes the form of close supervision. Danger signs from the bank’s point of view include—

- Checks issued to creditors for round amounts rather than for the exact amount owed, or payments delayed beyond the original purchase terms.
- Immediate disbursement of every cash receipt to satisfy pressing creditors (this is called living from hand to mouth).
- Credit facilities tapped to the maximum and not repaid as usual.

Bankers watch clients exhibiting this behavior for further signs of trouble.

Credit lines are often repayable on demand by the bank. However, few banks exercise this right except in the event of a disaster. When a bank demands immediate repayment, it is usually when a business can least afford to pay.

Long-Term Loans

Long-term loans are used to finance purchases of capital assets and form part of the debt structure of the balance sheet. The duration of most long-term loans is between ten and thirty years. Interest rates may be either fixed or floating, and they may be linked to the prime rate or any one of the other interest-rate indices. There are various repayment options for long-term debts. The more common ones include—

- Regular level repayment, whereby the principal and interest remain constant and fully amortized over the life of the loan.
- Deferred interest, whereby all interest payments are deferred until a future date; the lender charges interest on any unpaid interest.
- Interest only, whereby the borrower does not repay the principal until a future date; the payments therefore either stay level or fluctuate with the floating-rate index being used.
- Negative amortization, whereby the loan increases if interest rates rise above the agreed-upon monthly payment rate; the difference is added to the principal.
- Balloon payment, whereby the full unpaid principal must be repaid at a future date.

When dealing with long-term financing, beware of the following:

- Once such loans are in place, you are locked in. Prepayment often entails substantial penalties.
- Make sure that the loan is not callable by the bank. Borrowers have sometimes been surprised to find the bank demanding repayment during a business downturn or when the terms of the loan are in their favor.
- Banks require borrowers to comply with certain covenants and restrictions. Often these involve compensating balances, established financial ratios, and profitability targets. If you see that your firm is going to breach one of these covenants or restrictions, call the lender. Explain how you intend to correct the problem, and secure a waiver for the covenant or restriction you have breached. Without such a waiver, the banker could call the loan.
- Fixed-rate loans are offered during periods when lenders believe that interest rates will fall. If this occurs, you will be locked into a loan on which you must pay a premium for a long time to come.

Mortgages

Large loans are usually secured by hard assets such as real estate or capital equipment. Lenders determine the amount they will provide on an asset-based loan using the loan-to-value (LTV) ratio. This is the relationship between the amount of the loan and the appraised value of the underlying collateral that secures it. Loan-to-value ratios for most types of asset-based loans fall between 50 and 80 percent of the appraised value of the collateral.

If you wished to purchase a warehouse that the bank has appraised at $10 million, and you knew that the bank’s LTV for this type of loan was 72 percent, the maximum loan you could expect would be about $7.2 million ($10 million x 72 percent = $7.2 million). This would mean that $2.8 million in cash or secondary financing would be required to buy the warehouse. Further, such payments as closing fees, loan origination fees (at 1.5 points, these alone would come to $150,000), and escrow fees would also be
drawn from the loan. The actual cash invested in the project would therefore be more than $2.8 million.

When attempting to secure mortgage financing, there are a number of considerations you should keep in mind. For instance, although mortgage loans are usually five-, ten-, twenty-, or thirty-year loans, these may represent only the period over which the loan is amortized for the purpose of computing monthly payments. It may actually be due much sooner. Second, remember that by mortgaging underlying real estate to secure the loan, you have eliminated the ability of a major asset of the company to secure other financing. In addition, the loan's conditions may restrict the uses to which you can put the property for the duration of the loan. Finally, asset-based loans, especially large ones, require time for the bank to arrange. Appraisers, market specialists, and often multileveled loan committees are involved. You will probably be required to supply the financial history of your company.

**Asset-Based Lenders**

Asset-based lenders include thrift institutions, insurance companies, and pension funds. Insurance companies usually make larger loans that are secured by class-A investment-grade real estate. The underlying property requirements for loans made by pension funds are even more strict than those for insurance company loans.

The financing of major real-estate acquisitions is frequently arranged by mortgage bankers. These specialists are skilled at packaging loans for review by potential lenders. They can also assist in negotiating loan terms.

**Government Loans and Guarantees**

The federal and state governments and their agencies often provide loans or guarantees. Appendix B identifies many of the state business-development agencies set up specifically to assist new businesses in getting off the ground.

**TIPS FOR SOLICITING LOANS**

It is crucial to assess all the costs associated with borrowing. Frequently, there are indirect costs such as opportunity costs from restrictions leveled on particular operations of the firm. In addition, some loan covenants require audited or independently reviewed financial statements and periodic appraisal reports on collateral. Since these require outside professionals, their cost should be added to the overall cost of the loan. Moreover, loan covenants and restrictions may throw the firm into default for seemingly minor infractions.

Identify all encumbrances the lender has attached to your assets as security for the loan. Lenders try to hold as many assets as possible for collateral. If you think that a loan is overcollateralized, change the terms. Instead of using blanket statements such as "all real estate assets owned by the borrower," lenders faced with astute borrowers will often prepare a collateral schedule to secure the loan.

Be aware of cross-default clauses in the lending agreement. These clauses mean that defaulting on an entirely different loan will lead to the automatic default of the loan being considered. They are used to protect lenders from being last in a line of creditors when a company goes into bankruptcy. Cross-default clauses can have a domino effect, toppling a company's entire financial structure. They can turn situations that need not have been so serious into disasters.

Finally, negotiate lending agreements on the strength of your business plan. You are borrowing because the return you expect from the funds exceeds their cost plus a profit for management's time, attention, expertise, and the risk taken. Do not be forced into providing excessive collateral or pledging your personal assets to skittish bankers. You must, however, determine the cash flow required to service the loan, and be sure the company can support the payment agreement. Remember that money is subject to supply and demand. If your company warrants the lending risk, many lenders will be willing to advance the funds. If one bank is overly cautious, others may not be.

**BONDS, DEBENTURES, AND NOTES**

Bonds, debentures, and notes may be issued in a private placement or to the general public. Although the mechanics are similar either way, a public issue requires more extensive regulatory compliance procedures. The debt issue must be
underwritten by an investment banking firm. The prospectus contains the following types of information, among others:

- Audited financial statements (both current and historical) of the issuing company, along with the auditor’s report
- Legal opinion regarding the bond issue
- Tax opinion regarding the bond issue
- Management comments on the issue, proceeds of the funds, and their intended use
- Description of the management team

In addition, if a financial forecast is contained in the prospectus, the opinion of the independent accounting firm that compiled it must also be included.

The issue must be filed with the Securities and Exchange Commission (SEC) and conform to all of its rules and regulations. The issue must also comply with the laws of each state in which it will be offered.

Fees for a public debt issue vary according to size. All the professionals involved must be paid, the financial printer must be paid (in the case of very large issues, this alone can run well into six figures), and the investment banker also gets a percentage. Frequently, the investment banker can buy the bonds from the issuer at a discounted rate and then resell them at par in the marketplace. Total fees for public issues often run 7 percent and more of the gross proceeds.

**Convertible Bonds**

To make them more attractive to investors, bonds often can be converted into the common stock of the issuing company. Of importance to treasurers and cash managers is the fact that outstanding stock is not diluted by convertible securities but rather receives market support. Further, the conversion option allows the discount at which the bonds are issued to be between 300 and 700 basis points higher than it would be otherwise (making them more favorable to the issuer).

**Call Provisions**

Many bonds can be called back by the issuer before maturity. This protects the company from having to carry bonds with a high coupon when interest rates are falling. However, the company must usually pay a price for this protection feature, known as the call premium.

The call premium pays the investor for the interest lost on a bond called early. Generally, the company must pay bond holders a price equal to the principal plus the coupon interest income lost. Over time, as the investor begins to obtain many of the promised coupon payments, the call premium declines. Companies will not call their bonds while the call price exceeds the bond’s market price. For convertible bonds, the call provision is of even shorter duration, because the bond holder gets some protection from the conversion feature.

**Industrial Development Bonds**

Over the years, the distinction between industrial development bonds (IDBs) and industrial revenue bonds has been blurred. Municipalities used to guarantee their obligations for industrial development by issuing industrial development bonds. When there was no such public guarantee, the securities they issued were called revenue bonds. Today, we call both industrial development bonds. IDBs are issued to stimulate growth through capital projects beneficial to the municipalities that sponsor them. IDBs allow private companies to benefit from the lower interest rates afforded by the tax-exempt financing of a municipal bond issue.
Chapter 6
Equity

When large amounts of capital are required for a major expansion program—such as the acquisition of a new company—floating a stock issue can be an effective way of raising the necessary funds and spreading the financial risk among a large group of investors. Capital for new companies is often provided by an initial public offering.

Stock issue programs involve either a private placement or a public offering of the stock. For smaller issues, in which only a few investors are involved, a private placement is generally faster and less expensive. However, even small, private placements require the services of attorneys, independent certified public accountants, and investment bankers. Moreover, if the private placement falls under the jurisdiction of the SEC, proper forms must be filed and the company must comply with SEC rules and regulations governing such offerings. Additionally, companies with publicly listed stock must comply with ongoing SEC rules and regulations, and these may affect management decisions.

The equity capital used to fund small start-up companies is often referred to as risk capital. There is no guarantee that the shareholders of these companies will see any return on their money, or even that they will get their money back. Furthermore, there is no ready market where the stock can be sold, should that become necessary. If a small firm is profitable, however, excess profits not plowed back into the company are distributed to the shareholders in the form of dividends. If the company really takes off, its stock may receive a listing on a public exchange and begin to appreciate. If the firm fails, the shareholders will be the last to receive any distribution, and they may in fact receive nothing.

Financing your firm with equity capital (instead of debt) requires no interest payments to lenders. If your shareholders are more interested in capital appreciation than in dividends, the cost of your capital will be further deferred until the company goes public or is sold. However, management will lose a degree of control. Chances are that the major shareholders will demand a seat on the board of directors, and most equity investors insist on annual independent audits. Finally, when shares are publicly traded, the company must comply with the rules and regulations of the securities industry. The firm may also be exposed to a stock tender offer.

The process of offering stock to the general public has become a complex one. Offerings of a substantial size require a formal prospectus to be filed with the SEC and distributed to the public. The prospectus must include legal opinions, tax opinions, and independent accounting firm opinions. The offering itself must comply with federal and state statutes.

When the issue finally goes to market, the underwriter and investment bankers must actually float the issue and make sure it is sold in an orderly manner. For the risk they take, the investment bankers get a percentage of the proceeds from the stock sale.

**TYPES OF EQUITY**

Stock is issued in either of two types: preferred and common. Specific rights and payment preferences are associated with each.
Preferred Stock

Preferred shareholders are considered to be less at risk than holders of common stock. If the firm liquidates, the preferred shareholders will be repaid their capital before those holding common stock. In addition, preferred shareholders often get a preferred dividend that is paid out before any common stock dividends. However, preferred shareholders generally do not have a vote in the selection of management and corporate policies.

Common Stock

Holders of common stock receive no preferential dividend. The board may vote to issue dividends to common-stock holders only after those holding preferred shares are paid. However, common-stock ownership does give the shareholder a vote on critical management issues and membership on the board of directors.

In combination with various options, warrants, conversion rights, and other enticements to investors, an equity offering in your company can generate the capital you need. With the creative use of common stock ownership, a financial package that provides investors the return they demand at the level of risk they are willing to take can usually be structured.

PLANNING THE CAPITAL STRUCTURE

New companies that experience rapid growth often raise the capital necessary for expansion in several tiers, called tranches. Anticipating capital requirements and designing the overall capital structure at the outset usually saves time and expense. In addition, it causes less of a disruption to the business than the effort to raise capital from scratch several times.

Investors will also be more likely to continue investing if they are shown how capital requirements will be satisfied through a long-term plan. When a request for more money takes the form of a plea for help rather than an action that was anticipated at the outset, investors may wonder how often such an emergency is likely to recur. The company will come to be viewed as a money drain offering little promise of a return.

EQUITY PARTNERS

For an entrepreneur running a small business, inviting an equity investor aboard means a significant change in management style. No longer will the entrepreneur be able to make all the decisions, since the investor will have some say in the direction and strategy of the company. The greater the percentage of ownership, the greater the influence an outside investor will have the right to exert.

Most investors require a formal position within the company. Often they demand a seat on the board of directors (or several, depending on the percentage of ownership). Some want a substantial executive position enabling them to exercise the control necessary to protect their investment. Others, preferring to stay out of the daily business operations, merely ask for a job that allows them to watch what goes on.

When taking on an equity investor, the entrepreneur must determine the degree of control this step entails. Sometimes all that is required is strengthening the internal accounting controls, hiring an independent auditor, or providing monthly financial reports. When large amounts of money (or large egos) are at stake, a complete sharing of authority may be involved. Whatever the investor wants or is likely to want should be determined before consummation of the deal. Anything less than complete candor guarantees at best a rough transition, and could cause the enterprise to fail.

SELECTING THE RIGHT INVESTMENT BANKER

Investment bankers provide an entree into the world of capital funding. Some are skilled at putting together deals and have the contacts to make things happen. The following are five qualities to look for when choosing an investment banker.

1. Personality—You may not be looking for a best friend, but, neither do you need someone who grates on your nerves. Generating equity capital for your firm will be a stressful task at best. Make sure the investment banker you hire has a personality compatible with yours and your company’s.
2. **Resources**—Be sure the investment banking firms you consider have the resources necessary to close the deal. These include analytical expertise, automated financial modeling, accounting and legal skills, creativity, and staff to draft the offering documents.

3. **Vision**—The entrepreneur needs insight into where the market is headed and how best to structure the company to compete. The investment banker must have the same vision, as well as the ability to anticipate how much capital will be required three and five years down the road.

4. **Contacts**—The bottom line for any investment banker is the ability to cultivate contacts who are willing and able to invest in your company. The investment banker must be able to package the deal, present it, negotiate it, and close it.

5. **Knowledge**—The investment banker familiar with companies that could use your technology or whose technology would be of benefit to you has a value beyond the mere ability to raise money. Major customers or suppliers may also become investors.

### SOURCES OF EQUITY CAPITAL

There are many sources of equity capital. Most are accessible to solid firms with proven track records. Some funding sources specialize in particular industries or in companies at a certain stage of development.

**Private Investors**

Private investors will probably be the most actively involved source of capital your business will encounter. They usually want a say in the firm and will not hesitate to exert their influence. Often private investors bring a particular expertise that makes them more valuable than a mere source of money.

Private investors usually take a more long-term view of the investment than a venture capital firm that needs a definite, periodic return. When future profits are likely, the private investor may not be overly worried by the prospect of short-term losses.

There are newsletters and firms that specialize in bringing together companies in need of capital with private investors. There are also groups that meet to provide a forum for business financing proposals.

**Corporate Partners**

Corporations are active in the investment field, especially in smaller ventures. They frequently are looking for an innovative idea or technology with which to expand their existing product lines. Often the smaller company provides a means of diversifying or an inexpensive way of penetrating new markets. The direct return on the investment in a smaller company may be of less concern than how it fits in with the overall corporate strategy.

**Customer Investment**

Investment by customers in companies that supply them with critical goods and services is a quick means of vertical integration, allowing the entire manufacturing process to take place within a single company. If the products you sell are in short supply, this form of investment ensures that they will be received when needed by the customer, possibly even at a discount. If the cost of your goods is high enough, such discounts alone could provide a return on the customer’s investment.

**Competitor Investment**

Investment by a competitor that is not in direct competition with your firm may be a way to open up a new market. It may also provide an exchange of resources and expertise that can make both companies more efficient in their respective markets.

**Venture Capital**

There are many venture capital firms that have developed expertise in particular industries. Often these firms provide needed start-up capital or funds for expansion. However, such participation is not without a price. Venture companies require a return for the risk they take. Management must sometimes be prepared to relinquish
a substantial portion of its ownership to attract venture capital resources.

Venture capital firms are among the most savvy investors in the market today. They generally look for a large return on capital—over 30 percent is common. Venture firms seldom make an investment without extracting a proportionate percentage of ownership (or a disproportionate share if the company is in trouble). They demand representation on the board of directors if their stake in the company is high. Often they install several of their own executives in key operating positions.

These liabilities notwithstanding, venture firms have the expertise to help a company grow and realize its greatest potential. They have been down the road of growth before. They know the problems and they know how to exploit opportunities. Unlike the entrepreneur, they require no learning curve.

Venture specialists invest money to create value through the development and expansion of an enterprise. They are less concerned with the annual return than with capital appreciation. Venture capital tends to cost the entrepreneur a piece of the company’s equity, and in the beginning this price may seem small. However, if the firm takes off and its stock becomes valuable to the general public, venture funds may end up being the most expensive form of financing.

The availability of venture capital took off in the late 1970s. Everyone was willing to roll the dice, looking for the next Apple Computer. Since then the market has shaken out the weaker players. However, there are still many sources of venture capital. Private firms offering venture funds usually specialize in a particular technology, industry, or level of risk. Investors of venture capital include banks, insurance companies, and pension funds.

It is important that you refrain from papering the landscape with your business proposal by presenting it to every venture firm you can think of. Generally, these firms are not inclined to enter into a bidding war with other venture companies. Keep the number of firms looking at your proposal to three or four at a time.

Management Buy-outs and Buy-ins

Managers often want to buy into the company that employs them. They may see potential where the owners do not. During the 1980s, management buy-ins were often accomplished using leverage, whereby the existing or new management bought all or part of the company.

Leveraged buy-outs (LBOs) often involved the floating of huge securities issues (stocks and bonds), and were some of the most complex financial transactions in history. Frequently they were financed with high-yield (junk) bonds paying premium coupon rates. The new owners’ strategy was to sell part of the company, reduce the debt, and refinance when interest rates were lower.

Today the popularity of LBOs has dwindled. Investors are less likely to take the kind of risk this form of acquisition and financing involves. Still, with the right combination of business, management capability, and financial resources, an LBO can infuse needed capital into a firm while changing its ownership at the same time.

Public Stock Offerings

Companies with an established track record and solid growth potential usually need to raise large amounts of expansion capital. This often can be done in the public market through a stock offering. Public offerings are expensive and require the guidance of seasoned professionals. To be cost effective, they must raise several millions of dollars.

For a small firm, the first stage in going public might be to issue stock in a private placement to a small, select group, rather than to the general public. As the company grows and develops a financial track record, demand for its stock may also grow. As it expands in size and financial requirements, it might arrange for a listing on the NASDAQ market for over-the-counter trading. This will expand the trading market for its stock. As the company grows larger still, it may receive a listing on the American Stock Exchange and eventually on the New York Stock Exchange.

A stock issue for a new company is called an initial public offering (IPO). The market for IPOs has died away since its zenith in the 1980s, but for some companies this can still be a viable way to raise capital.

For venture capital investors, cashing out often requires that they take their companies public. Indeed, a public offering has frequently been their goal from the beginning.
With listing on a public exchange comes public disclosure requirements. The firm will undergo an annual independent audit, the results of which are publicly disclosed. It will also probably be required to issue quarterly financial results. Management must adhere to new insider-trading rules and comply with the requirements of the SEC and the National Association of Securities Dealers, as well as the rules of the stock exchange on which its stock is listed.

**TIPS FOR RAISING EQUITY CAPITAL**

Choose an equity partner who possesses not only capital, but also goals for a return that meets the firm's capabilities.

The period when capital is being raised is also a good time to increase management expertise and business capability. Many equity partners can provide this service as well as money. Other entrepreneurs who have raised equity capital may also be able to give you advice about potential hazards and opportunities.

There are no prizes for failing to meet your objectives. A realistic financial plan for the use of the additional capital is crucial. Potential investors will reach their decision at least in part on the basis of that plan. If it fails to anticipate future requirements and you must go to the equity market to raise additional funds later on, your position will be weakened.

Do not ignore the possibility that additional capital will be needed as the business expands. The equity partner you choose must have the capacity and willingness to provide those funds when the time comes. Be sure to structure the equity offering so that it takes into account the firm's overall long-term capital requirements.

Finally, be sure to allow enough time to raise the equity capital. This is a long, involved process, particularly if you are floating a public stock offering.
Chapter 7
Leasing

Leasing does not require a large cash outlay. Leases are typically used to obtain cars, trucks, rail stock, large overseas shipping containers, and other durable capital goods. Equipment-lease contracts run between three and five years, while those for assets such as buildings can be for ten years or much longer. Almost anything can be leased, from aircraft and computers to the fire sprinkler system in your office.

Providing you have a credit-worthy business, leasing agreements are easy to arrange. However, the actual costs of financing and the interest rate you will end up paying can be tricky to compute. Further, there are usually stiff penalties for breaking a leasing agreement.

LEASE TYPES

Leases fall into two categories: financing leases and operating leases.

Financing Leases

These are devices by which the lessee can eventually own the leased asset. They operate exactly as if the asset belonged to the lessee. In this sense, many financing leases are triple-net leases; that is, the lessee takes responsibility for all repairs, maintenance, and insurance. However, the asset continues to legally belong to the lessor. The provisions of a financing lease frequently include a bargain-purchase option at the end of the lease. Property under a financing lease is counted as an asset on the balance sheet and depreciated. The terms of the lease are disclosed in the notes to the financial statements.

Operating Leases

These are simply rental contracts that run for a specified period of time. The lessee does not own the asset at the expiration of the lease and does not record the operating lease as an asset on the balance sheet. Payments are expensed in the year they were incurred. A leased asset never legally belongs to the business, although the lessee may receive the bulk of any sale proceeds at the conclusion of the contract.

SALE-LEASEBACK

An alternative method of generating capital from long-term durable assets such as buildings is sale-leaseback. The owner sells the asset to an investor and then leases it back. In this way, the firm produces needed cash from an otherwise dormant asset. In the case of significantly appreciated real estate, the generated funds can be substantial, and the firm still can benefit from the use of the asset. From an operational standpoint, nothing has changed.

The cost of sale-leaseback compares favorably with both mortgage rates and the other traditional methods of raising capital. Be aware, however, that the sale involved in a sale-leaseback can generate substantial capital gains. Depending on the company’s other capital gains and losses, these can have a significant impact on the tax situation.

TIPS FOR NEGOTIATING A LEASE

First, determine whether your accountants classify the lease as an operating lease or a financing
lease. This affects the depreciation and reporting of the asset in your financial statements. Then determine the actual interest rate being paid under the lease contract. Compare that with the rate you could obtain if you borrowed the money and bought the asset instead. If you have the cash to acquire the asset without outside financing, the cost of capital and the return you would get with those funds should be the benchmark against which you measure the interest rate under the lease.

Remember that a triple-net lease requires you to pay for everything. The terms of the lease should disclose the lessor's and lessee's responsibilities for maintenance and operation of the asset. Lease payment escalation clauses and pass-throughs are other costs that you should anticipate from the outset. It is important to determine if these vary over the course of the lease.

The tax implications of the leasing contract also deserve consideration. You may be able to obtain use of the asset and receive favorable tax treatment at the same time if the lease is structured correctly.

Leases are complex legal documents. Their terms and ultimate costs can vary greatly. Shop around at several leasing firms. The lowest interest rate quoted is not always the best deal. Many variables are involved in a lease, and you must be sure you are not comparing apples and oranges when evaluating leasing proposals.
## Appendix A

### Financing Checklist

<table>
<thead>
<tr>
<th>Fundamentals</th>
<th>Funding structure</th>
<th>Soft loans and grants</th>
<th>Internal funding</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Consider your objectives.</td>
<td>- Consider how you might increase the business's own resources.</td>
<td>- Be innovative in searching out and using all forms of subsidized assistance.</td>
<td>- Consider the effect factoring may have on your other funding opportunities or on existing arrangements.</td>
</tr>
<tr>
<td>- Plan ahead to ensure you have adequate time for negotiating.</td>
<td>- Match the type of funding to the needs of the business.</td>
<td>- Approach these sources first.</td>
<td>- Ensure that the credit limits on each account will match your borrowing needs as the business expands.</td>
</tr>
<tr>
<td>- Consider the strengths and weaknesses of the management team.</td>
<td></td>
<td>- Don't start the project until you actually have the funding.</td>
<td>- Consider the administrative consequences of factoring.</td>
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<tr>
<td>- Present an enthusiastic plan, but be realistic in your figures.</td>
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<thead>
<tr>
<th>Debt</th>
<th>Equity</th>
<th>Leasing</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Take account of all the costs associated with borrowing.</td>
<td>- Negotiate the right deal structure.</td>
<td>- Look carefully at the tax consequences of leasing.</td>
</tr>
<tr>
<td>- Match short-term needs with short-term debt and long-term needs with long-term debt.</td>
<td>- Remember the venture capitalist's need for an exit route.</td>
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</tr>
<tr>
<td>- Ensure that you understand the consequences of all the clauses in a loan agreement.</td>
<td>- Choose an investor with whom you will feel happy to work during the period of the investment.</td>
<td></td>
</tr>
<tr>
<td>- Consider the tax and cash flow implications.</td>
<td>- Check that the investor will be able to provide additional funds, at what cost, and what the implications will be for the control of the business.</td>
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<tr>
<td>- Discuss your needs with two or three lending institutions to obtain competitive quotations.</td>
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*Appendix A: Financing Checklist*
Appendix B

State Business Development Corporations

BUSINESS DEVELOPMENT CORPORATIONS

A few states have Business Development Corporations (BDCs). The task of BDCs is to increase the number of jobs through business development. Here are the names and addresses of some of the BDCs:

First Arkansas Capital Corp.
910 Kand Bldg
Little Rock, AK
(501) 374-9247

The Business Development Corp. of Georgia, Inc.
4000 Cumberland Pkwy, Suite 1200A
Atlanta, GA 30339
(404) 434-0273

Iowa Business Development Credit Corp.
901 Insurance Exchange Bldg
Des Moines, IA 50309
(515) 282-2164

Kansas Development Credit Corp.
First National Bank Tower, Suite 1030
Topeka, KS 66603
(913) 235-3437

Maine Capital Corp.
70 Center St
Portland, ME 04101
(207) 772-1001

Massachusetts Business Development Corp.
One Liberty Sq
Boston, MA 02109
(617) 350-8877

Mississippi Business Investment Program
P.O. Box 849
Jackson, MS 39205
(601) 359-3449

Development Credit Corp. of Montana
P.O. Box 916
Helena, MT 59601
(406) 442-3850

Business Development Corp. of Nebraska
1044 Stuart Blvd
Lincoln, NE 68508
(402) 474-3855

New Hampshire Business Development Corp.
Associated General Contractor’s Bldg
Fort Eddy Rd
Concord, NH 03301
(603) 224-1432

New Mexico Business Development Corp.
6001 Marble, NE, Suite 6
Albuquerque, NM 87110
(505) 268-1316

New York Business Development Corp.
41 State St
Albany, NY 12207
(518) 463-2268

North Dakota State Development Credit Corp.
P.O. Box 1212
Bismark, ND 58502
(701) 223-2288

Business Development Corp. of South Carolina
111 Executive Center Dr, Suite 225
Columbia, SC 29210
(803) 798-4064

Wyoming Industrial Development Corp.
P.O. Box 3599
Casper, WY 82602
(307) 234-5351
Some private corporations and foundations award grants for R&D. These include the Ford, the Rockefeller, the Kellogg, and the Carnegie foundations.

The federal government has many programs. The National Science Foundation awards funds regularly for research. The Small Business Innovation Research program, the Small Business Administration, and the Department of Energy all provide grant programs and loans.

Some states provide funding for R&D that could lead to jobs in the state. Connecticut, for example, grants up to $350,000 for new-product development that leads to the employment of scientists in the state.

Various urban areas sponsor grant and loan programs. One such program is the Urban Development Action Grant, with $450 million available annually.
Appendix D

Suggestions for Further Reading


Glossary

**APR.** Annual percentage rate of interest. The law requires that this be disclosed to borrowers. For comparison purposes, APR is the most useful price index of a loan.

**Balloon payment.** A large lump-sum loan payment made at a specified point in time. Generally balloon payments repay the loan in its entirety. Typical loan terms requiring a balloon payment would be a thirty-year amortization due in five years. The thirty-year amortization is the term used to calculate the monthly payment; the longer the amortization, the lower the monthly payment. However, with smaller monthly payments come larger balloons that must be paid well before the amortization period.

**Base rate or index rate.** The rate on which floating-rate loans are based. The index may be one of a variety of interest rates such as the Federal Reserve’s 11th District cost of funds, the prime interest rate, the Federal Funds rate, and the London Interbank Offered Rate (LIBOR). The actual interest rate charged for the loan will be a spread over the index rate. Choice of the index rate is important in matching a movement in interest rates—and therefore the cost of your funds—with the income generated from use of the funds.

**Capitalization.** Purchased assets that are treated as capital assets and depreciated over the course of their economic lives. This allows a company to spread out the expense of a major asset over its useful life, instead of concentrating it in the year of the purchase. There are several common ways to depreciate an asset: straight line, sum of the year’s digits, and declining balances.

**Convertible.** Generally, a feature allowing for conversion to either equity (stock) or debt (bonds and notes). Convertible preferred stock may be swapped for common stock at a specified point in time and at a specified ratio and price. Bonds may be convertible to common stock.

**Cumulative.** Commonly applied to preferred stock dividends. Dividends not paid are carried forward (accumulated) and must be paid to preferred shareholders before any profits are distributed to the holders of common stock.

**Development capital.** Capital specified to be used for growth or expansion of established businesses. Such capital is less risky because it funds a company with a known record. It is usually easier to raise than start-up capital.

**Exit route.** The method of cashing out of an investment. The exit route for venture capital often involves taking the company public or selling it to a single buyer.

**LIBOR.** London Interbank Offered Rate. This common index rate is actually the rate at which London banks lend to each other. LIBOR is often used as the base or index rate for European capital funding American business. LIBOR moves as the European money market moves.

**Loan payment holiday.** A specified period between the date the loan is taken and the commencement of payments.
**Mezzanine debt.** The second tier of capital. Considered to be less risky than start-up or seed capital, it is generally used to finance the expansion of a company.

**OTC Stocks.** Over-the-counter stocks, generally those of smaller companies. A national over-the-counter market is publicly quoted in the press.

**Placing.** The selling of shares by an investment banker to selected buyers such as financial institutions or private individuals. Generally, placing refers to smaller issues with a small number of investors. For example, a private placement of stock may be limited to solicitation of just thirty-five investors.

**Public offering.** An issuing of stock to the public. The investment banking house that has underwritten the stock offering maintains an orderly market for the stock and manages the sale to the public. Usually large public offerings have several co-managers who take the risk of maintaining the price of the stock issue.

**Ratchet.** A mechanism whereby management’s equity percentage increases with improvements in performance. Ratchets normally permit movement in just one direction.

**Seed capital.** Funds for early development of an emerging enterprise. Often seed capital is used for the research and development of a product around which a new company will be built.

**Senior debt.** First in the line of creditors awaiting repayment in the event of default. Senior debt is considered more secure and, therefore, usually carries a lower interest rate than debt that is subordinated to (stands behind) the senior debt.

**Soft loans.** Loans of which the interest rate paid is less than the market rate. Soft loans are subsidized by a third party, often the government or one of its agencies.

**Start-up.** A completely new enterprise. Start-ups most often require seed capital, followed by venture capital.

**Stock subscription.** The promise to purchase a given number of shares when a stock is issued. The investment banking house obtains subscriptions from reputable customers to guarantee the sale of the stock.

**Venture buy-out (VBO).** An early buy-out of a start-up company by the venture capital suppliers. Also known as a flying start-up.
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