BUILDING VALUE
SUCCESS THROUGH COLLABORATION

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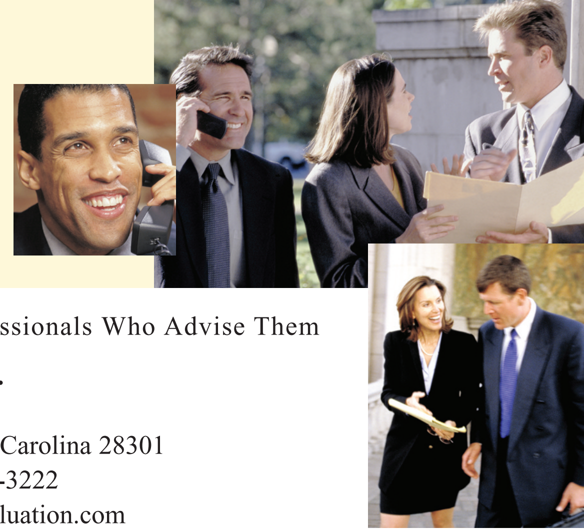

A Quarterly Business Valuation Newsletter for Business Owners and the Professionals Who Advise Them

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FINANCING: INCREASING THE ODDS

In order to improve the odds of obtaining the financing needed at the desired terms, it helps to understand how a banker looks at credit-worthiness of a company. Every banker learns the "Five Cs" of credit early in his or her career:

1. **C**haracter or integrity
2. **C**apacity to repay the loan
3. **C**apital or net worth
4. **C**ollateral
5. **C**onditions of the borrower, industry, or economy

The lender can request and analyze information related to the company, but that analysis is limited by the quality of the information provided. If quality information is not provided, lenders are less likely to provide the necessary financing (i.e., the perceived risk will be too high for the expected return). Even quality information will not help if the financing needs do not meet the lenders' overall criteria, so it is important to identify potential lenders with whom your needs are compatible. This brings us two more "Cs": Communication and Contacts.

The company seeking financing must perform the appropriate level of self-analysis, develop and communicate a well-conceived business plan, and locate the "right" lender.

Self-Analysis: How Does Your Company "Measure Up?"

This can be a difficult question, but should be considered well before talking to potential lenders. The more work a company does on the front end, the easier the process will be. The company must understand how it "measures up" to the five "Cs" of credit in the eyes of the lender.

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VALUATION AND BUSINESS CONCENTRATIONS

Concentrations are a significant issue in valuing a business enterprise. The presence and magnitude (or absence) of business concentrations are major considerations in assessing a company's risk profile and financial outlook. All else being equal, the presence of significant concentrations frequently results in a lower value than otherwise might be expected.

The term "business concentrations" covers a variety of situations, including a company dependent on:

- A single customer or a small group of customers for all or a major portion of its sales.
- Customers within a narrow industry segment for all or a major portion of its sales.
- Sales within a narrowly defined geographic territory.
- A single product or service with limited applications for all or a major portion of its sales.
- A single supplier for a key production input (materials or equipment).
- A limited pool of workers with highly specialized skills.
- Technology and other intellectual properties (trade secrets, patents, copyrights), controlled by others, which are an essential element in its services, products, or production processes.
- Internal concentrations, such as dependency on a key manager or worker, operation from a single plant, or dependence on a single piece of equipment.

Concentrations have two detrimental impacts on the company's value. First, they tend to imply a risk of a decline in revenues due to an interruption of the company's ability to deliver its products or a decline in the demand for its products. Second, they may imply limits on revenue growth through potential market saturation or through limits on the company's productive capacity.

In some cases, the negative implications for value of business concentrations may be substantially or even entirely mitigated by the presence of long-term contractual agreements binding customers and suppliers to the company.

A sound valuation analysis will include a discussion of all relevant business concentrations.

— *Mercer Capital Staff*

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Character or Integrity. The owner and the company must have a reputation of the highest character and integrity. The lender is looking for a client who is truthful and meets his or her obligations.

Capacity to Repay the Loan, Capital or Net Worth, and Collateral. Management should review and analyze its ability to repay the debt, to support the debt with an adequate net worth, and provide sufficient collateral relative to the requested debt. Begin the process with an analysis of the historical trends and include projections to show the expected results. Examples of trends and ratios to review include:

- Profitability: Revenue, profit, and profit margin trends
- Debt repayment: Cash flow coverage (e.g., EBITDA to debt service)
- Liquidity: Current ratio, working capital, or other current asset and liability ratios
- Capitalization: Leverage ratios (e.g., debt to tangible net worth)
- Collateral position: Collateral relative to existing and requested debt

The trends and ratios should be compared to industry averages and typical lending standards in the industry (if you do not know the typical standards, ask a lender). This process not only provides insight into your ability to obtain the necessary financing, but also enables you to submit a request that meets the lender's standards.

The projected results should be on an annual, if not monthly, basis. Management should carefully consider the assumptions behind the projections and be able to explain any deviations from historical results. Lenders will challenge the projections for reasonableness, so they had better be reasonable. In addition, lenders will often establish covenants, benchmarks, and targets based upon the projections, which could be costly if the company is unable to substantially meet or exceed the projections.

In short, the lender considers the past performance and current financial position, but the debt repayment will come from future performance. Therefore, management must be able to provide the lender with informed projections to assist in analyzing the potential loan.

Conditions of the Borrower, Industry, or Economy. Management should consider the current and future trends of the business, industry, and economy. Management should not only understand the company's internal strengths and weaknesses, but also how they measure up and are affected by external forces. A good framework to follow is the Five Forces Model (*Competitive Strategy: Techniques for Analyzing Industries and Competitors, Michael E. Porter, Free Press, 1998*). This model looks at the buyers or customers, the suppliers, the threat of substitutes, threat of entry, and competition within the industry.

Communication: Informing Lenders of Your Business Plan. If information is lacking, the lender will have difficulty making the loan. The lender may assume the company is unable to produce, does not have the required knowledge to provide, or is hiding the requested information. Therefore, it benefits the company to provide as much information as possible to decrease the risk to the lender. One way to communicate this information is with a business plan that provides potential lenders with the background information necessary to make a preliminary decision on the potential "fit" of the company and its financing needs.

The higher the quality of the business plan, the better the reception by lenders, the quicker the decision time, the better the eventual terms of the loans, and the more likely a quality, long-term relationship will be established with the lender.

Contacts: Finding the Right Lender. The right lender will understand the needs and risks involved, and will be more likely to provide the financing needed at the desired terms and conditions. Finding the right lender may involve contacting local bankers or searching regionally or nationally for a lender that can provide financing for your specific need. The complexity of the search may be due to industry characteristics, the loan amount, high risk situations, or other specific needs.

Homework Required

The ability to obtain the financing your company needs through a financial institution will ultimately depend on your ability to provide the lender reasonable assurance that your company meets their credit standards. You can improve your odds of obtaining the required financing by doing your homework on the front end with self-analysis, preparation of a business plan, and identifying the lenders that are best suited for your situation.

— *R. Brian Steen, CFA*

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