

FUNDING



EVEN THE BEST BUSINESS IDEAS NEED START-UP FUNDS TO GET THEM OFF THE GROUND — THIS IS THE ESSENTIAL GUIDE TO REELING THEM IN

BORROW BETTER: HOW TO GET A LOAN AND KEEP IT

Loans are big business for small business owners. Even applying for a simple credit facility can mean risking a lot. But a well-prepared borrower can negotiate from a position of strength, saving thousands of dollars. Before going out with your hat in your hand, remember these six keys to borrowing success:

— *Make it personal*

Long before you need a loan, you need a personal relationship with the lender. Loans are about trust, and trust starts with familiarity. Invite a banker to your place of business; impress them with product samples, maybe even take them out to lunch.

A good relationship with a banker (or two) can benefit your business in other ways. Take advantage of their experience and contacts by asking for their help on non-banking issues. Ask a banker to join a formal board of business advisors and you may learn more about your own business as well as theirs.

— *Know the numbers*

Every business loan has terms and covenants that may require you to meet or maintain certain operating parameters. Those restrictions could mandate certain profits, cash flows, or balance sheet ratios. Be prepared by reading up on these crucial business metrics in a book such as *Annual Statement Studies*, published by the Risk Management Association, or R.M.A. for short.

The R.M.A. guide includes common financial ratios and composite financial statements culled from more than 360 industries. You can get a glimpse into the mind of a banker by picking up a copy at your local bookstore, library or bank. Alternatively, download just the pages you need for your industry at rmahq.org. Benchmark ratios from the R.M.A. statements are likely to become your targets to qualify for, or maintain, commercial credit.

— *Sweeten the deal*

What banks want even more than profitable loans are customers who use savings and checking accounts and fee-generating services. If a loan request is your first and only contact with a bank, be prepared for a polite refusal. Instead, offer your bank a reward for structuring an attractive loan — shift your business checking accounts, payroll accounts and wire transfers to the lender. If your business accounts are slim, consider moving your personal mortgage or retirement savings. The more benefit for the bank you can offer, the more the bank will reward you with favorable rates and terms.

KNOW THE LINGO: A GLOSSARY OF LOAN & INVESTOR TERMINOLOGY

ARCHANGEL — A respected leader in the private investor community, often an ultra-high-net-worth individual who can influence other angel investors to make an investment.

CAPACITY — Ability to repay a loan. Capacity compares a company's cash flow to the monthly minimum loan payment due.

CONVERTIBLE DEBT — A loan that can be converted to stock, either by election or automatically upon reaching certain business milestones.

CONVERTIBLE STOCK — Stock that can be converted to debt, usually at the sole discretion of the investor.

DILUTION — The loss of ownership (as a percentage), which naturally results from selling company stock to new investors.

DOWN ROUND — An equity investment (stock purchase) at a price lower than previous investors paid. Down rounds can cause extreme dilution to prior shareholders.

MEZZANINE FINANCING — A finance package made up of an unsecured loan combined with a grant of warrants. A mixture of debt and equity.

PARTICIPATING PREFERRED — A class of investor stock that, in case of any sale or liquidation, requires the company to pay back the initial investment before any other distributions, and also entitles the holder to participate in capital gains along with common shareholders.

PRIVATE EQUITY GROUP — Any organized fund or institutional investor that specializes in purchasing, and sometimes managing, private companies.

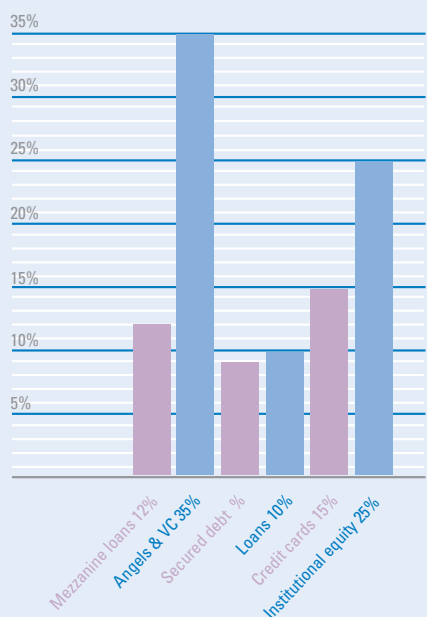
STOCKBROKERAGE MARGIN ACCOUNT — Investment account which allows you to purchase securities with funds borrowed from a broker at a specified interest rate.

TERM SHEET — A simple, plain-English memo which outlines the parameters of an investment or loan prior to the formal contract. Term sheets are the basis for negotiation between investor and business owner.

VALUATION — The dollar value of 100% of the company stock. If an investor buys 25% of the stock for \$10,000, then the valuation of the business is \$40,000.

WARRANTS — The right to purchase stock in the future at a predetermined price (called the strike price). Similar to options of a public company, warrants are commonly used to reward early investors, consultants or lenders.

RELATIVE COST OF CAPITAL PRICE (% RATE)



Source: Monterey Venture Partners

— *Plan not to fail*

If you want to win a banker's trust, show that you know all the ways your business could potentially fail. Write down 10 challenges your business faces — and the ways in which you would overcome those challenges. A list of potential pitfalls will show that you are prepared for success, and will also preempt many questions from the loan review committee that could slow approval.

Don't ignore the biggest risk to your business: key-person risk. If you or your business partners are incapacitated (or die) tomorrow, could you repay the loan? Key-person risk is present in every business and can best be addressed by investing in a substantial life- insurance policy. It's not unusual for banks to require insurance valued at twice the loan balance. It's morbid, and may be expensive, but it shows that you are helping the bank reduce its exposure to risk.

— *Budget pessimistically*

A thorough business plan with clear projections is vital to getting a loan approved. But projections that are too optimistic will get you into trouble. Remember that nothing ever goes as planned, so a pessimistic budget is the best kind. You will sleep better at night knowing that you have a little padding built into your numbers, and the bank will be impressed when you come in under budget.

— *Stay alert*

When you've finally closed a loan and think you can relax, think again. Loan covenants may change every month or quarter, and the bank may review your credit-worthiness periodically, too. Keep a clear eye on the terms and your ability to stay within the defined parameters. Equally important, keep building your relationship with the banker — no bank is immune from shifts in policy or priority, so be sure that your relationship is one that they value.

If you can put all the pieces together — a solid relationship, a convincing business plan, risk management, and lots of upside for the bank — you'll be ready to negotiate a generous loan package. Remember: For a well-prepared borrower, everything is negotiable.

There are as many different ways to finance a business as there are entrepreneurs. But in the end, there are only two kinds of money: debt, which must be paid back; and equity, which represents ownership of the business. These days, smart financiers are blurring the lines between debt and equity with convertible notes, convertible stock and so-called mezzanine financing, which is a blend of both stock and loans.

Many entrepreneurs are tempted by equity investments — not least because it can be attractive to share the risk with an investor. The downside is that equity is usually the most expensive form of finance. Since they are taking risks alongside you, lenders will expect the rate of return to be high enough to make it worth their while. While giving up a percentage of the company can be more expensive, it is still worth considering as it may provide a stable alternative to balance sheet liabilities.

Business owners love to dream that a large venture capital firm will step in with financial backing, but that's rarely how it works out. Fortunately, alternative sources of cash abound if you know where to look.

— *Do-it-yourself*

Nothing shows how serious you are about succeeding like investing your life savings into your company's growth. But choose carefully to minimize personal risk and maximize cash flow. Before taking a second mortgage on your home, look first at your life insurance policies and 401(k) plans. Ask your financial advisor if you can simply withdraw part of the death benefit, or, alternatively, take a loan against the cash value of a policy.

Many policies will allow you to pay back the principal at a flexible rate that suits your business cash needs. As a bonus, the interest may be a deductible expense for the business, and tax-deferred income for the individual. Paying yourself back can put extra money into your personal savings, plus create a higher cash balance for the next time a cash need arises.

Finally, don't forget your investments in public stocks. Traditional stockbrokerage margin accounts can free up cash quickly without liquidating your holdings, giving you a crucial tax advantage. Check with local banks first. Interest rates may be better at a lender than at your brokerage firm where the securities are held. Scout around for best rates.

— *Turn to a private equity group*

Huge private equity groups, or P.E.G.s, have been providing liquidity for medium and large companies for decades. These days, more and more boutique or "micro P.E.G.s" are opening their doors, and their checkbooks, to small businesses. While small business owners should carefully consider the downside of equity investments, small P.E.G.s can offer certain advantages. Sometimes also called pledge funds, these micro funds may manage just a few million dollars, typically gleaned from the personal wealth of one or more successful entrepreneurs. Their dual mission — to buy a substantial interest in high-potential companies and lend a helping hand to the business — is a win-win formula.

Another advantage to working with a P.E.G. is that you can put some of the investment in your pocket while the rest stays in the business for growth.

— *Go corporate*

If rapid growth is creating a cash emergency, traditional bankers, who are generally looking for "slow and steady," may not be able to help. That's where a commercial finance company can step in. Finance companies have fewer legal prohibitions than banks, but they still look for one of two things — hard assets to use as collateral or enough cash flow to comfortably make debt payments. If you have the collateral, look for "senior" or "asset-based" loans.

If you can afford to pay back the loan from cash flow, but don't have hard assets, ask about unsecured, mezzanine or subordinated loans. Subordinated and unsecured credit is widely available to businesses with solid operating profits, sometimes at two or three times the annual cash flow.

Credit card companies can provide unsecured lines of credit up to \$100,000. The rates for unsecured loans depend on your credit score and are usually around the same as a credit card.

— *Raising money from angel investors*

There are many benefits to owning 100 per cent of the business you are building, but if you'd rather not go it alone, there's never been a better time to look for a wealthy partner. According to research done by the University of New Hampshire, during just the first half of 2006, more than 130,000 high-net-worth individuals — or "angel investors" — made investments in private companies, putting almost \$13 billion into private companies. Unlike venture capital firms, which tend to invest exclusively in technology hotbeds, angel investors can be found in every state and city.

Since wealthy investors tend to stay out of the spotlight, finding an angel investor takes careful networking. Getting an introduction through a trusted lawyer, C.P.A. or business leader is often the best way to start negotiations with an angel. Somewhat surprisingly, however, more and more angels are banding together in clubs or investing en masse as an angel fund, making them much easier to find. The Angel Capital Education Foundation provides a list of more than 200 such groups at angelcapitaleducation.org.

If you decide to pursue an investment from a local angel investor or angel group, remember that it is incumbent upon you to provide full disclosure about your business — and you should expect the same in return. Learn all you can about the other investments your angel has made. Interview other entrepreneurs who have worked with him or her. Don't let the excitement of the deal cloud your judgment.

When you've found the right investor and are close to agreeing on terms, it's time to start the paperwork. Be sure to retain experienced legal counsel to prepare a private placement memorandum (P.P.M.) and stock subscription agreement. Without proper documentation, the investment can be rescinded, leaving you on the hook for a refund.

Even the best-intentioned partner may turn from helper to hindrance. If the investor wants to micro-manage your business, or worse, decides that you are mismanaging his money, beware. Too many entrepreneurs have landed in court thanks to a disgruntled partner. Usually, of course, angel investors live up to their name. Many want only to invest in growing companies and provide a small amount of help when they can.

— *Excerpted from OPEN Book:
A Practical Guide for Business Growth*