

7 Sources of Financing

Where to look for Money

by Glen Cooper, CBA

Financing a business acquisition can be as simple or as creative as you choose to make it - there are at least seven funding sources you can mix and match!

As in any other endeavor, the person who is fully prepared has the advantage. The keys to the process are 'know how' and 'know where.'

Business Plan A Must

You need a business plan to approach any investor or lender. This is where 'know how' comes in. You must know how you plan to run your business and be able to communicate this knowledge in an acceptable and convincing form to your potential investor or lender. There are business plan outlines to follow at every bookstore or library. Do not skip this crucial step.

'Know where' is the next key component. There are seven types of investors and/or lenders you should consider: 1) You, your family and close friends, 2) sellers, 3) banks, 4) various governmental or non-profit entities, 5) your suppliers, 6) your customers, and 7) other private individuals, including venture capitalists.

Phone Home First

Remember, in the movie, that 'ET' had to 'phone home' to be rescued? Well, who says life doesn't imitate art? When you buy a business, from 20% to 50% will probably come from you or your family. The other investors or lenders will insist that you are financially committed in this way.

Highly leveraged transactions - the ones you don't need much cash for - only happen for: 1) skilled individuals with special lender or investor relationships, 2) business buyers creating (or protecting) a large number of local jobs which are of public interest, or 3) businesses projected to make exceptional amounts of money. For the rest of us, large cash reserves are essential.

To be taken seriously as a potential small business buyer, you need somewhere between \$50,000 to \$150,000 of ready cash for a down payment and working capital. This is a minimum figure today.

Seller Financing Common

Sellers often prefer to finance their own business sale because 'playing bank' can be a smart strategy to achieve the highest possible purchase price. But, even when they don't want to, the realities of the sale often force them into it. Buyers need and want seller financing.

Sellers typically finance from 30% to 70% of the selling price. They usually take an interest rate below prevailing bank rates. Seller note terms are usually easier to negotiate than bank note terms. Sellers are usually more flexible because they understand the needs of the businesses they sell.

Sometimes, banks will only participate when there is a large amount of seller financing to indicate that the business is sound in the eyes of the seller.

Keep in mind, however, that sellers who are willing to finance buyers, like any other lenders, are also going to want a security interest (like a first mortgage on real estate) that makes sense to them. Sellers are very reluctant to finance large sums if they are forced to accept a security interest which is subordinate to that of another lender.

Banks Finance Assets

Banks are reluctant lenders for small business acquisitions by first-time buyers.

For many reasons, small business acquisition lending is often considered too risky and too cumbersome unless the loan package fits under some type of government-subsidized guaranty program. Even then, the amounts banks will finance are usually limited by the values of the underlying tangible assets being pledged as collateral.

Banks shy away from business buyers without previous experience in the business they are trying to finance. Many small business loans are also just too small to be attractively profitable to a bank.

When banks do finance your purchase of a small business, it's because you're a favored customer or you and the business fit the profile that will work for a government-guaranteed loan.

If you have good character, relevant business experience, a healthy down payment, cash reserves and great credit, you have half of what's needed. The financial ratios of the business also need to be acceptable. The bank is looking for collateral and a capacity to repay the loan from business cash flows.

When the borrower and business are found worthy, banks will finance 50-80% of real estate values, 75-90% of new equipment values, 50% of used equipment, and/or 25-50% of inventories. They generally don't finance intangible assets, except accounts receivable, for which they will finance 80-90%.

But, if you're a first time business buyer, with no previous direct experience in that business, don't count on the bank. Rejection rates for small business acquisition loans probably exceed 80%!

Banks still don't train branch managers and junior lending officers in how to screen applicants effectively. So, at the urging of these front line bankers, a lot of time is spent by loan applicants on business plans that never go anywhere. This is an important point to understand if you are involved in a time-sensitive buy/sell transaction.

The SBA & Others

Where banks fear to tread, the Small Business Administration (SBA) and other associated public and quasi-public agencies try to fill the void. They do this mostly by guaranteeing small business bank loans to minimize bank risks.

The good news is that the SBA and its sister agencies are setting records these days making loans. The bad news is that these are almost all loans to existing businesses for expansions, not to neophytes for new acquisitions or start-ups.

Timing is a problem with these loans - the whole process can take 3 to 4 months! This is fine for a business expansion loan, but it is a killer when you are trying to keep a buy/sell deal together.

The most useful purpose for these loans is that they can be used to take out seller notes from previous small business sales.

It's not unusual for a seller note to be written with a 'balloon payment' provision to cash out the seller in 3-5 years. By this time, the new owner of the business has a track record that fits the public agency guaranty profile. There is usually time, at this point, to allow for the lengthy 90 to 120-day loan guaranty process.

Tapping Your Suppliers

After the major sources of financing are in place, don't overlook your suppliers for some additional help. Almost everyone who sells something to your business can be called upon for special terms if you decide to make the effort of involving them.

Equipment vendors are the most common source - leasing equipment often makes sense for cash-starved business buyers. The rates of interest will most likely exceed 13%, but, you can often get 100% financing this way. Leasing companies can also create cash for you. Sometimes, they will buy your used equipment and lease it back to you.

Another common way to create working capital is to ask suppliers to stretch the interest-free period before you have to pay their bills. In many businesses, running 30, 60 or even 90 days behind on a regular basis can create quite a large working capital account!

Customers Might Help

If there ever was a stigma attached to asking customers to help you finance your business, it's not there anymore! Today, the practice of asking for a deposit on a job is common.

One way to do this is to require payment (in part, at least) before you do the job. Also, billing annually for year-long service contracts and offering incentives for pre-payment is now common.

Venture Capital Pros

Outside equity investors in your small business purchase are hard to find, but a few do exist.

If it's an individual 'angel' that you want, you will have to explain to this investor why he/she should take the risk when there are so many other, safer ways to invest money. In most cases, angels have strong relationships with those they sponsor. Look for wealthy old-timers you already know. Or, look for specialists who know your industry.

On the institutional side, professional venture capital investment groups nearly always want majority control in growing companies. In most cases, they are seeking only high-growth companies with sales over \$5 million. They are looking to invest in companies that can offer the hope of 20-40% annual rate of return on their investment!

Both angels and venture capitalists are mostly still equity investors, not lenders. There are

some changes on the horizon in private placement financing, but these will be slow in coming.

Mix and match these seven sources of financing. Plan well and be aggressive about your money search. Almost all businesses get funding from more than one source. There is every reason to seek out funds from all seven!■

About the Author

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