

## First Product

Responsibility for setting product lines fell to Robin Tator. Tator, the company's vice-president of marketing and sales, had given Szaky one of his very first jobs as a teen. Tator had joined the firm early in its development and had been dividing his time between Ontario and New Jersey ever since, steering sales and distribution efforts on both sides of the border.

Terracycle had already tentatively selected its first product: a sprayable, all-purpose indoor plant food aimed at the consumer market. Pricing was designed to match larger competitors like Miracle-Gro. While Terracycle couldn't match the scale economies of its competitors, the production process for its vermicompost was far less expensive than the energy-intensive production of chemical fertilizer products.

The size of the fertilizer and media market was appealing—in the United States alone, it was a US\$6-billion segment of the US\$37-billion lawn and garden market. But the segment was beset by sluggish growth—no more than 5 percent annually—and dominated by a handful of industry Goliaths. Scotts' Miracle-Gro controlled at least 35 percent of the consumer lawn and garden market—and had an even tighter grip on the all-purpose fertilizer market.

Tator considered the organic market a green field of opportunity: The market was small—perhaps \$400 million—for “designer” soils and premium plant food, but it was growing at a rate of 16 percent per year. Sales of organic products, which made up at best 10 percent of the overall lawn and consumables market, had grown well over 400 percent between 1997 and 2002. Though one competitor, Schultz, had made tentative steps into the market and Scotts was planning an organic line, the organic market was still dominated by small, regionally focused competitors.

Tator advocated a consumer focus, even though the agricultural and commercial markets offered higher margins. First, he expected indoor home users to respond positively to the product's safe, non-chemical formulation. Second, he anticipated that consumers would more readily try out the Terracycle product—while agricultural users, whose livelihood depended on the product's efficacy, would take longer to experiment with and adopt the product.

## Terracycle vs. Carrot

While Terracycle refined its production process and planned for its product rollout, however, the relationship with its potential financier began to sour. The discussions were conducted by Szaky, CFO Doug Feltman, and interim CEO Thomas Pyle. Feltman had joined the team after serving as CFO of market-

ing firm Grey Worldwide. Pyle's career in banking included senior roles at Deutsche Bank, Chase Manhattan, and Skandinaviska Enskilda Banken.

Despite their resumes, the financial projections they presented reflected both the company's embryonic stage of development and the fact that the leadership was balancing dozens of competing priorities. Their submissions included neither detailed cash-flow projections nor a proposed use of proceeds for the financing round.

Carrot wanted more. It needed a clear picture of what stage of development the young company would reach with its round of financing. Szaky and partners soon discerned that the financing would be tranced—delivered in stages—based on set metrics for sales, development, and hiring. Having attributed their survival thus far to their adaptability, the Terracycle team worried that set metrics would limit their flexibility in the face of unpredictable change.

Terracycle and its prospective investors also clashed on spending priorities. The company had budgeted relatively modest amounts for marketing, preferring to build sales through guerrilla marketing and a network of unpaid student interns. They also planned to place the management team—who had been sleeping at the office and drawing meagre, infrequent paycheques—on salary. Carrot expected, by contrast, investments into professional branding and marketing. They considered the intern program an unacceptable distraction.

The VC also wanted to rethink the management line-up. In a letter, Carrot allowed that the management members were smart and capable, but argued they were the wrong people for the company. Carrot wanted to hire start-up veterans with deeper experience in consumer products and retail marketing. Those who were left, Carrot made clear, would be expected to continue working at modest salaries or for equity alone.

Carrot, as an act of good faith, was willing to keep the company afloat with a \$20,000 bridge loan and agreed to give it additional time to work out a deal. But Terracycle's managers were skeptical, sensing a gulf between their vision and Carrot's aims. On top of those substantive challenges, Szaky felt uneasy with Carrot on a gut level, as if he was being cloistered from his team during the high-intensity negotiations with the VC.

Butting heads with Carrot over both strategy and spending, Terracycle was in an unenviable position. It would be months before they had a saleable product ready. Their coffers were empty. The company had some embryonic relationships with individual investors—enough, perhaps, to cobble together enough funding to survive a few more months—but there was still a very good chance that it would not survive if they rejected the venture capital deal.

## C · H · A · P · T · E · R

# 11

## OBTAINING DEBT CAPITAL<sup>1</sup>

*Leveraging a company is like driving your car with a sharp stick pointed at your heart through the steering wheel. As long as the road is smooth it works fine. But hit one bump in the road and you may be dead.*

Warren Buffet

**UPON COMPLETION OF THIS CHAPTER, YOU WILL BE ABLE TO:**

- |                         |  |   |                         |
|-------------------------|--|---|-------------------------|
| <b>RESULTS EXPECTED</b> | <b>1.</b> Identify sources of debt and how to access them in today's capital markets.  | <b>3.</b> Understand the key aspects of managing and orchestrating the acquisition of debt capital. | <b>RESULTS EXPECTED</b> |
|                         | <b>2.</b> Describe the lender's perspective and criteria in making loans, how to prepare a loan proposal, and how to negotiate a loan. | <b>4.</b> Discuss how lenders estimate the debt capacity of a company.                              |                         |
|                         |  | <b>5.</b> Identify tar pits entrepreneurs need to avoid in considering debt.                        |                         |
|                         |  |   |                         |
|                         |  |   |                         |

Market cycles impact credit availability—often creating a lack thereof—for emerging companies. After a market meltdown (such as in 2000 and again in 2009), many old rules disappeared and a harsher banking climate once again appeared. This chapter aims at preparing you to cope better with those realities in the debt capital markets. And as debt markets improve, and they always do, lessons learned here will provide important competitive advantages.

### A CYCLICAL PATTERN: THE GOOD OLD DAYS RETURN BUT FADE AGAIN

For entrepreneurs and their investors, the punishing credit crunch and stagnant equity markets give way to robust capital markets and once again are beaten down. Interest rates fluctuate and the credit environment turns from friend to foe in a short timeframe. The availability of bank loans and competition among banks changes dramatically from pursuer of entrepreneurs to playing hard to get. And as Jean-Etienne de Bettignies and James



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Brander, both of the University of British Columbia observe: "With bank finance, the entrepreneur keeps full control of the firm and has efficient incentives to exert effort." This may not be the case with venture capital finance—the subject of the previous chapter.<sup>2</sup>

Regardless of the credit environment lenders are becoming more savvy in seeking growth companies with the potential to assert themselves in the new economy. When times are good, bank presidents and loan officers aggressively seek entrepreneurial companies as prospective clients. They work with local universities and business development associations to sponsor seminars, workshops, and small business fairs, all to cultivate entrepreneurial customers. This is a very welcome credit climate for entrepreneurs. In a more severe credit crunch, regardless of interest rates, money slows, lenders turn reluctant and are less encouraging. The availability of credit is cyclical, the good times will return and fade, but remember that the fundamentals of credit don't change that much.

### A Word of Caution

History suggests a favourable credit environment can and will change, sometimes suddenly. When a credit climate reverses itself, personal guarantees come back. Even the most creditworthy companies with enviable records for timely repayment of interest and principal could be asked to provide personal guarantees by the owners. In addition, there could be a phenomenon viewed as a perversion of the debt capital markets. As a credit crunch becomes more severe, banks face their own illiquidity problems. To cope with their own balance sheet dissipation, banks can and might call the best loans first. Thousands of high quality smaller companies can be stunned and debilitated by such actions. Also, as competition among banks lessens, pricing and terms can become more onerous as the economy continues in a period of credit tightening. Debt reduction could then become a dominant financial strategy of small and large companies alike.

### The Lender's Perspective

Lenders have always been wary capital providers. Because banks may earn as little as a 1-percent net profit on total assets, they are especially sensitive to the possibility of a loss. If a bank writes off a \$1-million loan to a small company, it must then be repaid an incremental \$100 million in profitable loans to recover that loss.

Yet, lending institutions are businesses and seek to grow and improve profitability as well. They can do this only if they find and bet on successful, young, growing companies. Historically, points and fees charged for making a loan have been a major contributor to bank profitability. During parts of the credit cycle, banks may seek various sweeteners to make loans. Take, for instance, a lending proposal for a company seeking a \$15-million five-year loan. In addition to the up-front origination fees and points, the bank further proposed a YES, or yield enhancement security, as part of the loan. This additional requirement would entitle the bank to receive an additional \$3-million payment from the company once its sales exceeded \$10 million and it was profitable, or if it was sold, merged, or taken public. While this practice hasn't happened frequently in the current economic climate, it could be revived, depending on the cycle.

### SOURCES OF DEBT CAPITAL<sup>3</sup>

The principal sources of borrowed capital for new and young businesses are trade credit, commercial banks, finance companies, factors, and leasing companies.<sup>4</sup> Start-ups have more difficulty borrowing money than existing businesses because they don't have assets or a track record of profitability and/or a positive cash flow. Nevertheless, start-ups managed by an entrepreneur with a track record and with significant equity in the business who can present a sound business plan can borrow money from one or more sources. Still, if little equity or collateral exists, the start-up won't have much success with banks.

The availability of such debt for high-tech start-ups can sometimes depend on where a business is located. Debt and leases as well as equity capital can be more available to start-up companies in such hotbeds of entrepreneurial activity as, say, in the prairies. The hotbed areas also feature close contact between venture capital firms and the high-technology-focused lending officers of banks. This contact tends to make it easier for start-ups and early-stage companies to borrow money, although banks rarely lend to new ventures. But even in these hotbeds, very few banks are active in this start-up environment.

The advantages and disadvantages of these sources, summarized in Exhibit 11.1, are basically determined by such obvious dimensions as the interest rate or cost of capital, the key terms, the conditions and covenants, and the fit with the owner's situation and the company's needs at the time.<sup>5</sup> How good a deal you can strike is a function of your relative bargaining position and the competitiveness among the alternatives.

Ultimately, most important is the person with whom you will be dealing, rather than the amount, terms, or institution. You will be better off seeking the right banker (or other provider of capital) than just the right bank. Once again, the industry and market characteristics, and the stage and health of the firm in terms of cash flow, debt coverage, and collateral are central to the evaluation process. Exhibit 11.2 summarizes the term of financing available from these different sources. Note the difficulty in finding sources for more than one year of financing.

Finally, an enduring question entrepreneurs ask is, What is bankable? How much money can I expect to borrow based on my balance sheet? Exhibit 11.3 summarizes some general guidelines in answer to this question. Because most loans and lines of credit are asset-based loans, knowing the lender's guidelines is very important. The percentages

#### EXHIBIT 11.1 Debt Financing Sources for Types of Business

| Source              | Start-up Company                                     | Existing Company                      |
|---------------------|--|---------------------------------------|
| Trade credit        | Yes  | Yes                                   |
| Finance companies   | Occasionally, with strong equity                     | Yes                                   |
| Commercial banks    | Rare (if assets are available)                       | Yes                                   |
| Factors             | Depends on nature of the customers                   | Yes                                   |
| Leasing companies   | Difficult, except for start-ups with venture capital | Yes                                   |
| Credit unions       | Depends on strength of personal guarantee            | Real estate and asset-based companies |
| Insurance companies | Rare, except alongside venture capital               | Yes, depending on size                |

Source: Jeffrey A. Timmons, *Financing and Planning the New Venture* (Acton, MA: Brick House Publishing Company, 1990).

#### EXHIBIT 11.2 Debt Financing Sources by Term of Financing

| Source              | Term of Financing |                   |   |
|---------------------|-------------------|-------------------|---|
|                     | Short             | Medium            | Long  |
| Trade credit        | Yes               | Yes               | Possible                                    |
| Commercial banks    | Most frequently   | Yes (asset-based) | Rare (depends on cash flow predictability)  |
| Factors             | Most frequently   | Rare              | No  |
| Leasing companies   | No                | Most frequently   | Some  |
| Credit unions       | Yes               | Yes               | Real estate and other asset-based companies |
| Insurance companies | Rare              | Rare              | Most frequently                             |

Source: Jeffrey A. Timmons, *Financing and Planning the New Venture* (Acton, MA: Brick House Publishing Company, 1990), p. 34.

**EXHIBIT 11.3** What Is Bankable? Specific Lending Criteria

| Security                   | Credit Capacity   |
|----------------------------|---|
| Accounts receivable        | 70–85% of those less than 90 days of acceptable receivables |
| Inventory                  | 20–70% depending on obsolescence risk and saleability       |
| Equipment                  | 60–70% of market value (less if specialized)                |
| Chattel mortgage*          | 80% or more of auction appraisal value                      |
| Conditional sales contract | 60–70% or more of purchase price                            |
| Plant improvement loan     | 50–70% of appraised value or cost                           |

Source: Jeffrey A. Timmons, *Financing and Planning the New Venture* (Acton, MA: Brick House Publishing, 1990).

\*A lien on assets other than real estate backing a loan.

of key balance sheet assets that are often allowable as collateral are only ranges and will vary from region to region, for different types of businesses, and for stages in the business cycle. For instance, non-perishable consumer goods versus technical products that may have considerable risk of obsolescence would be treated very differently in making a loan collateral computation. If the company already has significant debt and has pledged all its assets, there may not be much room for negotiations. A bank with full collateral in hand for a company having cash flow problems is unlikely to give up such a position to enable the company to attract another lender, even though the collateral is more than enough to meet these guidelines.

**Trade Credit<sup>6</sup>**

Trade credit is a major source of short-term funds for small businesses. Trade credit represents 30 to 40 percent of the current liabilities of non-financial companies, with generally higher percentages in smaller companies. It is reflected on the balance sheet as accounts payable, or sales payable-trade.

If a small business is able to buy goods and services and be given, or take, 30, 60, or 90 days to pay for them, that business has essentially obtained a loan of 30 to 90 days. Many small and new businesses are able to obtain such trade credit when no other form of debt financing is available to them. Suppliers offer trade credit as a way to get new customers, and often build the bad debt risk into their prices. Additionally, channel partners who supply trade credit often do so with more industry-specific knowledge than can be obtained by commercial banks.<sup>7</sup> Such credit is often termed *spontaneous credit* and is “subject to gradual and automatic modification in direct relation to the volume of business and profitability.”<sup>8</sup>

The ability of a new business to obtain trade credit depends on the quality and reputation of its management and the relationships it establishes with its suppliers. Continued late payment or non-payment may cause suppliers to cut off shipments or ship only on a COD basis. A key to keeping trade credit open is to continually pay some amount, even if not the full amount. Also, the real cost of using trade credit can be very high; for example, the loss of discounts for prompt payment. Because the cost of trade credit is seldom expressed as an annual amount, it should be analyzed carefully, and a new business should shop for the best terms.

Trade credit may take some of the following forms: extended credit terms; special or seasonal datings, where a supplier ships goods in advance of the purchaser's peak selling season and accepts payment 90 to 120 days later during the season; inventory on consignment, not requiring payment until sold; and loan or lease of equipment.

**Commercial Bank Financing**

Canadian chartered banks prefer to lend to existing businesses that have a track record of sales, profits, and satisfied customers, and a current backlog of orders. Their concern about the high failure rates in new ventures can make banks less than enthusiastic about making loans to such firms. They like to be lower-risk lenders, which is consistent with their profit margins. For their protection, they look first to positive cash flow and then to collateral, and in new and young enterprises (depending on the credit environment) they are likely to require personal guarantees of the owners. Like equity investors, commercial banks place great weight on the quality of the management team.

Notwithstanding these factors, certain banks do, rarely, make loans to start-ups or young businesses that have strong equity financings from venture capital firms. This has been especially true in centres of entrepreneurial and venture capital activity.

**Commercial banks are the primary source of debt capital for existing (not new) businesses.** Small business loans may be handled by a bank's small business loan department or through credit scoring (where credit approval is done “by the numbers”). Your personal credit history will also impact the credit-scoring matrix. Larger loans may require the approval of a loan committee. If a loan exceeds the limits of a local bank, part or the entire loan amount will be offered to “correspondent” banks in neighbouring communities and nearby financial centres. This correspondent network enables the smaller banks in rural areas to handle loans that otherwise could not be made.

Most of the loans made by Canadian chartered banks are for one year or less. Some of these loans are unsecured, while receivables, inventories, or other assets secure others. Commercial banks also make a large number of intermediate-term loans (or term loans) with a maturity of one to five years. On about 90 percent of these term loans, the banks require collateral, generally consisting of stocks, machinery, equipment, and real estate. Most term loans are retired by systematic, but not necessarily equal payments over the life of the loan. Apart from real estate mortgages and loans guaranteed by the Business Development Bank of Canada or a similar organization, commercial banks make few loans with maturities greater than five years.

Banks also offer a number of services to the small business, such as computerized payroll preparation, letters of credit, international services, lease financing, and money market accounts.

According to a World Economic Forum report released in October 2008, Canada has the world's soundest banking system.

**The Canadian Angle**

**Richard Kinlough and Bill Holy of CIT Corporate Finance, Canada state in the official journal of the Canadian Venture Capital and Private Equity Association that “the mid-market never got as frothy as in the U.S., likely the result of our conservative banking system. Total leverage never reached the 6s, peaking at around 5x total, with senior pricing in the BA+250 to 300 range. . . which was about as borrower-friendly as it got in Canada. Because the mid-market was not as aggressive as in the U.S., the correction was not as severe. By the end of Q4 2008, pricing increased 100bps to BA+400 while total leverage came down a turn to around 4.0x”**

**“BA” stands for Banker's Acceptance and is a short-term credit note generated for investment purposes and guaranteed by a bank. BAs are discounted from face value and traded in secondary markets. Banker's Acceptances are similar to government-backed debt (e.g., treasury bills) and are generally found in money market funds.**

**100, 200, 300, 400 refers to 1, 2, 3, 4 percent. 100bps similarly refers to 100 basis points or 1 full percent; a basis point is 1/100 of a percent.**

**Kinlough and Holy go on to state, “In Canada, liquidity is less constrained and lending terms are set at levels that send an ‘open for business’ signal. But just like in the U.S., the market has become a bit more conservative and pricey.**

Senior leverage is around 2.5x to 3.0x, priced at BA+450. Total leverage is in the 4.0x range and should remain there for the foreseeable future.”<sup>9</sup>

What this assessment means is that by being a bit behind the more risk tolerant U.S. banking practices became good news for the Canadian banking sector. Canadian firms were not allowed to play the leverage games that firms in the U.S. played—thus avoiding driving with the sharp stick on the steering wheel that Warren Buffet warned of in this chapter’s opening quote. Or in reference to another Warren Buffet quote: “It is only when the tide goes out that you know who was swimming naked.” Prime Minister Harper stated, “The global economic crisis has revealed quite a few skinny-dippers, but Canada is not one of them.”<sup>10</sup> This Canadian austerity means that the highs and lows are avoided in favour of a moderate approach, which is not without critics—particularly in times of economic growth and free-flowing capital. It was over 25 years ago that Ben Bernanke, now Chairman of the U.S. Federal Reserve, noted that during the Great Depression (1930–1933) Canada avoided the catastrophic bank failures as plagued the U.S.<sup>11</sup>

Sources: Richard Kinlough and Bill Holy, “The Debt Market,” *Private Capital*, Spring 2009; “Canada Will Emerge from Slump Faster, Stronger: PM,” CBC News, March 10, 2009; Ben S. Bernanke, “Nonmonetary Effects of the Financial Crisis in the Propagation of the Great Depression,” *American Economic Review* 73, no. 3 (1983): 257–276.

### Line of Credit Loans

A line of credit is a formal or informal agreement between a bank and a borrower concerning the maximum (and sometimes minimum, e.g., \$10,000) loan a bank will allow the borrower for a one-year period. Often the bank will charge a fee of a certain percent of the line of credit for a definite commitment to make the loan when requested.

Line of credit funds are used for such seasonal financings as inventory build-up and receivable financing. These two items are often the largest and most financeable items on a venture’s balance sheet. It is general practice to repay these loans from the sales and reduction of short-term assets that they financed. Lines of credit can be unsecured, or the bank may require a pledge of inventory, receivables, equipment, or other acceptable assets. Unsecured lines of credit have no lien on any asset of the borrower and no priority over any trade creditor, but the banks may require that all debt to the principals and stockholders of the company be subordinated to the line of credit debt.

The bank will expect the borrower to pay off his or her open loan within a year and to hold a zero loan balance for one to two months. This is known as “resting the line” or “cleaning up.” Canadian chartered banks may also generally require that a borrower maintain a chequing account at the bank with a minimum (“compensating”) balance of 5 to 10 percent of the outstanding loan.

For a large, financially sound company, the interest rates for a “prime risk” line of credit will be quoted at the prime rate. A small, more risky, firm may be required to pay a higher rate. The true interest calculations should also reflect the multiple fees that may be added to the loan. Any compensating-balance or resting-the-line requirements or other fees will also increase effective interest rates.

### Time-Sales Finance

Many dealers or manufacturers who offer instalment payment terms to purchasers of their equipment cannot themselves finance instalment or conditional sales contracts. In such situations, they sell and assign the instalment contract to a bank or sales finance company. (Some very large manufacturers do their own financing through captive finance companies. Most small retailers merely refer their customer instalment contracts to sales finance companies, which provide much of this financing, and on more flexible terms.)

From the manufacturer or dealer’s point of view, time-sales finance is a way of obtaining short-term financing from long-term instalment accounts receivable. From the purchaser’s point of view, it is a way of financing the purchase of new equipment.

Under time-sales financing, the bank purchases instalment contracts at a discount from their full value and takes as security an assignment of the manufacturer/dealer’s interest in the conditional sales contract. In addition, the bank’s financing of instalment note receivables includes recourse to the seller in the event of loan default by the purchaser. Thus, the bank has the payment obligation of the equipment purchaser, the manufacturer/dealer’s security interest in the equipment purchased, and recourse to the manufacturer/dealer in the event of default. The bank also withholds a portion of the payment (5 percent or more) as a dealer reserve until the note is paid. Since the reserve becomes an increasing percentage of the note as the contract is paid off, an arrangement is often made when multiple contracts are financed to ensure that the reserve against all contracts will not exceed 20 percent or so.

The purchase price of equipment under a sales financing arrangement includes a “time-sales price differential” (e.g., an increase to cover the discount, typically 6 to 10 percent) taken by the bank that does the financing. Collection of the instalments may be made directly by the bank or indirectly through the manufacturer/dealer.

### Term Loans

Bank term loans are generally made for periods of one to five years, and may be unsecured or secured. Most of the basic features of bank term loans are the same for secured and unsecured loans.

Term loans provide needed growth capital to companies. They are also a substitute for a series of short-term loans made with the hope of renewal by the borrower. Banks make these generally on the basis of predictability of positive cash flow.

Term loans have three distinguishing features: Banks make them for periods of up to five years (and occasionally more); periodic repayment is required; and agreements are designed to fit the special needs and requirements of the borrower (e.g., payments can be smaller at the beginning of a loan term and larger at the end).

Because term loans do not mature for a number of years, during which time the borrower’s situation and fortunes could change significantly, the bank must carefully evaluate the prospects and management of the borrowing company. Even the protection afforded by initially strong assets can be wiped out by several years of heavy losses. Term lenders stress the entrepreneurial and managerial abilities of the borrowing company. The bank will also carefully consider such things as the long-range prospects of the company and its industry, its present and projected profitability, and its ability to generate the cash required to meet the loan payments, as shown by past performance. Pricing for a term loan may be higher, reflecting a perceived higher risk from the longer term.

To lessen the risks involved in term loans, a bank will require some restrictive covenants in the loan agreement. These covenants might prohibit additional borrowing, merger of the company, payment of dividends, sales of assets, increased salaries to the owners, and the like. Also, the bank will probably require financial covenants to provide early warning of deterioration of the business, like debt to equity and cash flow to interest coverage.

### Chattel Mortgages and Equipment Loans

Assigning an appropriate possession (chattel) as security is a common way of making secured term loans. The chattel is any machinery, equipment, or business property that is made the collateral of a loan in the same way as a mortgage on real estate. The chattel remains with the borrower unless there is default, in which case the chattel goes to the bank. A lien charge against the title is registered with the province.<sup>12</sup> Generally, credit against machinery and equipment is restricted primarily to new or highly serviceable and saleable used items.

## Conditional Sales Contracts

Conditional sales contracts are used to finance a substantial portion of the new equipment purchased by businesses. Under a sales contract, the buyer agrees to purchase a piece of equipment, makes a nominal down payment, and pays the balance in instalments over a period of from one to five years. Until the payment is complete, the seller holds title to the equipment. Hence, the sale is conditional upon the buyer's completing the payments.

A sales contract is financed by a bank that has recourse to the seller should the purchaser default on the loan. This makes it difficult to finance a purchase of a good piece of used equipment at an auction. No recourse to the seller is available if the equipment is purchased at an auction; the bank would have to sell the equipment if the loan goes bad. Occasionally, a firm seeking financing on existing and new equipment will sell some of its equipment to a dealer and repurchase it, together with new equipment, in order to get a conditional sales contract financed by a bank.

The effective rate of interest on a conditional sales contract is high, running to as much as 15 to 18 percent if the effect of instalment features is considered. The purchaser/borrower should make sure the interest payment is covered by increased productivity and profitability resulting from the new equipment.

## Plant Improvement Loans

Loans made to finance improvements to business properties and plants are called plant improvement loans. They can be intermediate and long term and are generally secured by a first or second mortgage on that part of the property or plant that is being improved.

## Commercial Finance Companies

The commercial bank is generally the lender of choice for a business. But when the bank says no, commercial finance companies, which aggressively seek borrowers, are a good option. They frequently lend money to companies that do not have positive cash flow, although commercial finance companies will not make loans to companies unless they consider them viable risks. In tighter credit economies, finance companies are generally more accepting of risk than are banks.

The primary factors in a bank's loan decision are the continuing successful operation of a business and its generation of more than enough cash to repay a loan. By contrast, commercial finance companies lend against the liquidation value of assets (receivables, inventory, equipment) that it understands, knows how and where to sell, and whose liquidation value is sufficient to repay the loan. Banks today own many of the leading finance companies. As a borrower gains financial strength and a track record, transfer to more attractive bank financing can be easier.

In the case of inventories or equipment, liquidation value is the amount that could be realized from an auction or quick sale. Finance companies will generally not lend against receivables more than 90 days old, federal or provincial government agency receivables (against which it is very difficult to perfect a lien and payment is slow), or any receivables whose collection is contingent on the performance of a delivered product.

Because of the liquidation criteria, finance companies prefer readily saleable inventory items such as electronic components or metal in such commodity forms as billets or standard shapes. Generally, a finance company will not accept inventory as collateral unless it also has receivables. Equipment loans are made only by certain finance companies and against such standard equipment as lathes, milling machines, and the like. Finance companies, like people, have items in which they are more comfortable and therefore would extend more credit against certain kinds of collateral.

How much of the collateral value will a finance company lend? Generally, 70 to 85 percent of acceptable receivables under 90 days old, 20 to 70 percent of the liquidation value of raw materials and/or finished goods inventory that are not obsolete or damaged, and

60 to 70 percent of the liquidation value of equipment, as determined by an appraiser, is acceptable. Receivables and inventory loans are for one year, while equipment loans are for three to seven years.

All these loans have tough prepayment penalties: Finance companies do not want to be immediately replaced by banks when a borrower has improved its credit image. Generally, finance companies require a three-year commitment to do business with them, with prepayment fees if this provision is not met.

The data required for a loan from a finance company includes all that would be provided to a bank, plus additional details for the assets being used as collateral. For receivables financing, this includes detailed aging of receivables (and payables) and historical data on sales, returns, or deductions (all known as dilution), and collections.

For inventory financing, it includes details on the items in inventory, how long they have been there, and their rate of turnover. Requests for equipment loans should be accompanied by details on the date of purchase, cost of each equipment item, and appraisals, which are generally always required. These appraisals must be made by acceptable (to the lender) outside appraisers.

The advantage of dealing with a commercial finance company is that it will make loans that banks will not, and it can be flexible in lending arrangements. The price a finance company exacts for this is an interest rate anywhere from 0 to 6 percent over that charged by a bank, prepayment penalties, and, in the case of receivables loans, recourse to the borrower for unpaid collateralized receivables.

Because of their greater risk taking and asset-based lending, finance companies usually place a larger reporting and monitoring burden on the borrowing firm to stay on top of the receivables and inventory serving as loan collateral. Personal guarantees will generally be required from the principals of the business. A finance company or bank will generally reserve the right to reduce the percentage of the value lent against receivables or inventory if it gets nervous about the borrower's survivability.

## Factoring

Factoring is a form of accounts receivable financing. However, instead of borrowing and using receivables as collateral, the receivables are sold, at a discounted value, to a factor. Factoring is accomplished on a discounted value of the receivables pledged. Invoices that do not meet the factor's credit standard will not be accepted as collateral. (Receivables more than 90 days old are not normally accepted.) A bank may inform the purchaser of goods that the account has been assigned to the bank, and payments are made directly to the bank, which credits them to the borrower's account. This is called a notification plan. Alternatively, the borrower may collect the accounts as usual and pay off the bank loan; this is a non-notification plan.

Factoring can make it possible for a company to secure a loan that it might not otherwise get. The loan can be increased as sales and receivables grow. However, factoring can have drawbacks. It can be expensive, and trade creditors sometimes regard factoring as evidence of a company in financial difficulty, except in certain industries.

In a standard factoring arrangement, the factor buys the client's receivables outright, without recourse, as soon as the client creates them, by shipment of goods to customers. Although the factor has recourse to the borrowers for returns, errors in pricing, and so on, the factor assumes the risk of bad debt losses that develop from receivables it approves and purchases. Many factors, however, provide factoring only on a recourse basis.

Cash is made available to the client as soon as proof is provided (old-line factoring) or on the average due date of the invoices (maturity factoring). With maturity factoring, the company can often obtain a loan of about 90 percent of the money a factor has agreed to pay on a maturity date. Most factoring arrangements are for one year.

Factoring can also be on a recourse basis. In this circumstance, the borrower must replace unpaid receivables after 90 days with new current receivables to allow the borrowings to remain at the same level.

Factoring fits some businesses better than others. For a business that has annual sales volume in excess of \$300,000 and a net worth over \$50,000 that sells on normal credit terms to a customer base that is 75-percent credit rated, factoring is a real option. Factoring has become almost traditional in such industries as textiles, furniture manufacturing, clothing manufacturing, toys, shoes, and plastics.

The same data required from a business for a receivable loan from a bank are required by a factor. Because a factor is buying receivables with no recourse, it will analyze the quality and value of a prospective client's receivables. It will want a detailed aging of receivables plus historical data on bad debts, return, and allowances. It will also investigate the credit history of customers to whom its client sells and establish credit limits for each customer. The business client can receive factoring of customer receivables only up to the limits so set.

The cost of financing receivables through factoring is higher than that of borrowing from a bank or a finance company. The factor is assuming the credit risk, doing credit investigations and collections, and advancing funds. A factor generally charges up to 2 percent of the total sales factored as a service charge.

There is also an interest charge for money advanced to a business, usually 2 to 6 percent above prime. A larger, established business borrowing large sums would command a better interest rate than the small borrower with a one-time, short-term need. Finally, factors withhold a reserve of 5 to 10 percent of the receivables purchased.

Factoring is not the cheapest way to obtain capital, but it does quickly turn receivables into cash. Moreover, although more expensive than accounts receivable financing, factoring saves its users credit agency fees, salaries of credit and collection personnel, and maybe bad debt write-offs. Factoring also provides credit information on collection services that may be better than the borrower's.

### Leasing Companies

The leasing industry has grown substantially in recent years, and lease financing has become an important source of medium-term financing for businesses. There are hundreds of leasing companies in Canada. In addition, many commercial banks and finance companies have leasing departments. Some leasing companies handle a wide variety of equipment, while others specialize in certain types of equipment—machine tools, electronic test equipment, and the like.

Common and readily resalable items such as automobiles, trucks, computers, and office furniture can be leased by both new and existing businesses. However, the start-up will find it difficult to lease other kinds of industrial, computer, or business equipment without providing a letter of credit or a certificate of deposit to secure the lease, or personal guarantees from the founders or from a wealthy third party.

An exception to this condition is high-technology start-ups that have received substantial venture capital. Some of these ventures have received large amounts of lease financing for special equipment from equity-oriented lessors, who receive some form of stock purchase rights in return for providing the start-up's lease line. Like many financing options, availability of venture leasing may be reduced significantly in tight money markets.

Generally, industrial equipment leases have a term of three to five years, but in some cases may run longer. There can also be lease renewal options for 3 to 5 percent per year of the original equipment value. Leases are usually structured to return the entire cost of the leased equipment plus finance charges to the lessor, although some so-called operating leases do not, over their term, produce revenues equal to or greater than the price of the leased equipment.

Typically, an up-front payment is required of about 10 percent of the value of the item being leased. The interest rate on equipment leasing may be more or less than other forms of financing, depending on the equipment leased, the credit of the lessee, and the time of year.

Leasing credit criteria are very similar to the criteria used by commercial banks for equipment loans. Primary considerations are the value of the equipment leased, the justification of the lease, and the lessee's projected cash flow over the lease term.

Should a business lease equipment? Leasing has certain advantages. It enables a young or growing company to conserve cash and can reduce its requirements for equity capital.

Leasing can also be a tax advantage, because payments can be deducted over a shorter period than can depreciation.

Finally, leasing provides the flexibility of returning equipment after the lease period if it is no longer needed or if it has become technologically obsolete. This can be a particular advantage to high-technology companies.

Leasing may or may not improve a company's balance sheet, because accounting practice currently requires that the value of the equipment acquired in a capital lease be reflected on the balance sheet. Operating leases, however, do not appear on the balance sheet. Generally, this is an issue of economic ownership rather than legal ownership. If the economic risk is primarily with the lessee, it must be capitalized and it therefore goes on the balance sheet along with the corresponding debt. Depreciation also follows the risk, along with the corresponding tax benefits. Start-ups that don't need such tax relief should be able to acquire more favourable terms with an operating lease.

### BEFORE THE LOAN DECISION<sup>13</sup>

Choosing a bank and, more specifically, a banker is one of the more important decisions a new or young business will make. Entrepreneurs seeking to develop a constructive banking relationship should note:

- ✓ *Industry experience is critical.* Choose a banker who understands your particular industry. They will have other clients in the same industry and may serve as a valuable resource for networking and service professionals with relevant experience. In the case of funding requests, bankers with industry knowledge are more apt to make a quick and reasoned determination.
- ✓ *Understand their business model.* Every bank has different criteria with regard to working with new ventures and their lending decisions are largely based on quantitative credit scoring metrics. The entrepreneur needs to have an understanding of how a particular bank works and determine whether that model is a fit with his or her venture.
- ✓ *Understand who you're dealing with.* Bankers are relationship managers whose job is to support their clients—including expediting the approval of loans and credit lines that fit with their bank's lending criteria. Like a lot of good vendors, the best of them have specialized knowledge, excellent contacts, and will take a genuine interest in your business.

Much of the following discussion of lending practices and decisions applies to commercial finance company lenders as well as to banks. A good lender relationship can sometimes mean the difference between the life and death of a business during difficult times. There have been cases where one bank has called its loans to a struggling business, causing it to go under, and another bank has stayed with its loans and helped a business to survive and prosper.

Those banks that will not make loans to start-ups and early-stage ventures generally cite the lack of operating track record as the primary reason for turning down a loan. Lenders that make such loans usually do so for previously successful entrepreneurs of means or for firms backed by investors with whom they have had prior relationships and whose judgment they trust (e.g., established venture capital firms when they believe that the venture capital company will invest in the next round).

In centres of high technology and venture capital, the main officers of the major banks will have one or more high-technology lending officers who specialize in making loans to early-stage, high-technology ventures. Through much experience, these bankers have come to understand the market and operating idiosyncrasies, problems, and opportunities of such ventures. They generally have close ties to venture capital firms and will refer entrepreneurs to such firms for possible equity financing. The venture capital firms, in turn, will refer their portfolio ventures to the bankers for debt financing.

What should an entrepreneur consider in choosing a lender? What is important in a lending decision? How should entrepreneurs relate to their lenders on an ongoing basis? In many ways, the lender's decision is similar to that of the venture capitalist. The goal is to make money for his or her company, through interest earned on good loans. The lender

fears losing money by making bad loans to companies that default on their loans. To this end, he or she avoids risk by building in every conceivable safeguard. The lender is concerned with the client company's loan coverage, its ability to repay, and the collateral it can offer. Finally, but most important, he or she must judge the character and quality of the key managers of the company to whom the loan is being made.

Exhibit 11.4 outlines the key steps in obtaining a loan. Because of the importance of a banking relationship, an entrepreneur should shop around before making a choice. The criteria for selecting a bank should be based on more than just loan interest rates. Equally important, entrepreneurs should not wait until they have a dire need for funds to try to establish a banking relationship. The choice of a bank and the development of a banking relationship should begin when you do not urgently need the money. When an entrepreneur faces a near-term financial crisis, the venture's financial statements are at their worst and the banker has good cause to wonder about management's financial and planning skills—all to the detriment of the entrepreneur's chance of getting a loan.

Entrepreneurship experts Gordon Baty and James Stancill of the University of Southern California each describe factors that are especially important to an entrepreneur in selecting a bank.<sup>14</sup> The bank selected should be big enough to service a venture's foreseeable loans but not so large as to be relatively indifferent to your business. Banks differ greatly in their desire and capacity to work with small firms. Some banks have special small business loan officers and regard new and early-stage ventures as the seeds of very large future accounts. Other banks see such new venture loans as merely bad risks. Does the bank tend to call or reduce its

#### EXHIBIT 11.4 Key Steps in Obtaining a Loan

Before choosing and approaching a banker or other lender, the entrepreneur and his or her venture team should prepare by taking the following steps:

- Decide how much growth they want, and how fast they want to grow, observing the dictum that financing follows strategy.
- Determine how much money they require, when they need to have it, and when they can pay it back. To this end, they must:
  - Develop a schedule of operating and asset needs.
  - Prepare a real-time cash flow projection.
  - Decide how much capital they need.
  - Specify how they will use the funds they borrow.
- Revise and update the "corporate profile" in their business plan. This should consist of:
  - The core ingredients of the plan in the form of an executive summary.
  - A history of the firm (as appropriate).
  - Summaries of the financial results of the past three years.
  - Succinct descriptions of their markets and products.
  - A description of their operations.
  - Statements of cash flow and financial requirements.
  - Descriptions of the key managers, owners, and directors.
  - A rundown of the key strategies, facts, and logic that guide them in growing the corporation.
- Identify potential sources for the type of debt they seek, and the amount, rate, terms, and conditions they seek.
- Select a bank or other lending institution, solicit interest, and prepare a presentation.
- Prepare a written loan request.
- Present their case, negotiate, and then close the deal.
- After the loan is granted, borrowers should maintain an effective relationship with the lending officer.

Source: Jeffrey A. Timmons, *Financing and Planning the New Venture* (Acton, MA: Brick Housing Publishing, 1990).

loans to small businesses that have problems? When it has less capital to lend will it cut back on small business loans and favour older, more solid customers? Is the bank imaginative, creative, and helpful when a venture has a problem? To quote Baty, "Do they just look at your balance sheet and faint or do they try to suggest constructive financial alternatives?"

Has the bank had lending experience in your industry? If it has, your chances of getting a loan are better, and the bank will be more tolerant of problems and better able to help you exploit your opportunities. Is there good personal chemistry between you and your prospective lending officer? Remember, the person you talk to and deal with is the bank. Does this person know your industry and competition? Can this officer competently explain your business, technology, and uniqueness to other loan officers? Is he or she experienced in administering loans to smaller firms? Can you count on this person consistently? Does he or she have a good track record? Does his or her lending authority meet or exceed your needs? Does he or she have a reputation for being reasonable, creative, and willing to take a sound risk?

How does an entrepreneur go about evaluating a bank? First, the entrepreneur should consult accountants, lawyers, and other entrepreneurs who have had dealings with the bank. The advice of entrepreneurs who have dealt with a bank through good and bad times can be especially useful. Second, the entrepreneur should meet with loan officers at several banks and systematically explore their attitudes and approaches to their business borrowers. Who meets with you, for how long, and with how many interruptions can be useful measures of a bank's interest in your account. Finally, ask for small business references from their list of borrowers and talk to the entrepreneurs of those firms. Throughout all of these contacts and discussions, check out particular loan officers as well as the viability of the bank itself; they are a major determinant of how the bank will deal with you and your venture.

#### Approaching and Meeting the Banker

Obtaining a loan is, among other things, a sales job. Many borrowers tend to forget this. An entrepreneur with an early-stage venture must sell himself or herself as well as the viability and potential of the business to the banker. This is much the same situation that the early-stage entrepreneur faces with a venture capitalist.

The initial contact with a lender will likely be by telephone. The entrepreneur should be prepared to describe quickly the nature, age, and prospects of the venture; the amount of equity financing and who provided it; the prior financial performance of the business; the entrepreneur's experience and background; and the sort of bank financing desired. A referral from a venture capital firm, a lawyer or accountant, or other business associate who knows the banker can be very helpful.

If the loan officer agrees to a meeting, he or she may ask that a summary loan proposal, description of the business, and financial statements be sent ahead of time. A well-prepared proposal and a request for a reasonable amount of equity financing should pique a banker's interest.

The first meeting with a loan officer will likely be at the venture's place of business. The banker will be interested in meeting the management team, seeing how team members relate to the entrepreneur, and getting a sense of the financial controls and reporting used and how well things seem to be run. The banker may also want to meet one or more of the venture's equity investors. Most of all, the banker is using this meeting to evaluate the integrity and business acumen of those who will ultimately be responsible for the repayment of the loan.

Throughout meetings with potential bankers, the entrepreneur must convey an air of self-confidence and knowledge. If the banker is favourably impressed by what has been seen and read, he or she will ask for further documents and references and begin to discuss the amount and timing of funds that the bank might lend to the business. Exhibit 11.5 provides a snapshot of the relationship between Canadian banks and entrepreneurs. An additional resource worth examining is "Dealing with your banker and other lenders," which can be found at [www.canadabusiness.ca](http://www.canadabusiness.ca); simply type "banker" into the search box.

### EXHIBIT 11.5 Fast Facts about Small and Medium-Sized Enterprises (SMEs) and Canada's Banks

- ▶ Banks authorized \$85 billion in financing to 1.2 million SMEs in 2007
- ▶ 72% of SMEs use a bank as their main financial institution
- ▶ 65% use the same financial institution for personal and business banking
- ▶ Access to credit and a face-to-face relationship are identified as the most important factors between SMEs and their banks
- ▶ 72% of SMEs maintain a credit relationship with a financial institution
- ▶ 51% of SMEs have held a credit relationship with their financial institution for more than 10 years
- ▶ 38% have more than four credit relationships

Source: Canadian Bankers Association, www.cba.ca.

### What the Banker Wants to Know<sup>15</sup>

You first need to describe the business and its industry. Exhibit 11.6 suggests how a banker "sees a company" may differ from what the entrepreneur might say. What are you going to do with the money? Does the use of the loan make business sense? Should some or all of the money required be equity capital rather than debt? For new and young businesses, lenders do not like to see total debt-to-equity ratios greater than one. The answers to these questions will also determine the type of loan (e.g., line of credit or term).

1. How much do you need? You must be prepared to justify the amount requested and describe how the debt fits into an overall plan for financing and developing the business. Further, the amount of the loan should have enough cushion to allow for unexpected developments (see Exhibit 11.7).
2. When and how will you pay it back? This is an important question. Short-term loans for seasonal inventory build-ups or for financing receivables are easier to obtain than long-term loans, especially for early-stage businesses. How the loan will be repaid is the bottom-line question. Presumably you are borrowing money to finance activity that will generate enough cash to repay the loan. What is your contingency plan if things go wrong? Can you describe such risks and indicate how you will deal with them?
3. What is the secondary source of repayment? Are there assets or a guarantor of means?

### EXHIBIT 11.6 How Your Banker Interprets the Income Statement

|                                 |   |
|---------------------------------|---|
| <b>Sales</b>                    | What do you sell?<br>Whom do you sell to?<br>How do you buy?<br>What do you buy?<br>Whom do you buy from?   |
| Cost of goods                   |   |
| <b>Gross margin</b>             | Are you a supermarket or a boutique?<br>How do you sell and distribute the product?<br>How much overhead and support is needed to operate?<br>How much is reinvested in the product?    |
| Selling                         |   |
| G&A: General and Administration |   |
| R&D                             |   |
| <b>Operating margins</b>        | Dollars available before financing costs?<br>How big is this fixed nut?<br>Do you make money?<br>Corporation or not?<br>How much and to whom?<br>How much money is left in the company? |
| Interest expense                |   |
| Profit before taxes             |   |
| Taxes                           |   |
| Profit after taxes              |   |
| Dividends/withdrawals           |   |

Source: This exhibit was created by Kathie S. Stevens and Leslie Charm as part of a class discussion and is part of a presentation titled "Cash Is King, Assets Are Queen, and Everybody Is Looking for an Ace in the Hole." Ms. Stevens is former chief lending officer and member of the credit committee for a Boston bank.

### EXHIBIT 11.7 Sample of a Summary Loan Proposal

|                                       |  |
|---------------------------------------|--|
| <b>Date of request:</b>               | May 30, 2010   |
| <b>Borrower:</b>                      | Cole Graham & Sons, Inc.   |
| <b>Amount:</b>                        | \$4,200,000  |
| <b>Use of proceeds:</b>               | A/R, up to \$1,600,000   |
|                                       | Inventory, up to 824,000   |
|                                       | WIP, up to 525,000   |
|                                       | Marketing, up to 255,000   |
|                                       | Ski show specials 105,000  |
|                                       | Contingencies 50,000   |
|                                       | Officer loans due 841,000  |
|                                       | <u>\$4,200,000</u>   |
| <b>Type of loan:</b>                  | Seasonal revolving line of credit  |
| <b>Closing date:</b>                  | June 15, 2010  |
| <b>Term:</b>                          | One year   |
| <b>Rate:</b>                          | Prime plus 1/2 percent, no compensating balances, no points or origination fees. |
| <b>Takedown:</b>                      | \$500,000 at closing   |
|                                       | \$1,500,000 on August 1, 2010  |
|                                       | \$1,500,000 on October 1, 2010   |
|                                       | \$700,000 on November 1, 2012  |
| <b>Collateral:</b>                    | 70 percent of acceptable A/R under 90 days                                       |
|                                       | 50 percent of current inventory  |
| <b>Guarantees:</b>                    | None   |
| <b>Repayment schedule:</b>            | \$4,200,000 or balance on anniversary of note                                    |
| <b>Source of funds for repayment:</b> | a. Excess cash from operations (see cash flow).                                  |
|                                       | b. Renewable and increase of line if growth is profitable.                       |
|                                       | c. Conversion to three-year note.  |
| <b>Contingency source:</b>            | a. Sale and leaseback of equipment.  |
|                                       | b. Officer's loans (with a request for a personal guarantee).                    |

Source: Updated and adapted from Jeffrey A. Timmons, *Financing and Planning the New Venture* (Acton, MA: Brick House Publishing, 1990).

4. When do you need the money? If you need the money tomorrow, forget it. You are a poor planner and manager. On the other hand, if you need the money next month or the month after, you have demonstrated an ability to plan ahead, and you have given the banker time to investigate and process a loan application. Typically, it is difficult to get a lending decision in less than three weeks (some smaller banks have once-a-month credit meetings).

One of the best ways for all entrepreneurs to answer these questions is from a well-prepared business plan. This plan should contain projections of cash flow, profit and loss, and balance sheets that will demonstrate the need for a loan and how it can be repaid. Particular attention will be given by the lender to the value of the assets and the cash flow of the business, and to such financial ratios as current assets to current liabilities, gross margins, net worth to debt, accounts receivable and payable periods, inventory turns, and net profit to sales. The ratios for the borrower's venture will be compared to averages for competing firms to see how the potential borrower measures up to them.

For an existing business, the lender will want to review financial statements from prior years prepared or audited by a CA, a list of aged receivables and payables, the turnover of inventory, and lists of key customers and creditors. The lender will also want to know that all tax payments are current. Finally, he or she will need to know details of fixed assets and any liens on receivables, inventory, or fixed assets.

The entrepreneur-borrower should regard his or her contacts with the bank as a sales mission and provide data that are required promptly and in a form that can be readily understood. The better the material entrepreneurs can supply to demonstrate their business credibility, the easier and faster it will be to obtain a positive lending decision. The entrepreneur should also ask, early on, to meet with the banker's boss. This can go a long way to help obtain financing. Remember you need to build a relationship with a bank, and not just a banker.

### Specialist Banks for Lenders

There exist investment banks that focus on particular industries or geographic locales. Brett Wilson, as seen on CBC's *Dragons' Den*, was born in North Battleford, Saskatchewan, and began working at mainstream investment banks. He eventually went out on his own and co-founded Wilson Mackie & Co. and later FirstEnergy Capital Corp. to provide banking services to Canada's oil and gas enterprises. Following these successes he launched Prairie Merchant Corp.—a private bank for high-potential enterprises in energy, agriculture, real estate, sports, and entertainment. With singer Beverly Mahood, Brett Wilson has formed BPM Entertainment Corp. to seize investment opportunities in the entertainment world.<sup>16</sup>

There have even been calls for the creation of more Canadian investment banks. Such as to lend capital to those interested in taking over assets in Hamilton, Ontario to create a steel company. The same could be done for the auto industry. The rationale: let the assets fall where they may and see if enterprises emerge, and back those with bank loans.<sup>17</sup>

Sources: Tom Keyser, "Rebel With a Cause," [www.albertaventures.com](http://www.albertaventures.com), December 1, 2008; Duncan Cameron, "Needed: The Canadian Investment Bank," [www.rabble.ca](http://www.rabble.ca), May 12, 2009; University of Saskatchewan, "100 Alumni of Influence," [www.usask.ca/100/alumni/brett\\_wilson.php](http://www.usask.ca/100/alumni/brett_wilson.php) (accessed July 8, 2009).

## THE LENDING DECISION

One of the significant changes in today's lending environment is the centralized lending decision. Traditionally, loan officers might have had up to several million dollars of lending authority and could make loans to small companies. Besides the company's creditworthiness as determined by analysis of its past results via the balance sheet, income statement, cash flow, and collateral, the lender's assessment of the character and reputation of the entrepreneur was central to the decision. As loan decisions are made increasingly by loan committees or credit scoring, this face-to-face part of the decision process has given way to deeper analysis of the company's business plan, cash flow drivers and dissipaters, competitive environment, and the cushion for loan recovery given the firm's game plan and financial structure.

The implication for entrepreneurs is a demanding one: You can no longer rely on your salesmanship and good relationship with your loan officer alone to continue to get favourable lending decisions. You, or the key team member, need to be able to prepare the necessary analysis and documentation to convince people (you may never meet) that the loan will be repaid. You also need to know the financial ratios and criteria used to compare your loan request with industry norms and to defend the analysis. Such a presentation can make it easier and faster to obtain approval of a loan because it gives your relationship manager the ammunition to defend your loan request.

## Lending Criteria

First and foremost, as with equity investors, the quality and track record of the management team will be a major factor. Historical financial statements, which show three to five years of profitability, are also essential. Well-developed business projections that articulate the company's sales estimates, market niche, cash flow, profit projections, working capital, capital expenditure, uses of proceeds, and evidence of competent accounting and control systems are essential.

In its simplest form, what is needed is analysis of the available collateral, based on guidelines such as those shown in Exhibit 11.3, and of debt capacity determined by analysis of the coverage ratio once the new loan is in place. Interest coverage is calculated as earnings before interest and taxes divided by interest (EBIT/interest). A business with steady, predictable cash flow and earnings would require a lower coverage ratio (say, in the range of two) than would a company with a volatile, unpredictable cash flow stream, for example, a high-technology company with risk of competition and obsolescence (which might require a coverage ratio of five or more). The bottom line, of course, is the ability of the company to repay both interest and principal on time.

## Loan Restrictions<sup>18</sup>

A loan agreement defines the terms and conditions under which a lender provides capital. With it, lenders do two things: try to assure repayment of the loan as agreed and try to protect their position as creditor. Within the loan agreement (as in investment agreements) there are negative and positive covenants. Negative covenants are restrictions on the borrower; for example, no further additions to the borrower's total debt, no pledge to others of assets of the borrower, and no payment of dividends or limitation on owners' salaries.

Positive covenants define what the borrower must do. Some examples are maintenance of some minimum net worth or working capital, prompt payment of all federal and provincial taxes, adequate insurance on key people and property, repayment of the loan and interest according to the terms of the agreement, and provision to the lender of periodic financial statements and reports.

Some of these restrictions can hinder a company's growth, such as a flat restriction on further borrowing. Such a borrowing limit is often based on the borrower's assets at the time of the loan. However, rather than stipulating an initially fixed limit, the loan agreement should recognize that as a business grows and increases its total assets and net worth, it will need and be able to carry the additional debt required to sustain its growth; however, banks (especially in tighter credit periods) will still put maximums after allowed credit as it gives them another opportunity to recheck the loan. Similarly, covenants that require certain minimums on working capital or current ratios may be very difficult, for example, for a highly seasonal business to maintain at all times of the year. Only analysis of past financial monthly statements can indicate whether such a covenant can be met.

### Canwest Global Communications in Crisis

The Winnipeg-based media conglomerate was "scrambling to cut costs and reduce debt" in hopes of appeasing banks and other nervous lenders. The lenders conditions were not being met: "The covenants require Canwest to stick below numbers that measure the company's financial leverage." With quarterly figures revealing bad news, credit was permanently reduced to \$112 million from \$300 million and certain borrowing requirements had to be waived. But with \$92 million already drawn, Canwest has little breathing room. "And if the company's cash runs out, it could face an extreme makeover in CCAA." The Companies' Creditors Arrangement Act permits financially troubled enterprises to restructure and hopefully avoid bankruptcy.

"President and CEO Leonard Asper, whose family controls Canwest, blames the tanking economy." But Chris Diceman, a senior VP of DBRS, indicates "management should have focused on paying down debt. . . Instead, Canwest

embarked on international expansion." Too much leverage at an inopportune time was catching up with them. "The company's shares have lost 95 percent of their value in a year." Falling from \$4 to 20¢ per share; it should be noted that \$4 itself was a fair distance from share prices of over \$20 in 2000, \$15 in 2005, and about \$11 in 2007. And if Canwest heads toward bankruptcy and the courts takeover "that would likely mean an end to the Asper family's control."<sup>19</sup>

After missing a \$30-million interest payment earlier in 2009, Canwest failed to make \$10 million in debt payments at the end of May 2009. Acknowledging it was in default it moved to negotiate "broader restructuring of its finances."<sup>20</sup> Grappling with \$3.9 billion in debt during an economic recession cannot be easy.<sup>21</sup>

It was years prior that Canwest developed an appetite for debt. Numerous expensive acquisitions seemed like a good idea at the time. Driving along on a smooth road on a sunny day with a sharp stick on the steering wheel may not have seemed threatening at the time, but Warren Buffet's wisdom about leverage comes through now that the driving conditions are looking treacherous and economic uncertainty looms. Canwest filed for bankruptcy in late 2009.

Sources: Calvin Leung, "The Good, The Bad & The Ugly," *Canadian Business*, March 30, 2009; "Most Actively Traded Companies on Canadian Stock Markets," *Canadian Free Press*, May 30, 2009; "Canwest Media Gets Bondholder Reprieve," *United Press International*, May 21, 2009.

### Covenants to Look For

Before borrowing money, an entrepreneur should decide what sorts of restrictions or covenants are acceptable. Lawyers and accountants of the company should be consulted before any loan papers are signed. Some covenants are negotiable (this changes with the overall credit economy), and an entrepreneur should negotiate to get terms that the venture can live with next year as well as today. Once loan terms are agreed upon and the loan is made, the entrepreneur and the venture will be bound by them. If the bank says, "Yes, but . . ."

- Wants to put constraints on your permissible financial ratios.
- Stops any new borrowing.
- Wants a veto on any new management.
- Disallows new products or new directions.
- Prevents acquiring or selling any assets.
- Forbids any new investment or new equipment.

What follows are some practical guidelines about personal guarantees: when to expect them, how to avoid them, and how to eliminate them.

### Personal Guarantees and the Loan

Personal guarantees may be required of the "lead" entrepreneur or, more likely, shareholders of significance (more than 10 percent) who are also members of the senior management team. Also, personal guarantees are often "joint and severable"—meaning that each guarantor is liable for the total amount of the guarantee.

#### When to Expect Them

- If you are under collateralized.
- If there are shareholder loans or lots of "due to" and "due from" officer accounts.
- If you have had poor or erratic performance.
- If you have management problems.
- If your relationship with your banker is strained.
- If you have a new loan officer.
- If there is turbulence in the credit markets.
- If there has been a wave of bad loans made by the lending institution, and a crackdown is in force.
- If there is less understanding of your market.

#### How to Avoid Them

- Good to spectacular performance.
- Conservative financial management.
- Positive cash flow over a sustained period.
- Adequate collateral.
- Careful management of the balance sheet.

#### How to Eliminate Them (if you already have them)

- See "How to Avoid Them."
- Develop a financial plan with performance targets and a timetable.
- Negotiate elimination *upfront* when you have some bargaining chips, based on certain performance criteria.
- Stay active in the search for backup sources of funds.

### Building a Relationship

After obtaining a loan, entrepreneurs should cultivate a close working relationship with their bankers. Too many businesspeople do not see their lending officers until they need a loan. The astute entrepreneur will take a much more active role in keeping a banker informed about the business, thereby improving the chances of obtaining larger loans for expansion and cooperation from the bank in troubled times.

Some of the things that should be done to build such a relationship are fairly simple.<sup>22</sup> In addition to monthly and annual financial statements, bankers should be sent product news releases and any trade articles about the business or its products. The entrepreneur should invite the banker to the venture's facility, review product development plans and the prospects for the business, and establish a personal relationship with him or her. If this is done, when a new loan is requested, the lending officer will feel better about recommending its approval.

What about bad news? Never surprise a banker with bad news; make sure he or she sees it coming as soon as you do. Unpleasant surprises are a sign that an entrepreneur is not being candid with the banker or that management does not have the business under the proper control. Either conclusion by a banker is damaging to the relationship.

If a future loan payment cannot be met, entrepreneurs should not panic and avoid their bankers. On the contrary, they should visit their banks and explain why the loan payment cannot be made and say when it will be made. If this is done before the payment due date and the entrepreneur-banker relationship is good, the banker may go along. What else can he or she do? If an entrepreneur has convinced a banker of the viability and future growth of a business, the banker really does not want to call a loan and lose a customer to a competitor or cause bankruptcy. The real key to communicating with a banker is candidly to inform but not to scare. In other words, entrepreneurs must indicate that they are aware of adverse events and have a plan for dealing with them.

To build credibility with bankers further, entrepreneurs should borrow before they need to and then repay the loan. This will establish a track record of borrowing and reliable repayment. Entrepreneurs should also make every effort to meet the financial targets they set for themselves and have discussed with their banker. If this cannot be done, the credibility of the entrepreneur will erode, even if the business is growing.

Bankers have a right to expect an entrepreneur to continue to use them as the business grows and prospers, and not to go shopping for a better interest rate. In return, entrepreneurs have the right to expect that their bank will continue to provide them with needed loans, particularly during difficult times when a vacillating loan policy could be dangerous for a business's survival.

### Handling a Banker or Other Lender

1. Your banker is your partner, not a difficult minority shareholder.
2. Be honest and straightforward in sharing information.
3. Invite the banker to see your business in operation.

4. Always avoid overdrafts, late payments, and late financial statements.
5. Answer questions frankly and honestly. *Tell the truth.* Lying is illegal and undoubtedly violates loan covenants.
6. Understand the business of banking.
7. Have an "Ace in the Hole."

## WHAT TO DO WHEN THE BANK SAYS NO

What do you do if the bank turns you down for a loan? Regroup, and review the following questions.

1. Does the company really need to borrow now? Can cash be generated elsewhere? Tighten the belt. Are some expenditures unnecessary? Sharpen the financial pencil: be lean and mean.
2. What does the balance sheet say? Are you growing too fast? Compare yourself to published industry ratios to see if you are on target.
3. Does the bank have a clear and comprehensive understanding of your needs? Did you really get to know your loan officer? Did you do enough homework on the bank's criteria and their likes and dislikes? Was your loan officer too busy to give your borrowing package proper consideration? A loan officer may have 50 to as many as 200 accounts. Is your relationship with the bank on a proper track?
4. Was your written loan proposal realistic? Was it a normal request, or something that differed from the types of proposals the bank usually sees? Did you make a verbal request for a loan, without presenting any written backup?
5. Do you need a new loan officer, or a new bank? If your answers to the above questions put you in the clear, and your written proposal was realistic, call the head of the commercial loan department and arrange a meeting. Sit down and discuss the history of your loan effort, the facts, and the bank's reasons for turning you down.
6. Who else might provide this financing (ask the banker who turned you down)?

You should be seeing multiple lenders at the same time so you don't run out of time or money.

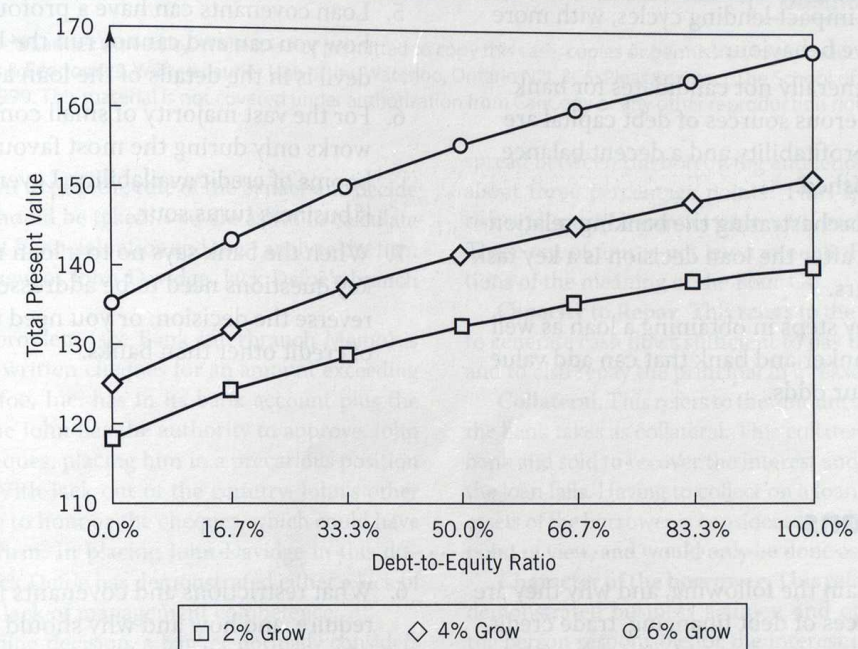
## TAR PITS: ENTREPRENEURS BEWARE

Modern corporate financial theory has preached the virtues of zero cash balances and the use of leverage to enhance return on equity. When applied to closely held companies whose dream is to last forever, such thinking can be extremely destructive. The excessive leverage used by so many larger companies was apparently just not worth the risk: Two-thirds of the LBOs done in the 1980s have ended up in serious trouble. The serious erosion of IBM began about the same time as the company acquired debt on its balance sheet for the very first time, in the early 1980s. This problem was manifested in the acquisition binges of the early 1990s and in the high-technology feeding frenzy of the late 1990s. Following the 2000–2003 downturn, LBOs once again emerged as a popular growth vehicle. The same can be expected after the economic turmoil that began in late 2008 and pushed on into 2010 subsidies and those on the inside embrace risk thinking they know better and can do better.

### Beware of Leverage: The ROE Mirage

According to the theory, one can significantly improve return on equity (ROE) by utilizing debt. Thus, the present value of a company would also increase significantly as the company went from a zero debt-to-equity ratio to 100 percent, as shown in Exhibit 11.8. On closer examination, however, such an increase in debt only improves the present value, given

EXHIBIT 11.8 Total Present Value



Source: William A. Sahlman, "Note on Free Cash Flow Valuation Models," Harvard Business School, 2003.

the 2 to 8 percent growth rates shown, by 17 to 26 percent. If the company gets into any trouble—and the odds of that happening sooner or later are very high—its options and flexibility become very seriously constrained by the covenants of the senior lenders. Leverage creates an unforgiving capital structure, and the potential additional ROI often is not worth the risk. If the upside is worth risking the loss of the entire company should adversity strike, then go ahead. This is easier said than survived, however.

Ask any entrepreneur who has had to deal with the workout specialists in a bank and you will get a sobering, if not frightening, message: It is hell and you will not want to do it again.

### Neither a Lender Nor a Borrower Be, But If You Must . . .

Canadian billionaire investor and philanthopist, Stephen Jarislowsky repeats the words of Shakespeare "neither a borrower nor a lender be,"<sup>23</sup> which is actually very good advice for early-stage entrepreneurs in this time of "economic war."<sup>24</sup> Thus, the following may serve as useful tips if you must borrow:

1. Borrow when you do not need it (which is the surest way to accomplish No. 2).
2. Avoid personal guarantees. Put caps and time limits on the amounts based on performance milestones, such as achieving certain cash flow, working capital, and equity levels. Also, don't be afraid in many markets to offer your guarantee and then negotiate ways to get it back in whole or in part!
3. The devil is in the details. Read each loan covenant and requirement carefully—only the owner can truly appreciate their consequences.
4. Try to avoid or modify so-called hair-trigger covenants, such as: "If there is any change or event of any kind that can have any materially adverse effect on the future of the company, the loan shall become due and payable."
5. Be conservative and prudent.

## Chapter Summary

1. Business cycles impact lending cycles, with more or less restrictive behaviour.
2. Start-ups are generally not candidates for bank credit, but numerous sources of debt capital are available once profitability and a decent balance sheet are established.
3. Managing and orchestrating the banking relationship before and after the loan decision is a key task for entrepreneurs.
4. Knowing the key steps in obtaining a loan as well as selecting a banker and bank that can add value and improve your odds.
5. Loan covenants can have a profound impact on how you can and cannot run the business. The devil is in the details of the loan agreement.
6. For the vast majority of small companies, leverage works only during the most favourable economic booms of credit availability. Leverage is a disaster if business turns sour.
7. When the bank says no to a loan request, several key questions need to be addressed in an effort to reverse the decision; or you need to seek sources of credit other than banks.

## Study Questions

1. Define and explain the following, and why they are important: sources of debt financing, trade credit, line of credit, accounts receivable financing, time-sales factoring, commercial finance company.
2. What security can be used for a loan, and what percentage of its value do banks typically lend?
3. What are the things to look for in evaluating a lender, and why are these important?
4. What does "value-added banker" mean, and how and why is this crucial?
5. What criteria do lenders use to evaluate a loan application, and what can be done before and after the loan decision to facilitate a loan request?
6. What restrictions and covenants might a lender require, and how and why should these be avoided whenever possible?
7. What issues need to be addressed to deal with a loan request rejection?
8. Why do entrepreneurs in smaller enterprises need to be especially wary of leverage?
9. At what stages should a venture borrow money?

## Mind Stretchers *Have you considered?*

1. With the recent "credit crunch," capital is scarce. You have knocked on the doors of quite a few banks and had your loan applications denied. What next? Do you keep trying traditional lending options? What about an Internet or off-shore bank? Someone gives you the name of a guy in Las Vegas that can front you some cash off the books, do you follow up?
2. Why is Warren Buffet so wary about leverage?
3. Can you calculate the debt capacity of your proposed venture three to four years hence if it achieves positive cash flow and profitability?

## CASE

## JACK DEFOE, INC.

**LAURIER**  
Business & Economics

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### Instruction:

This case calls for you to play the role of the banker and decide what action if any should be taken. You are asked to calculate a second year's set of financial ratios and then analyze the firm from the point of view of John Davidge, Jack Defoe's branch bank manager.

John Davidge's problem (see Bank Interbranch Memo) is that Jack Defoe has written cheques for an amount exceeding the money Jack Defoe, Inc. has in its bank account plus the maximum credit line John has the authority to approve. John honoured those cheques, placing him in a precarious position with his superior. With Jack out of the country, John's other choice was to refuse to honour the cheques, which could have brought down the firm. In placing John Davidge in this distressing position, Jack Defoe has demonstrated either a lack of business ethics or a lack of management competence.

In making a lending decision, a banker normally considers four factors that we call the Four C's. These are Capacity to repay, Collateral, Character of the borrower, and business Conditions. A bank normally borrows the money it lends from depositors and purchasers of guaranteed investment certificates, which are similar to bonds. It then lends this money to borrowers such as Jack Defoe, Inc. The bank has very little

spread between the borrowing and lending rates, traditionally about three percentage points. Thus it can afford very little risk and must be comfortable with each one of the Four Cs. Three out of four is not good enough. Following are explanations of the meaning of the Four Cs.

**Capacity to Repay.** This refers to the ability of the borrower to generate cash flows sufficient to pay the interest on the loan and to also repay the principal in a reasonable time frame.

**Collateral.** This refers to the amount and quality of the assets the bank takes as collateral. This collateral can be seized by the bank and sold to recover the interest and principal of the loan if the loan fails. Having to collect on a loan by resorting to seizing assets of the borrower is considered a failed loan from the bank's point of view, and would only be done as a last resort.

**Character of the borrower.** This refers to the credit record, demonstrated business acumen and other personal traits of the person responsible for the interest payments and the loan repayment, in this case Jack Defoe.

**Business Conditions.** This refers to the nature and prospects of the business borrowing the money. The key question is, "Is this a business area in which the bank wants to have its money? Will this business sector thrive and grow?"

Use these criteria in your evaluation of Jack Defoe, Inc.

### Bank Interbranch Memo

From: Don James, Loans Manager  
Sent: Friday, December 19, 2008 — 2:44 PM  
To: John Davidge, Branch Manager  
Subject: Jack Defoe Inc.

Hello John,

This account has been outstanding for three years without repayment and has grown in the past year from \$6,300 to \$27,840 (including overdraft). This account exceeds your \$25,000 discretionary limit and must be referred to your Loans Supervisor.

Please forward your file along with your analysis and recommendations on this account.

Don

#### Background (abstracted from file)

Jack Defoe Inc. is a small business manufacturing components for computer monitors. The process and production equipment are highly specialized and were developed by the president and principal shareholder, Jack Defoe. Product quality is reputedly high and the product commands a premium price.

Despite the premium price, the company has been expanding sales rapidly. It has a significant market share in North America. Jack Defoe spent time in Europe and Japan this past year and is enthusiastic about export opportunities beyond North America. He has received token orders.

Until the beginning of 2008, production was carried out in a large double garage. Commencing about April 1, operations were moved to rented premises in an industrial park. Reason for the move was insufficient space. At that time most of the fixed assets were replaced, because the old assets could not meet the required production levels. The Company sold the excess fixed assets for \$4,500.

Jack Defoe owns 1,500 shares in Jack Defoe Inc. He is 32 years old and is trained as an engineering technician. He is married with three children. Substantially all his personal resources are invested in the business. His wife owns the family home, which is heavily mortgaged.

Mrs. Anne Defoe, Jack's mother, owns 500 shares in Jack Defoe Inc. acquired in 2008 in exchange for a note payable of \$18,000. This is believed to be a substantial part of her personal resources. The conversion was made at our request.

A total of \$3,000 in dividends were paid in 2008, to give Mrs. Anne Defoe a small return on her investment. No dividends were paid in 2006 or 2007.

Jack Defoe is in Japan at this time and cannot be reached before this analysis is due.

REQUIRED: Prepare your analysis, including statements of changes in financial position.

This case was written by Don B. Smith, Wilfrid Laurier University, Business & Economics, for purposes of classroom discussion.

## EXHIBIT 1

Jack Defoe Inc.  
Balance Sheet as at November 30, 2008

| ASSETS                           |           | LIABILITIES                  |           |
|----------------------------------|-----------|------------------------------|-----------|
| <b>Current Assets</b>            |           | <b>Current Liabilities</b>   |           |
| Accounts Receivable              | \$45,870  | Bank overdraft               | \$3,840   |
| Less allow. doubtful ac.         | 3,720     | Demand loan                  | 16,000    |
|                                  | \$42,150  | Accounts payable             | 16,190    |
| <b>Inventories</b>               |           | Accrued wages                | 120       |
| Raw Materials                    | \$35,670  | Income tax payable           | 11,460    |
| Finished Goods                   | 10,680    | Total current liabilities    | \$47,610  |
|                                  | 46,350    | <b>Long Term Liabilities</b> |           |
| <b>Prepaid rent (current)</b>    |           | Note payable—bank            | 8,000     |
| Total current assets             | \$90,000  | <b>SHAREHOLDER EQUITY</b>    |           |
| <b>Long Term Assets</b>          |           | Common stock 2,000           |           |
| Deposit on machine               | 3,000     | Shares outstanding           | \$31,500  |
| Prepaid rent (over 1 year)       | 3,000     | <b>Retained Earnings</b>     |           |
| <b>Machinery &amp; equipment</b> |           | Opening balance              | \$9,760   |
| \$42,200                         |           | Net income for year          | 38,370    |
| Less accum. deprec.              | 5,960     | Closing balance              | \$48,130  |
|                                  | 36,240    | Less dividends               | 3,000     |
|                                  |           |                              | \$45,130  |
|                                  |           |                              | 76,630    |
|                                  |           |                              | \$132,240 |
|                                  | \$132,240 |                              | \$132,240 |

## EXHIBIT 2

Jack Defoe Inc.  
Income Statement for the Year Ended November 30, 2008

|   |           |           |
|---|-----------|-----------|
| Sales   |           | \$388,440 |
| Less Cost of Goods Sold   |           | 270,555   |
| Gross Profit  |           | \$117,885 |
| <b>Selling &amp; Administrative Expenses</b>                              |           |           |
| Salary  | \$42,000  |           |
| Travel & entertainment  | 10,830    |           |
| Bad debts   | 1,990     |           |
| Telephone   | 2,540     |           |
| Interest  | 4,580     |           |
| Loss on disposal of equipment   | 5,725     |           |
| Other expense   | 390       |           |
|   | 68,055    |           |
| <b>Net Profit Before Income Taxes</b>                                     |           | \$49,830  |
| Less income taxes   |           | 11,460    |
|   |           | \$38,370  |
| <b>Net Profit After Income Taxes</b>                                      |           |           |
| <b>Details of Cost of Goods Sold for the Year Ended November 30, 2008</b> |           |           |
| Finished Goods Inventory December 1, 2007                                 |           | \$9,450   |
| <b>Cost of Goods Manufactured</b>   |           |           |
| Raw materials December 1, 2007  | \$17,460  |           |
| Purchases during year   | 192,810   |           |
|   | \$210,270 |           |
| Raw materials November 30, 2008   | 35,670    |           |
| Raw materials used  | \$174,600 |           |
| <b>Manufacturing Expenses</b>   |           |           |
| Direct labour   | \$51,510  |           |
| Production supplies   | 6,300     |           |
| Depreciation on equipment   | 4,635     |           |
| Maintenance   | 7,200     |           |
| Building rent   | 14,400    |           |
| Electricity   | 5,880     |           |
| Miscellaneous production  | 7,260     |           |
|   | 271,785   |           |
| Cost of goods available for sale  | \$281,235 |           |
| Finished goods Inventory November 30, 2008                                | 10,680    |           |
| <b>Cost of goods sold during the year</b>                                 |           | \$270,555 |

**EXHIBIT 3**

Jack Defoe Inc.  
Balance Sheet as at November 30, 2007

| ASSETS                      |                 | LIABILITIES                      |                 |
|-----------------------------|-----------------|----------------------------------|-----------------|
| <b>Current Assets</b>       |                 | <b>Current Liabilities</b>       |                 |
| Cash in bank                | \$2,010         | Demand loan                      | \$6,300         |
| Accounts Receivable         | \$19,720        | Rent payable                     | 600             |
| Less allow. doubtful ac.    | 3,300           | Accounts payable                 | 6,030           |
|                             |                 | Accrued wages                    | 4,050           |
|                             |                 | <b>Total current liabilities</b> | <b>\$16,980</b> |
| <b>Inventories</b>          |                 | <b>Long Term Liabilities</b>     |                 |
| Raw Materials               | \$17,460        | Note payable—A. Defoe            | 18,000          |
| Finished Goods              | 9,450           |                                  |                 |
| <b>Total current assets</b> | <b>\$45,340</b> |                                  |                 |
| <b>Long Term Assets</b>     |                 | <b>SHAREHOLDER EQUITY</b>        |                 |
| Machinery & equipment       | \$19,500        | Common stock 1,500               |                 |
| Less accum. deprec.         | 6,600           | Shares outstanding               | \$13,500        |
|                             |                 | <b>Retained Earnings</b>         |                 |
|                             |                 | Opening balance (deficit)        | \$(10,490)      |
|                             |                 | Net income for year              | 20,250          |
|                             |                 | <b>Closing balance</b>           | <b>\$9,760</b>  |
|                             |                 |                                  | <b>23,260</b>   |
|                             |                 |                                  | <b>\$58,240</b> |

Note: No income tax was payable on account of 2007 operations because of losses carried forward.

**EXHIBIT 4**

Jack Defoe Inc.  
Income Statement for the Year Ended November 30, 2007

|   |                  |
|---|------------------|
| Sales   | \$192,210        |
| Less Cost of Goods Sold   | 116,640          |
| <b>Gross Profit</b>   | <b>\$75,570</b>  |
| <b>Selling &amp; Administrative Expenses</b>                              |                  |
| Salary  | \$40,000         |
| Travel & entertainment  | 7,740            |
| Bad debts   | 1,170            |
| Telephone   | 1,110            |
| Interest  | 4,010            |
| Other expense   | 1,290            |
|   | <b>55,320</b>    |
| <b>Net Profit for the year</b>  | <b>\$20,250</b>  |
| <b>Details of Cost of Goods Sold for the Year Ended November 30, 2007</b> |                  |
| Finished Goods Inventory December 1, 2006                                 | \$5,700          |
| <b>Cost of Goods Manufactured</b>   |                  |
| Raw materials December 1, 2006  | \$7,860          |
| Purchases during year   | 87,600           |
|   | <b>\$95,460</b>  |
| Raw materials November 30, 2007   | 17,460           |
| <b>Raw materials used</b>   | <b>\$78,000</b>  |
| <b>Manufacturing Expenses</b>   |                  |
| Direct labour   | \$23,640         |
| Production supplies   | 1,980            |
| Depreciation on equipment   | 2,700            |
| Maintenance   | 2,550            |
| Building rent   | 3,600            |
| Electricity   | 2,730            |
| Miscellaneous production  | 5,190            |
|   | <b>120,390</b>   |
| <b>Cost of goods available for sale</b>                                   | <b>\$126,090</b> |
| Finished goods Inventory November 30, 2007                                | 9,450            |
| <b>Cost of goods sold during the year</b>                                 | <b>\$116,640</b> |

## EXHIBIT 5

Jack Defoe Inc.  
Balance Sheet as at November 30, 2006

| ASSETS                   |          | LIABILITIES                  |            |
|--------------------------|----------|------------------------------|------------|
| <b>Current Assets</b>    |          | <b>Current Liabilities</b>   |            |
| Cash in bank             | \$605    | Rent payable                 | 1,800      |
| Accounts Receivable      | \$10,545 | Accounts payable             | 8,870      |
| Less allow. doubtful ac. | 2,600    | Accrued wages                | 2,150      |
|                          |          | Total current liabilities    | \$12,820   |
| <b>Inventories</b>       |          | <b>Long Term Liabilities</b> |            |
| Raw Materials            | \$7,860  | Note payable—A. Defoe        | 14,000     |
| Finished Goods           | 5,700    |                              |            |
| Total current assets     | \$22,110 |                              |            |
| <b>Long Term Assets</b>  |          | <b>SHAREHOLDER EQUITY</b>    |            |
| Machinery & equipment    | \$11,620 | Common stock 1,500           |            |
| Less accum. deprec.      | 3,900    | Shares outstanding           | \$13,500   |
|                          | 7,720    | <b>Retained Earnings</b>     |            |
|                          |          | Opening balance (deficit)    | \$(8,730)  |
|                          |          | Net income for year          | (1,760)    |
|                          |          | Closing balance              | \$(10,490) |
|                          |          |                              | 3,010      |
|                          |          |                              | \$29,830   |

Note: No income tax was payable on account of 2007 operations because of losses carried forward.

## EXHIBIT 6

Jack Defoe Inc.  
Income Statement for the Year Ended November 30, 2006

|   |           |
|---|-----------|
| Sales   | \$128,970 |
| Less Cost of Goods Sold   | 81,310    |
| Gross Profit  | \$47,660  |
| <b>Selling &amp; Administrative Expenses</b>                              |           |
| Salary  | \$36,000  |
| Travel & entertainment  | 7,610     |
| Bad debts   | 950       |
| Telephone   | 1,095     |
| Interest  | 2,135     |
| Other expense   | 1,630     |
|   | 49,420    |
| <b>Net Profit for the year</b>  | \$(1,760) |
| <b>Details of Cost of Goods Sold for the Year Ended November 30, 2006</b> |           |
| Finished Goods Inventory December 1, 2005                                 | \$3,825   |
| <b>Cost of Goods Manufactured</b>   |           |
| Raw materials December 1, 2005  | \$5,320   |
| Purchases during year   | 54,210    |
|   | \$59,530  |
| Raw materials November 30, 2006   | 7,860     |
| Raw materials used  | \$51,670  |
| <b>Manufacturing Expenses</b>   |           |
| Direct labour   | \$14,880  |
| Production supplies   | 1,830     |
| Depreciation on equipment   | 2,140     |
| Maintenance   | 2,525     |
| Building rent   | 3,600     |
| Electricity   | 2,315     |
| Miscellaneous production  | 4,225     |
|   | 83,185    |
| Cost of goods available for sale  | \$87,010  |
| Finished goods Inventory November 30, 2006                                | 5,700     |
| <b>Cost of goods sold during the year</b>                                 | \$81,310  |

**EXHIBIT 7**

Jack Defoe Inc.

## Cash Flow Statement for the Year Ended November 30, 2008

|                                   | Sources  | Uses     | Incr.(Decr)      |
|-----------------------------------|----------|----------|------------------|
| Net Income From Operations        | \$38,370 |          |                  |
| Add back Depreciation             | 4,635    |          | \$48,730         |
| Loss on disposal of equipment     | 5,725    |          |                  |
| <b>Changes in Working Capital</b> |          |          |                  |
| Accounts payable increase         | \$10,160 |          |                  |
| Income tax payable increase       | 11,460   |          |                  |
| Accounts receivable increase      |          | \$25,730 |                  |
| Raw materials increase            |          | 18,210   |                  |
| Finished goods increase           |          | 1,230    |                  |
| Prepaid rent increase             |          | 4,500    |                  |
| Rent payable decrease             |          | 600      |                  |
| Accrued wages decrease            |          | 3,930    |                  |
|                                   | \$21,620 | \$54,200 | (32,580)         |
| <b>Cash from operations</b>       |          |          | <b>\$16,150</b>  |
| <b>Investing Activities</b>       |          |          |                  |
| Sale of old equipment             | \$4,500  |          |                  |
| Deposit on new equipment          |          | \$3,000  |                  |
| Purchase of new equipment         |          | 38,200   |                  |
|                                   | \$4,500  | \$41,200 | (36,700)         |
| <b>Financing Activities</b>       |          |          |                  |
| Demand loan—Bank                  | \$9,700  |          |                  |
| Note payable—Bank                 | 8,000    |          |                  |
| Issue of common shares            | 18,000   |          |                  |
| Retired note payable              |          | \$18,000 |                  |
| Dividend paid                     |          | 3,000    |                  |
|                                   | \$35,700 | \$21,000 | 14,700           |
| <b>Decrease in cash</b>           |          |          | <b>\$(5,850)</b> |

**EXHIBIT 8**

Jack Defoe Inc.

## Cash Flow Statement for the Year Ended November 30, 2007

|                                       | Sources  | Uses     | Incr.(Decr)      |
|---------------------------------------|----------|----------|------------------|
| Net Income From Operations            | \$20,250 |          |                  |
| Add back Depreciation                 | 2,700    |          | \$22,950         |
| <b>Changes in Working Capital</b>     |          |          |                  |
| Accrued wages increase                | \$1,900  |          |                  |
| Accounts receivable increase          |          | \$8,475  |                  |
| Raw materials increase                |          | 9,600    |                  |
| Finished goods increase               |          | 3,750    |                  |
| Rent payable decrease                 |          | 1,200    |                  |
| Accounts payable decrease             |          | 2,840    |                  |
|                                       | \$1,900  | \$25,865 | (23,965)         |
| <b>Cash from operations (deficit)</b> |          |          | <b>\$(1,015)</b> |
| <b>Investing Activities</b>           |          |          |                  |
| Purchase of new equipment             |          | \$7,880  | (7,880)          |
| <b>Financing Activities</b>           |          |          |                  |
| Demand loan—Bank                      | \$6,300  |          |                  |
| Note payable                          | 4,000    |          |                  |
|                                       | \$10,300 |          | 10,300           |
| <b>Increase in cash</b>               |          |          | <b>\$1,405</b>   |

## EXHIBIT 9

Jack Defoe Inc.  
Ratio Calculations

|                              |   | 2007<br>Input                                    | 2007<br>Result | Measure | 2008<br>Input | 2008<br>Result |
|------------------------------|---|--|----------------|---------|---------------|----------------|
| <b>Liquidity Ratios</b>      |   |  |                |         |               |                |
| Current Ratio                | $\frac{\text{Current Assets}}{\text{Current Liabilities}}$                  | $\frac{45,340}{16,980}$                          | 2.67           | to 1    |               |                |
| Acid Test                    | $\frac{\text{Quick Assets}}{\text{Current Liabilities}}$                    | $\frac{18,430}{16,980}$                          | 1.09           | to 1    |               |                |
| Working Capital              | Current Assets – Current Liabilities  | 45,340 – 16,980                                  | 28,360         | \$      |               |                |
| Accounts Receivable Turnover | $\frac{\text{Annual Credit Sales}}{\text{Accounts Receivable}}$             | $\frac{192,210}{16,420}$                         | 11.71          | times   |               |                |
| Average Collection Period    | $\frac{\text{Accounts Receivable} \times 365}{\text{Annual Credit Sales}}$  | $\frac{16,420 \times 365}{192,210}$              | 31.18          | days    |               |                |
| Inventory Turnover           | $\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$                | $\frac{116,640}{(13,560 + 26,912)/2}$            | 5.76           | times   |               |                |
| Age of Inventory             | $\frac{\text{Average Inventory} \times 365}{\text{Cost of Goods Sold}}$     | $\frac{(13,560 + 26,912)/2 \times 365}{116,640}$ | 63.32          | days    |               |                |
| Age of Payables              | $\frac{\text{Accounts Payable} \times 365}{\text{Raw Materials Purchases}}$ | $\frac{6,030 \times 365}{87,600}$                | 25.13          | days    |               |                |
| <b>Profitability Ratios</b>  |   |  |                |         |               |                |
| Gross Profit Margin          | $\frac{\text{Gross Profit} \times 100}{\text{Sales}}$                       | $\frac{75,570 \times 100}{192,210}$              | 39.3           | percent |               |                |
| Net Profit Margin            | $\frac{\text{Net Profit} \times 100}{\text{Sales}}$                         | $\frac{20,250 \times 100}{192,210}$              | 10.5           | percent |               |                |
| Return on Equity             | $\frac{\text{Net Income} \times 100}{\text{Total Shareholder Equity}}$      | $\frac{20,250 \times 100}{23,260}$               | 87.1           | percent |               |                |
| Return on Tangible           | $\frac{\text{Net Income} \times 100}{\text{Total Tangible Assets}}$         | $\frac{20,250 \times 100}{58,240}$               | 34.8           | percent |               |                |



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## PART

## V

## START-UP AND BEYOND

Under conditions of rapid growth, entrepreneurs face unusual paradoxes and challenges as their companies grow and the leadership modes required by these companies change.

Whether they have the adaptability and resiliency in the face of swift developments to grow fast enough as leaders and whether they have enough courage, wisdom, and discipline to balance controlled growth with growing fast enough to keep pace with the competition and industry turbulence will become crystal clear.

Entrepreneurs face enormous pressures and physical and emotional wear and tear during the rapid growth of their companies. It goes with the territory. Entrepreneurs after start-up find that “it” has to be done now, that there is no room to falter, and that there are no “runners-up.” Those who have a personal entrepreneurial strategy, who are healthy, who have their lives in order, and who know what they are signing up for fare better than those who do not.

Among all the stimulating and exceedingly difficult challenges entrepreneurs face—and can meet successfully—none is more liberating and exhilarating than a successful harvest. Perhaps the point is made best in one of the final lines of the musical *Oliver*: “In the end, all that counts is in the bank, in large amounts!”

Obviously, money is not the only thing, or everything. But money can ensure both independence and autonomy to do what you want to do, mostly on your terms, and can significantly increase the options and opportunities at your discretion. While value creation was the goal, the measure of success is wealth creation, and how one chooses to distribute and use that wealth. In effect, for entrepreneurs, net worth is the final scorecard of the value creation process.