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Business Financing Guide

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Introduction

This guide was compiled and written to offer business owners and managers a concise overview of the key concepts and considerations which, if understood and used, could substantially increase the likelihood of obtaining business financing.

The vast majority of all proposals and requests which are submitted to financing sources are eventually turned down for a wide variety of reasons including, but not limited to, the following:

1. they are submitted by small business concerns which have access to, in the final analysis, less than 10% of the total capital markets (which are dominated by big business);

2. they are submitted in a manner which is not professional or which does not permit review and analysis by a lender or investor in accordance with generally accepted lending procedures or investment criteria;

3. they propose a lending or financing arrangement which is simply not compatible with a reasonable assessment of the risk involved on the part of the lender or investor; and/or

4. they are not adequately secured or collateralized in a manner which can protect the lender or investor in the event of default.

The unfortunate reality, therefore, is that most business owners and managers, in their effort to obtain financing, step up to the plate with two strikes against them. They are simply not aware, and not prepared for, the standards they will be expected to meet in order to obtain the financing they need.

In response, business principals often seek the assistance of other professionals (attorneys, accountants, consultants, brokers, etc) which can produce results ranging anywhere from a blessing to very unsatisfactory.

Why?

Most outside professionals are, in fact, interested in helping their clients obtain financing by providing their technical expertise (ie: providing financial statements and information, providing legal help and opinions, assisting in the application process, etc.). However, there are many who are primarily interested in obtaining points and fees for very little work. Almost every business principal who has been looking for financing for an extended period of time can relate an experience of getting ripped offin the financing process .

In and of itself, this fear of brokers creates another dilemma in the financing process: business principals don't want to pay any front fees for assistance with the preparation of financing proposals, costs and expenses of negotiations, and other reasonable costs associated with the financing process unless they are guaranteed that the given financing will be successful.

On the other hand, professionals who are capable of helping understand that (1) there is no such thing as a guarantee until all the due-diligence is completed and (2) they deserve to get paid for the work they do whether or not a deal closes.

The result can be a Mexican standoff with the deal put into suspended animation. The borrower agrees to pay a broker a contingent fee only and the broker, not wanting to spend a lot of time and effort on a deal which might not close, chooses to pass the deal on to another broker. etc. Soon the deal becomes characterized as being shopped around and nobody wants to touch it.

We've seen this happen many times.

The reason this problem is emphasized here is that this guide provides the real solutions to the problem:

1. It will give you enough foundation information so that you can ask the tough questions when dealing with third parties or intermediaries;

2. It will give you some insight and suggestions about how to seek financing without exposing yourself to some of the traditional pitfalls; and

3. It will enable you to trouble-shoot your own financing proposal before it's too late.

Adequate financing is crucial to the very existence of a business. The reason business owners and entrepreneurs work so hard to keep one step ahead is because they know it's curtain time when they run out of cash. Businesses survive in the midst of incredible adversities; but not without cash.

There is hardly a business in existence which has not experienced cash flow problems at one time or another. It's a phenomenon that comes with the territory. Perhaps the one operating characteristic that distinguishes big business from small business is working capital: big businesses have it and small businesses don't.

Outside of winning the lottery or having a rich relative provide a cash boost that is needed, a business owner's ability to obtain adequate financing will dictate whether or not the business will survive. Even more difficult to swallow is the fact that, in the final analysis, if a business owner obtains financing or funding in any manner that cannot eventually be repaid out of earnings, the business will not survive.

Millions of businesses will go out of business in the next year because of the lack of adequate financing. By the very fact that you have taken this small step in the business financing process, you have improved your odds of continued or future success.

We sincerely hope that this guide will provide a valuable insight and positive step forward in the successful financing of your business.

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The Basic Financing Options

In the final analysis, there are only four basic ways that your business can obtain more money:

1. by increasing profits;
2. by increasing equity or capital contributions;
3. by borrowing; and
4. by selling assets.

These sources of money correspond to the major areas of concern most lenders and investors have about any business in which they might put some money: Is the business profitable? How much does the owner have at stake? How much debt does the business have? What does the business have for assets?

Therefore, each of these methods of raising money has some profound implications, especially in the eyes of a lender or investor, of which you must be thoroughly aware in your search for the right financing. These implications are best understood by asking yourself the following questions:

A. What am I really gaining?
B. What am I really giving up?
C. What will be the real effect on my business?

These questions seem simple and obvious, but history has proven that financing can just as easily be the key to failure as the key to success. The reason is this: If the result of financing only serves to add steam to the pressure cooker instead of providing for increased profits, cash flow, and/or other financial and operational gains and advantages; then the financing will pave the way for bigger problems and the need for greater amounts of funding, etc.

Below are some actual examples of how financing has created business failures:

Example A

A seafood broker was making, in the final analysis, 5% on his sales. In order to obtain money to expand, he accepted a factoring arrangement for his accounts receivable which cost him 1/10th of 1 percent per day. He was attracted by the idea that he didn't have to wait for his money. What he didn't figure out (until it was too late) was that (1) the cost of the factoring wiped out more than half of his total profit margin since his average receivable was paid in 30 days (that's 3%) and (2) he was only advanced 70% of a given invoice anyway; which means that his actual cost was more like 4.5%.

Bottom line*: He gave the factoring company 9/10 of his profit margin. They are still in business but he is not.*

Example B

A wholesale distributor who was just barely breaking even was convinced that, if he could invest $10,000 in a promotion push, new customers and increased sales would provide economies of scale which would increase margins. The result was that he spent $10,000 to create negative margins because of unanticipated and increased costs of operation resulting from the new sales.

Bottom line*: He lost his house and his business by borrowing $10,000.*

The common thread which runs through these examples is that generating profit in business is everything. Most other approaches usually fail. Therefore, your first consideration about raising money is to make sure that its use will contribute to increased profits and/or cash flow. If it doesn't, you may find yourself just buying time and, possibly, a bigger headache than the one you were trying to alleviate to begin with. If you use someone else's money to dig a deeper hole, you are asking for trouble.

On the other hand, here's an actual example of a very prudent and well-thought financing which, on the surface, didn't seem that good:

Example C

A non-bankable, small building contractor needed $60,000 to build a house for a customer. She was offered a construction loan at 3% per month. Everybody told her not to do it. Instead, she obtained a sales contract with a deposit on the house, borrowed the money at the high rate, built the house in 2 months and closed on the sale for $120,000.

Bottom line*: She made over $30,000 on the deal and she's building another house which is also under contract.*

In any event, here are some basic rules which, if you follow, will pay you big dividends in your business financing arrangements:

1. Don't speculate on your ability to repay debt without, at the very least, a well thought and comprehensive cash flow projection.

2. Don't borrow or invest if you can't prove to yourself that future business will be profitable.

3. Don't ask someone else to lend or invest money that you wouldn't lend or invest if you had it.

The following sections will discuss key concepts and considerations which might contribute to your strategy and decisions with respect to future financings.

Increasing Profits

We've included this section not because we can offer any great insight on specifically how to increase profits in your particular business, but because the failure to address and assess profitability as part of almost any financing or refinancing proposal is often the reason that a given financing is unsuccessful.

Another way to put it is this: If a business is not doing the types of things that enhance profitability, then the business is also less likely to be successful in meeting its debt obligations. Almost all lenders and investors know this. It is precisely what they are referring to when they say they need to feel comfortable with a deal. It's hard to feel comfortable lending or investing money in a business that doesn't show inherent profitability.

It is important, therefore, to be able to prove to any lender or investor that your business is profitable and that the particular financing will increase, or at the very least, enhance its profitability. You must be able to prove your case in terms of standard and accepted lending practices. Unfortunately, this area is where many entrepreneurs simply come up short. They are simply not able to translate their need for financing into a healthy argument expressed in terms that a seasoned lender or investor will respect and understand.

Here's a case study which provides an excellent example:

> *Health care company X was in the business of renting certain types of medical equipment to its customers. The company made money by financing the cost of the equipment such that the monthly payment they received for renting the equipment was greater than the monthly payment to buy the equipment. Therefore, if the company could buy, for example, an oxygen concentrator for $40 per month (and eventually own it free and clear) while renting it out for $60 per month, then the company felt it was in good shape because it appeared on the surface to have a 50% gross profit margin and, in addition, continually gaining equity in its equipment inventory.*
>
> *Eventually, the firm was grossing in the neighborhood of a million dollars per year and its debt service (monthly payment amount) on its equipment inventory was approximately $25,000 per month. This was viewed as excellent and the owner proudly told his creditors and other associates that his business was becoming MORE profitable because more and more of the equipment he rented was owned free and clear. He started to expand into new equipment lines and into new geographic areas of distribution.*
>
> *Soon he was unable to meet his debt service. He had trouble meeting his payroll. He dipped into his withholding account to pay some urgent bills.*
>
> *What happened?*

The effect of several negative factors, all related to the calculation and assessment of actual profitability, caught up with him all at the same time:

1. That 50% profit margin wasn't really there to begin with because he didn't factor in the deposits he made on the purchase of equipment, the cost of servicing equipment and accounts according to industry regulations, and the increasing costs to compete in an industry dominated by larger firms.

2. Too much of his existing financing for equipment was short term with a comparatively high rate of interest. Extending the term of his equipment financing to 5 years would have cut his debt service in half.

3. His marginal costs of expansion were too high: phone bills in the thousands; new vehicles, more travel, increased servicing and sales costs, etc.

4. Receivables and collection costs went up at a time when he needed cash the most.

All of these factors contributed to a general difficulty in getting refinanced due, to a large extent, to the fact that he couldn't prove his case regarding profitability.

The lesson to be learned from this example is simply that the first step in approaching any lender or investor is to make sure the lender or investor can see that a proposed loan or investment will have a positive effect on the financial condition of the company. The most positive effect a loan or investment can make is to increase a company's profitability.

Here are some situations, however, which raise red flags in the minds of lenders and investors; and which you should understand thoroughly when explaining why your business needs more money:

1. ***Cash Flow***
   "I need more working capital to improve the cash flow in my business" is probably the number one reason cited by small business owners for needing financing.

   If you make this statement, make sure you back it up with exactly how. For example, don't merely request money for advertising. Be explicit about the type of advertising, the expected results and costs, the economies of scale which you can take advantage of, the long term effects, and the amount of increased profit you can generate. If you can't, or don't, put these details on paper, a lender or investor knows that the real probability of it happening is slim.

2. ***Expansion***
   "I need money to expand". This declaration probably ranks number two on the entrepreneur's wish list.

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> It sounds good because it connotates that more money will automatically be made by the business and it takes advantage of an almost universal misconception that bigger is better. In most cases, the flaw in this argument is two-fold: First, if the business isn't profitable before it expands, expansion might result in only the opportunity to lose MORE money. Second, a larger
>
> business is not necessarily a more profitable business. In fact, it may be just the opposite. Expansion is one of the more common reasons for a trip to the bankruptcy court.

The bottom line with respect to the issue of probability and its inter-relation with obtaining financing for your business is simply that lenders and investors don't ever assume that any business is going to be profitable in the future. You have to show them exactly why their money will make you more money because, if you don't, they won't feel comfortable that you can repay them.

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Increasing Equity Or Capital

Equity can exist in a variety of forms. It could be money that a company earned and left in the business. It could be money that the owner(s) of a business put in the business to get it started. It could be the difference between what was paid for an asset owned by the business as compared to what the asset is really worth. It could be what the business is worth.

One of the most fundamental equations in business is the one from which a balance sheet is derived:

ASSETS = LIABILITIES + NET WORTH

The effect of this formula is so great that it, literally, forms the basis for the world economy by defining the basis for speculation of the value of a company's shares as traded on stock markets all over the world. On a much, much smaller scale, it can also be the key to how an investor perceives your company and the apparent risk versus the possible return to be realized by investing in your company. Invariably, more equity means more financial strength and more financial flexibility. However, if your plan is to increase equity by having other people put their money into your business, you also create the necessity to address some extremely crucial considerations:

1. Outside equity dollars create a claim on the ownership of your company. You now have a partner, whether you want one or not.

2. That partner's (or shareholder's) rights are protected by a myriad of state and federal laws and regulations which you must comply with.

3. Selling shares in your company makes you accountable to the shareholders and, accordingly, can take away some of the benefits of being your own boss.

On the other hand, outside equity dollars can provide the following advantages:

1. Equity dollars, generally speaking, do not have to be repaid on a fixed schedule. Rather, payments to equity participants are made out of profits.

2. Equity dollars cannot help but improve the financial structure of a company and, therefore, increase the likelihood of obtaining other types of financing.

3. Equity dollars contribute to profitability since they eliminate interest expense that would have to be paid on the same dollars if borrowed.

A specific point should be mentioned here. The best of both worlds is possible when the owner of a business has the ability to personally provide the equity dollars needed for his business. However, it should also be noted that an investor is likely to balk if he knows that he is asked to invest dollars that the owner is not willing to invest in accordance with the same terms and conditions. Entrepreneurs are notorious for expecting investors to do things with their money that the same entrepreneur would never even consider.

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The following chart illustrates the basic differences between equity and debt financing (which will be discussed in the next section):

ITEM COMPARED	EQUITY FINANCING	DEBT FINANCING
MATURITY	Has no maturity	Must be repaid at a specific time and/or on a specific schedule
CLAIM ON INCOME	Residual claim at the discretion of management	Priority claim which must be paid as a set obligation
CLAIM ON ASSETS	Residual claim	Priority claim on default
VOICE IN MANAGEMENT OF COMPANY	Yes; but may be restricted for certain shareholder classes or limited partners	None except under defined circumstances in loan agreement or default

Therefore, if you are going to seek outside equity dollars for your business, the following steps are well advised:

1. Prepare a business plan and share it with your prospective investors;

2. Check the state and federal securities laws that are applicable to the transactions you envision;

3. Don't make a securities offering if you are not 100% sure you are in compliance with the required disclosures, registrations, and other prerequisite filings.

4. Make sure that any financial or operational information you disclose does not contain any material errors or omissions.

Also, be sure to avoid the most common misconception about selling stock in your company: that it represents free money since it doesn't have to be paid back unless profits are realized. Equity investors think in terms of making multiples of their money.

A special note should be made here regarding Small Corporate Offering Registrations (SCOR). Since 1989, more than 35 states have approved the sale of stock in small firms via SCOR filings. In essence, the SCOR filing is like a do it yourself IPO (initial public offering); permitting companies to raise up to $1 million annually. The SCOR filing is a simplified disclosure which is exempt from SEC filing. The document is referred to as Form U-7 and it consists of 30 pages in question and answer format which can be completed by a company owner or entrepreneur with the help of an attorney and accountant who may not be securities experts. Its uniform nature makes it much more practical than other exempt filings which have existed since 1982. Additional information may be obtained by contacting the North American Securities Administrators Association (NASAA) at 750 First Street, N.E., Suite 1140, Washington, D.C. 20002 (202) 737-0900.

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Lastly, don't be blinded by your emotions and your sweat equity when determining what the equity in your company is really worth. Be up front about the degree of speculation you are looking for in equity investors and be prepared to prove your case, at least, on paper.

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Borrowing

For the most part, borrowing money is the method most business owners rely on the most in order to capitalize or finance their business operations. Traditionally, lenders have applied the five C's of lending to determine if a business principal is qualified for a loan:

1. **CHARACTER**
   Is the principal going to repay the debt?
2. **CAPACITY**
   Can the borrower perform (ie: generate the cash flow and circumstances necessary to repay the debt)?
3. **CAPITAL**
   How much does the borrower have at stake?
4. **CONDITION**
   What is the current financial status of the borrower?
5. **COLLATERAL**
   How is the lender going to get the money back if the loan is defaulted?

In assessing the viability of a loan, lenders also look at key ratios. or comparisons. that exist in a borrower' s financial information. The following chart will serve to familiarize you with basic ratios and what a lender's objective is in looking at them:

Objective	Ratio(s)
Measure Liquidity	Current Ratio (Current Assets over Current Liabilities) Quick Ratio (Current Assets less Inventory over Current Liabilities) *NOTE: If your current ratio is less than 1.00, it means that you can't pay your bills. Lender 's lookfor a current ratio of 2.00 to 3.00.*
Evaluate Operations	Inventory Turnover (Sales over Inventory) Average Collection Period (Receivable s over Sales per Day) Asset Turnover (Total Assets over Sales) *NOTE: Higher inventory and asset turnover are usually best; as with a shorter average collection period.*
Evaluate Financial Strength	Capitalization Ratio (Total Debt over Capital) and (Equity over Capital) *NOTE: Too much debt in comparison to capital is not good; and capital which has eroded is not good.*
Determine Profitability	Return on Equity (Net Income over Owner's Equity) Gross Profit Margin (Gross Income over Sales) *NOTE: A business which is not profitable is a poor lending risk.*

Another ratio which you will frequently come across is the debt service ratio. When a lender says he wants a debt service of, for example, 1.25, it means that there should be $125 available to service every $100 of debt payment.

Therefore, if a loan requires a monthly payment of $400, the lender wants to see that there is at least $500 available to make that payment.

The basic factors which comprise a loan transaction are the following:

Principal	Amount How much money is being borrowed?
Interest Rate	How much is the borrower paying for the use of the money?
Term	For what period of time is the money borrowed?
Security	What is the collateral for the loan?
Conditions	What other conditions are imposed upon the borrower?
Costs	What other costs are involved in addition to interest?

A common pitfall among business owners and managers is the failure to read and understand the loan documents which they sign. It is no accident that lenders, both private and institutional, will spend weeks of analysis and due diligence in approving a loan and several days preparing loan documents; but act inconvenienced or even balk at the idea of a borrower having a complete set of closing documents to review before a closing. In fact, most borrowers see the closing documents for the first time when they show up at the closing and, because they don't want to upset the apple cart, they proceed to sign without thoroughly reading, asking questions, and/or discussing items they feel should be changed. Lenders know that time is usually of the essence and that the greater the urgency to close on the part of a borrower, the greater the likelihood that the lender's closing documents won't be challenged.

This creates a very unfortunate situation for the borrower because even a straightforward loan can be evidenced by a stack of documents which can contain crucial terms and conditions of which a borrower might not even know about.

The following is a basic checklist of items which borrowers sometimes don't pay enough attention to, if any, at closings; together with some comments about the implications which can result:

1. **Liability On The Debt**

> Who are the specific parties that are liable? In what specific capacity is each party to the debt signing? How is each party exposed by signing?
>
> Regardless of the nature of a debt, or the collateral which may secure the debt, when a party signs (could be as a maker, co-maker, co-signer, guarantor, etc) in a given capacity, that party is exposing the corresponding assets. Even if the proceeds of a loan are used for business purposes, if you sign personally, you are exposing your personal assets in the event that the debt obligation is defaulted upon. Many business borrowers mistakenly believe that creditors

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MUST go after the collateral or assets of the business first. The reality is that the creditor is going to take the path of least resistance if a legal action has to be taken to collect a debt. In many cases that path leads, literally, to the front door of the business owner's house.

This is not to suggest that a lender doesn't have the absolute right to require personal, or additional signatures, on a given debt obligation. The point is that you should be absolutely aware, and in agreement, well in advance of a closing so that you can make an informed and intelligent decision about if and how to proceed. It's way too late when the creditor's attorney is asking a judge for an exparte attachment on your house because your business defaulted on an equipment lease and personal liability is asserted.

2. **Security Agreements**

What is the specific collateral for the loan? What additional obligations does the collateral create for the borrower? What specific rights does the creditor have with respect to the collateral in the event of a default?

If you are financing the purchase of a specific piece of equipment, the security agreement is likely to be very straightforward; especially if the equipment is a titled vehicle. If you don't pay, the vehicle is repossessed, sold, the debt is paid off, and you get anything left over after costs.

However, consider this scenario: You borrow a $100,000 form a bank. They take everything your business owns for security, both real and personal property, and they file UCC's which include property hereafter acquired.

This type of arrangement can become a nightmare as time goes on for several reasons:

A. The bank may not release a given piece of equipment, or a vehicle, when you want to replace, upgrade, trade, or sell it.

B. As the loan is paid down, it may become over-collateralized; meaning that you aren't getting your money's worth out of your assets.

C. Such an arrangement could prevent you from getting any other financing without paying off the creditor in full.

3. **Rates And Costs**

How much are you really paying for the money? Are the costs in line with your understanding? Have additional costs been added to the deal?

Don't be afraid to challenge the following items if you encounter any surprises at a closing:

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A. **The interest rate**
Even a fraction of a percent can mean a lot of money that you have to pay over the course of a loan. Also, if the lender is selling your note, an extra 1/4 or 1/2 percent means he makes hundreds, if not thousands, of extra dollars. Fight for it if it's not exactly what you anticipated. Also, do not accept prepaid interest charges for any period prior to the time the loan proceeds are disbursed. This often happens when a loan closing is delayed for a few days.

B. **Points, processing fees, loan discount fees, origination fees, brokerage fees**
These fees can mean thousands of extra dollars being paid at a closing if you don't catch them. For example, lenders will say "no points" and then charge a processing fee. They'll say "no brokerage fees" and then charge an origination fee. Again, if you didn't know about these fees in advance, don't be afraid to fight for their removal. You're going to be the one making the payments.

C. **Attorneys fees**
We've seen thousands of dollars added on for who knows what in addition to fees for title exams, document preparation, and other legal costs.

4. **Restrictive Covenants Or Agreements**

Does the financing arrangement come with any contingencies you can't really live with? Are you giving the creditor control which could hurt you or your business?

Here are some common restrictions which are often found in loan agreements:

A. You can't raise your salary until the loan is paid off.

B. You have to maintain a certain cash position, or debt service ratio, during the course of the loan.

C. You have to file financial statements with the creditor on a continuing basis.

What these types of thing s really mean, in essence, is that the borrower is working for the lender until the loan is paid off and you can't make any major financial moves without the lender's permission.

Therefore, getting into bed with the wrong lender can result in your business on the auction block for pennies on the dollar. It happens every day.

Here are some suggestions on how to prevent a host of headaches related to business borrowing and debt transactions:

1. Familiarize yourself with the standard debt instruments and agreements which are generally used in business. These include promissory notes; security agreements (including mortgages); lease agreements for real estate, equipment, and vehicles; assignment agreements (for rents, contract rights, accounts receivables); loan agreements and compliance agreements; and closing statements.

2. Familiarize yourself with applicable statutes and laws related to borrowing, collections, secured transactions, etc. (including the Uniform Commercial Code). Most libraries carry a copy of the state's statutes. Three or four hours could make all the difference in the world. You'll be surprised what you'll be able to find out with very little effort or searching.

The final area of discussion in this guide about borrowing relates to current trends in the marketplace which might affect your strategy and approach to borrowing money for your business.

One trend is that more and more business loans are being made by private and institutional parties that are not banks.

This may be a reflection of the fact that banks are simply not able to be close enough to the majority of small business concerns so that they can be competitively responsive to their needs. Many business owners and managers simply can't endure the typically drawn out due-diligence process that has traditionally characterized bank transactions. Instead, business principals are opting to pay higher rates and costs for faster and more palatable financing arrangements.

Another trend is that business lending is becoming focused on collateral. Many new players deal in a particular type of collateral because they are extremely knowledgeable about its value, rate of depreciation, re-sale, etc. Consequently, they are ready to deal immediately and are less concerned about a default. In fact, finding a single lender to make a single loan on several different types of collateral is becoming all but impossible unless the loan is for a million dollars or more.

Perhaps one final observation is that business principals are beginning to recognize that, more than ever, timing is everything. Because of the high-pace demands and pressure to survive in today's business economy, financing needs simply must be accommodated in shorter and shorter windows of time.

Selling Assets

Generally speaking, the sale of assets to generate cash is something to consider when other forms of business financing fail. The sale of assets we are referring to are assets which are not sold as part of the normal course of business and are sold because of an immediate need for cash.

One of the most common assets sold to generate immediate cash is accounts receivable. The reason selling accounts receivable can work when other types of financing fail is that the buyer of accounts receivable (sometimes called a factor) is looking to the credit-worthiness and financial condition of the payor (the party that owes the money) and not the payee (the party to whom the money is owed). The price paid for a receivable is usually dependent on how long it takes to collect the receivable and whether or not the buyer has recourse to the seller. For example, one factor charges 1/10 of 1% per day (or 3% per month) with recourse after 90 days. This means that if the factor can collect a $100 receivable in, let's say, 60 days, he ends up paying $94 for the receivable.

The factor also holds back anywhere from 15% to 30% of the amount of an invoice when it is purchased. This forms a reserve account so that the factor can charge back the purchase price of invoices which aren't collectable in the 90 days.

> *NOTE: Selling (or factoring) accounts receivable should not be confused with financing accounts receivable which simply involves pledging the receivables as collateral against a loan.*

Almost any reliable future income stream can be sold in whole or part: annuities, notes and mortgages, pensions, judgments, and even lottery winnings. The amount paid is entirely negotiable and dependent on the assessed value of the deal by the buyer. Many of these transactions are referred to as structured settlements.

For example, the buyer of a mortgage note which is seasoned, running at a high rate, and well secured will probably be willing to pay MORE than the principal balance of the mortgage note. On the other hand, a buyer might only offer 10% of the principal balance for an unsecured note on which the payments are in default.

The key concept to remember here is that asset buyers are interested in an attractive bargain because they either know or suspect that sellers have an immediate need for cash.

Some business assets should be sold, even at a substantial loss, because they have lost their value (idle inventories), have become obsolete (certain types of equipment), or have become a bad investment (income property with a negative cash flow). In these instances, it might be better to recoup some cash and take the loss rat her than taking the chance of getting nothing back.

However, there are some key considerations about selling assets which you must be aware of:

1. Are you sure the asset is not encumbered in any way? If it is, you must get the asset released by the party that has a claim on it or you must payoff the claim so that your title to the asset is free and clear. For example, if you have a business loan at the bank, chances are the bank might have a security interest in your accounts receivable. Therefore, you have to get the bank's permission or release in order to sell your receivables.

2. Will the sale of assets render your company insolvent? Ifthis might be the case, you should get a legal opinion from your attorney before you proceed. The issue is this: If you have partners or creditors, selling an asset (especially for less than it's worth) might be taking equity away which is protecting the interests of these parties. As a result, the transaction might be construed as a fraud on creditors.

This is why bankruptcy courts actually have the authority to go back in time and undo certain transactions which, according to applicable laws, have unfairly discriminated against certain creditors or which prevent certain creditors from getting paid.

The bottom line about selling assets is that it can be risky for these major reasons:

1. If you sell an asset which contributes toward your ability to make money, you may be diminishing your future success in business. If you substantially deplete your income-producing assets (example: a distributor selling inventory at cost, or at a loss, to generate immediate cash), you may put yourself out of business.

2. If you sell assets whose equity is protecting other creditors, you may be asking for future legal problems, Therefore, if you decide to sell assets, you might consider doing it on a last resort basis only.

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Selling Your Deal

In the introduction to this guide, we spoke about some of the basic reasons why proposals for business financing fail.

The purpose of this section, in response, is to suggest certain strategies and methods which you can employ to substantially increase your odds of a successful financing.

The first step is to recognize that a financing proposal or request is like a first date ; meaning that you can't take back the first impression you have made. Therefore, our suggestion is to first test the waters with a concise, well-thought and well-written introduction and inquiry regarding the lender's level of interest. Doing this has several advantages:

1. You aren't disclosing confidential information indiscriminately.

2. You establish that the financing proposal will be made on a level playing field (ie: via a mutual interest).

3. You create the opportunity to find out what the lender wants before you give the lender any information or documentation.

4. You can make several such inquiries and proceed with the most favorable responses.

Once a lender expresses an interest, proceed with a custom-made or custom-tailored information. Lenders can immediately recognize a one size fits all presentation which has been mass-produced and distributed. Such a presentation has major disadvantages :

1. A lender will shy away from a package which is perceived as being shopped around. They simply don't want to waste their time and energy.

2. Such presentations get out-dated quickly. If a lender sees a projected cash flow that starts two months ago, you can hardly blame the lender for losing interest.

Rather, when a lender expresses interest, be responsive with professionally prepared, complete information. Pay close attention to what the lender wants and make every conceivable effort to provide what's asked for ASAP. In fact, the manner in which you respond goes a long ways toward creating the necessary comf ort level. Make sure all written materials are neat, complete, accurate, and consistent. If you change your story or numbers along the way, your deal will be politely declined.

What is important, therefore, is that you have properly completed your homework, including the following:

1. Make sure you are familiar with, or have immediate access to, your financial statements. If you don't feel that you are technically qualified to explain certain accounting items, be ready to connect the lender with the party who can (ie: your accountant, consultant, etc).

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2. Be prepared to explain exactly how the financing will (a) help your business operation and/or (b) improve your financial condition.

3. Prepare, compile, and set up files for information and documents that the lender is likely to request.

To the extent that you can relate your financing request in terms of standard and accepted accounting principles, you will find that the reception and interest in your request improves substantially. Therefore, you want to emphasize such items as decreasing debt service, decreasing current debt, improving cash flow, etc. Don't emphasize reliance on speculation. One example is a distributor who wanted money to finance trips around the country and visit more manufacturers so that he could look at a wider variety of merchandise to buy. Despite the best of intentions, this financing objective is simply not one that a lender would have a lot of respect for and, accordingly, the collateral behind this loan would have to offer some type of absolutely guaranteed security.

Part of the due-diligence process on the part of a lender, then, is to make sure all the pieces of the puzzle fit. The reality is that one missing piece can ruin the entire picture. Below is a list of typical deal-killers with some appropriate comments:

1. Collateral values are overstated and prove to be much less. In many cases, this is an innocent mistake because property is always perceived by the party that owns it as being worth more. However, lenders think in terms of fair market value at best and, in many cases, liquidation value. Remember, the more a lender will have to rely on the collateral to recover in the event of a default, the more conservatively that lender will assess the value of the collateral.

2. Undisclosed liens, encumbrances, or contingent liabilities surface during the due-diligence process.

   The key concept here is that a material omission (ie: a crucial fact or circumstance that would affect the lender's position that you do not disclose) is just as damaging to your cause as a misrepresentation (ie: information you give which, whether intentional or not, proves to be wrong). A good example of a material omission would be the non-disclosure of a pending lawsuit. An example of a misrepresentation would be the understatement of accounts payable.

3. Financial statements and information can't be reconciled. Some of the more typical problem areas are:

   (a) equities that can't be substantiated by reasonable cost figures or reasonable appreciation,

   (b) profits that can't be substantiated or which never make their way to the balance sheet, and

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(c) tax returns that simply can't be reconciled to financial statements.

NOTE: Lenders understand that tax returns are filed in a manner to avoid unnecessary taxes.

However, tax returns and financial statements have a certain common ground that should remain intact.

Lenders are also true believers that the best laid plans of mice and men oft go astray. Therefore, it is always better to present your business plan, strategy, and rationale for financing in terms of steady, conservative, controlled results.

Finally, lenders are ALWAYS looking for a hidden agenda because, unfortunately, lenders know that, to a greater or lesser extent, hidden agendas are a fact of life in loaning money to businesses. It comes with the territory. In some circumstances, a lender is justified in looking for the hook. For example, one business owner explained he needed to close quickly so that he could take advantage of a window of opportunity. What he didn't explain was that the window of opportunity was the length of time that the holder of the mortgage on his residence was giving him until foreclosure proceedings would begin!

On the other hand, it is not necessarily prudent to disclose operational strategy or other proprietary information to lenders. This is especially true if a lender is well secured and is relying only on the collateral, and not the viability of your business operation, for security and repayment.

In summary, the key steps in selling your deal are:

1. Proceed only with mutual interest as derived from mutual introductions;

2. Be immediately responsive to requests for information and documentation with complete, accurate, and professionally-appearing information;

3. Be knowledgeable about the due-diligence objectives and underwriting criteria for a given transaction so that you can comfortably communicate with a lender or investor; and

4. Avoid inconsistencies, delays, corrections, changes, and other negative factors which detract from the viability of your proposal.

Hopefully, this guide will contribute to the successful financing of your business. For further information, please don't hesitate to contact:

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