Chapter 3

Financing the Deal

Sea Story

Equity Cash Infusions

I sat silently in the passenger seat of Matt's SUV as he merged onto I-55 N, which would take us from Springfield back to Chicago. We'd just completed a face-to-face, onsite meeting with Ron, the owner of a print shop that serviced much of southern Illinois.

The meeting had been odd. Despite signing NDAs, Ron flatly refused to discuss his business' economics. He acted as though questions like *"what percentage of total revenue is each business segment"* were sinister attempts to steal state secrets. Needless to say, we hadn't learned much.

The facility tour, however, had been more productive. The administrative spaces were clean and well kept. The production floor was well organized – each work station positioned to optimize workflow. The industrial-grade shelves in the back storage room were stacked with inventory.

"What do you think?" I asked, breaking the silence.

"He wasn't very talkative," Matt said with a chuckle, "but the plant looked good. I think we move forward with an offer."

I nodded in agreement, "So now we have to figure out the deal structure."

"Well," Matt replied, "the SBA will let us use up to 90% leverage."

"That's still about $150k we need to raise in equity capital," I leaned back in my seat and sighed.

"We can pitch the deal to family offices..." Matt nodded as his voice trailed off.

"…and if they don't invest?" I asked.

"Then it's on to friends and family!"

The Process

Introduction to Deal Structure

After determining the purchase price (*how much* you will pay for the business), you have to determine the deal structure (*how* you will pay that amount). Businesses are usually acquired with a combination of equity, outside debt, and seller financing.

Equity refers to the cash provided by the buyer(s) to acquire the business. Buyers contribute equity capital to obtain their ownership (or equity) stake in the business.

Outside debt, on the other hand, is the portion of the purchase price borrowed from lending sources (i.e. banks). If multiple lenders are providing debt capital, they will have an order of priority. This is what is meant by *senior* vs. *subordinate* debt. Senior lenders must be paid first.

Equity and outside debt capital typically compose the portion of the purchase price know as *cash at close*. Cash at close is the amount of cash transferred to the seller when the deal closes. Unless the business has particularly risky attributes, cash at close tends to be at least 80% of the purchase price.

The remaining portion, which the seller did not receive at close, is seller financing. Seller financing is effectively debt provided by the seller. This typically takes the form of a *seller note* that specifies how the remainder of the purchase price is to be paid.

The Process

Raising Equity Capital

The SBA 7a loan program allows up to 90% leverage on a business acquisition. That is the most debt any lender will offer. However, even if you use 7a to its maximum, there's still 10% of the purchase price you'll need to come up with. If you raise this amount from investors, they will require an ownership or *equity* stake in the business. Your own personal savings, friends and family, high-net worth individuals, family offices, and investment firms are all typical sources of equity capital.

Capital Sources

Personal Savings – When seeking equity capital, look first to your own savings. The more you can afford to invest yourself, the less equity (ownership) you'll need to sell to outside investors.

While this is a straightforward concept, there is one trick that buyers should understand. It is possible to use retirement savings as equity capital when buying a small business.

This method of financing is known as Rollovers as Business Startup (ROBS). By partnering with a specialized attorney or ROBS provider, the buyer forms a new C-Corp and sets up a 401k. The buyer then rolls his retirement savings into that 401k plan. The rolled-over funds are then used to purchase stock in the C-Corp. This approach puts your retirement savings at risk but may be a needed source capital.[i]

Guidant Financial is a leading ROBS provider that can walk you through the process.

Friends and Family – Those close to you can be a source of equity capital. Selling an ownership stake to a friend or family member has the advantage of partnering with someone you know and trust. Of course, the risk is damaging an important relationship should the business fail and the investment be lost.

High-Net Worth Individuals – If you are fortunate enough to have wealthy individuals in your network, they are obvious targets for equity investment. Just remember that they didn't become wealthy by chance. Expect them to drive a hard bargain when it comes to exchanging equity dollars for ownership stake.

Family Offices - Some very wealthy families hire investment professionals to manage their money. These *family offices* often entertain small to mid-size business investments. Because they answer only to the family they serve, family offices may be free of short-term *return on investment* targets. This enables them to allocate funds to more illiquid opportunities in pursuit of superior returns over five to ten years.

Investment Firms – Professional investment firms vary greatly with respect to investment criteria. However, there is a small subset that will entertain investment in small to mid-sized business. A111 Capital, Broadtree Partners, and Corridor Capital are examples of such firms. These firms are much more likely to invest in larger deals (i.e. EBITDA greater than $2M).

Sea Story

Mergers and Consternations

"Mark, book value of equity *is not* an appropriate way to value our company!" I exclaimed, exasperated by yet another frustrating conference call.

Mark was a print industry investment banker representing us in a potential merger with Johnson Election Services, a national player in ballot printing. Since the beginning of negotiations, the deal structure had changed several times.

The initial idea was for our business to be acquired by theirs, creating a single company with production assets in the Southwest and Midwest United States. Next, Johnson suggested they proceed with a full acquisition, but that we continue to run the businesses separately. Finally, they proposed acquiring an ownership stake in our company with the option to buy more down the road. This is what we were trying to finalize. The question now was how to value the equity Johnson wanted to buy.

We had presented Johnson with a *pro forma* – a reasonable set of financial projections showing that a $1M investment for 25% of our company was likely to yield a return greater than 30%. This return would be a combination of free cash flow produced by the business and equity value achieved by paying down debt.

Unfortunately, Johnson (and even our own investment banker) deemed that approach invalid. We had spent two years and over a million dollars to modernize our operation and position ourselves to print ballots nationwide. While this investment was a strategic necessity, it fundamentally changed the cost structure of the business. As a result, the P&L for this recent period bared little resemblance to pro forma. Johnson, quite reasonably, was having a hard time getting comfortable with a cash flow story untethered from past results.

Mark's suggestion, however, was a non-starter. He proposed selling equity to Johnson based on the current balance sheet. That is, subtract liabilities from assets to determine total equity value and sell a portion of the equity on that basis. This method was skewed against us and misrepresented the true value of the company. Our recent production investments had increased company debt, but had not been online long enough to realize increased revenues and reduced costs. For us, valuation by book value of equity was all downside.

Ultimately, we were unable to reach a deal. Both sides had a valid point of view. Johnson could not invest on the basis of unproven cash flows. We could not sell before our investments began to pay off. The timing just wasn't right.

Equity Valuation Methodology

Having determined sources of equity capital, the question becomes how much equity to offer for a given investment. We will examine three different ways to value equity sold to investors. The first is *book value of equity*. This is used when selling equity *subsequent* to acquiring the company. What I call the *Shark Tank* method and the *IRR Hurdle Rate* method are used when raising equity capital to close the deal.

Book Value of Equity – This valuation methodology comes right off your balance sheet and is only used when selling an ownership stake in a business you already own. The balance sheet shows an equity value, which is the difference between the company assets and liabilities. If your company has $3M in assets and $2M in liabilities, the equity value in the company is $1M. When selling equity to an outside investor, you sell based on this valuation. For instance, using this example, a $200k investment would warrant a 20% ownership stake in the company.

A note of caution – be careful with balance sheet depreciation when using this methodology. Tax CPAs are skilled at accelerating depreciation to the greatest extent allowed by law, giving business owners the tax advantage of depreciation expense as soon as possible. We once invested in a printing press that cost $1.254mm. Thanks to the Tax Cut and Jobs Act (TCJA) of 2017, we were able to fully depreciate this equipment in its first year. As a result, the $1.254mm asset was offset by accumulated depreciation of the same amount, netting to a balance sheet value of zero. Of course, the liquidation value of that equipment was in excess of $1mm. That value would have to be added back to company assets to come to a proper equity value.

Shark Tank Method – I've named this method after NBC's hit television show. On the show, an entrepreneur enters the "tank" and makes his or her pitch to five self-made millionaires ("sharks"). The pitch ends with an *ask*. This *ask* is typically a dollar amount of equity investment in exchange for an ownership stake in the company. For instance, the entrepreneur might ask the sharks for $100k for 10% of the company. This imputes a valuation – in the case $1mm. After the *ask*, Mark Cuban or one of the other sharks often states the implied valuation for the benefit of the audience. This valuation methodology is simple – the investor's ownership is equal to their investment as a percentage of company value. While this methodology makes sense intuitively, it may give away too much to investors who do not intend to be active in the business.

IRR Hurdle Rate Method – If an investor is *passive* (not involved in day-to-day business operations), they should only expect a fair return on their money. Capital has an *opportunity cost*. If you have money, you have the opportunity to make different investments. If you make the safest possible investment (government bonds), you might expect an average return of 2%. Let's consider 2% the *risk-free rate of return*. Of course, introducing riskier investments into your portfolio increases both the expected return *and* the volatility of those returns. I've been told the big oil companies use 10% as their opportunity cost of capital. This is the benchmark I use for a liquid portfolio of securities with a reasonable risk-reward profile.

But investment in a privately owned business is not a *liquid* investment. *Liquidity* refers to the ability to be transacted. Cash is completely liquid – you can always exchange cash for goods and services at a moments notice. Owned real estate is less liquid – it takes time and effort to sell the property before obtaining the cash that can then be exchanged for goods and services.

Business investment is highly illiquid. Investors only see cash when the business makes distributions from profitable operations or when the business is sold. Otherwise, the investor's value is tied up in the business and cannot be easily extracted. The inconvenience of illiquidity requires a higher rate of return. If you're going to tie up capital in a business investment, you better get a higher return than the 10% you would expect from your financial advisor who invests in public securities.

The minimum expected return required to make an investment worthwhile is sometimes called the *hurdle rate*. If an investment can't produce a return greater than or equal to the hurdle rate, you shouldn't invest in it. Business investment hurdle rates will vary with industry. For the print industry, between 25% and 28% is conventional.

To determine the appropriate ownership stake for a given investment, we must present the expected *internal rate of return (IRR)* to the prospective investor. IRR represents the discount rate at which the net present value (NPV) of future cash flows is zero; but, for our purposes, it is enough to know that IRR represents return on invested capital.

Let's consider the acquisition of Paula's Print Shop, which was our example from previous chapters. Remember that we valued this company at 4x adjusted EBITDA, which came to $1.16mm. Let's assume that we will finance this purchase price using an SBA 7a loan for 90% leverage. This means we still need to come up with 10% of the purchase price (or $116k). Let's assume we will contribute $16k ourselves,

but want to bring in an outside investor to contribute the remaining $100k. Let's look at a financial model to determine the equity stake we should offer for this $100k investment.

PAULA'S PRINT SHOP BUYOUT MODEL

$ in 000's

	(Historical) Year - Seller's Results						(Future) Year - Buyer's Projections				
	1	2	3	4	5		6	7	8	9	10
						t=0	1	2	3	4	5
Annual Sales Growth Rate							10.0%	10.0%	10.0%	10.0%	10.0%
INCOME STATEMENT											
Sales	$ 1,625,000	$ 1,710,000	$ 1,765,000	$ 1,810,000	$ 1,840,000		$ 2,024,000	$ 2,226,400	$ 2,449,040	$ 2,693,944	$ 2,963,338
EBITDA	$ 308,750	$ 359,100	$ 388,300	$ 325,800	$ 368,050		$ 423,258	$ 486,746	$ 559,758	$ 643,722	$ 740,280
Margin	*19%*	*21%*	*22%*	*18%*	*20%*		*21%*	*22%*	*23%*	*24%*	*25%*
Buyer Synergies	[redacted]						700,000	700,000	700,000	700,000	700,000
Deductible Earnout Payment							-	-	-	-	
Interest on Debt							(53,839)	(48,559)	(42,962)	(37,029)	(30,740)
Depreciation (Five Year Average Write-off)							(82,144)	(45,502)	(60,197)	(76,360)	(94,140)
Taxes -S-Corp / LLC (40% of cumulative profits)							(394,910)	(437,074)	(462,640)	(492,133)	(526,160)
Net Income							**$ 592,365**	**$ 655,611**	**$ 693,960**	**$ 738,200**	**$ 789,240**
BALANCE SHEET											
Cash	[redacted]				276,214		276,214	276,214	276,214	276,214	276,214
Receivables					238,526		262,378	288,616	317,478	349,225	384,148
Inventories					171,889		189,078	207,986	228,785	251,663	276,830
Other Current Assets					209,636		230,599	253,659	279,025	306,928	337,621
AP					(214,673)		(236,140)	(259,754)	(285,730)	(314,303)	(345,733)
Accrued Expenses					(12,840)		(14,124)	(15,536)	(17,090)	(18,798)	(20,678)
Income Tax Payables					(60,638)		-	-	-	-	-
Line of Credit					-		-	-	-	-	-
Working Capital					608,114		708,006	751,185	798,682	850,929	908,401
PP&E					100,000		160,720	227,512	300,983	381,802	470,702
Accum. Depreciation					(50,000)		(82,144)	(127,646)	(187,843)	(264,203)	(358,344)
Other assets					51,897		-	-	-	-	-
Intangibles (including deal costs)					51,897		51,897	51,897	51,897	51,897	51,897
Net Assets					**$ 761,907**		**$ 838,479**	**$ 902,947**	**$ 963,719**	**$ 1,020,424**	**$ 1,072,655**
Notes Payable - SBA 7a Loan	[redacted]				0		1,071,993	978,706	879,821	775,004	663,897
Deferred Taxes					-		-	-	-	-	-
Equity					710,011		(233,515)	(75,758)	83,898	245,420	408,758
Long-Term Debt + Equity					**$ 710,011**		**$ 838,479**	**$ 902,947**	**$ 963,719**	**$ 1,020,424**	**$ 1,072,655**
CASH FLOW											
EBITDA							$ 1,123,258	$ 1,186,746	$ 1,259,758	$ 1,343,722	$ 1,440,280
Interest							(53,839)	(48,559)	(42,962)	(37,029)	(30,740)
CAPEX (3% of sales)							(60,720)	(66,792)	(73,471)	(80,818)	(88,900)
Extra CAPEX							-	-	-	-	-
Earnout							-	-	-	-	-
Taxes / Dividends							(394,910)	(437,074)	(462,640)	(492,133)	(526,160)
Principle Payments							(88,007)	(93,287)	(98,884)	(104,818)	(111,107)
Working Capital							(99,892)	(43,179)	(47,497)	(52,247)	(57,472)
Free Cash Flow							**$ 425,890**	**$ 497,855**	**$ 534,304**	**$ 576,677**	**$ 625,902**

SHAREHOLDER VALUE									
Total Equity Infusion of Capital at Closing Table	$ 116,000								
Investor Initial Equity / Exit Value @ 4x Average Last Five Year EBITDA)	$ 100,000	for	7.70%						$ 329,540
Cash Flow		$ 100,000	$ -	$ -	$ -	$ -	$ (329,540)		
IRR (Target 25% to 28%)	**27%**								

DEBT STATISTICS					
Total Debt (Net Cash)	1,348,207	1,254,920	1,156,035	1,051,218	940,111
Total Debt to EBITDA (Max 4)	1.20	1.06	0.92	0.78	0.65
Senior Debt to EBITDA (Max 3)	0.00	0.00	0.00	0.00	0.00

When you present this model, you are asking the prospect to invest on the basis of the company's expected future performance. This can be a tough sell. Experienced investors know that reality is never as rosy as a pro forma financial model makes it out to be. Even so, let's examine the future results claimed by the model above.

The pro forma anticipates 10% year-over-year revenue growth, corresponding to 15% year-over-year growth in EBITDA. Any claim of double-digit sales growth (even 10%) is likely to raise eyebrows. Most

investors will accept 5%, but become skeptical of greater optimism. EBITDA growth should be a bit higher. After all, the business' overhead expenses remained fixed when revenue increases, leading to higher profit margins.

Next, the pro forma claims $700k in annual cash flow from *synergies*. Synergies are additional profits obtained by combining two or more businesses. The cynic in me feels obliged to note that *synergies* can also be a nonsense word used to make financial models say what you want them to say.

There are, however, times when synergies are quite real. Let's say you also already own *Dan's Digital Printing*, which utilizes digital printing presses for high-speed, variable data printing. In addition to this type of work, many customers also ask *Dan's* to print their product catalogs. Because catalogs are most efficiently printed on old-fashion offset printing presses, *Dan's* outsources that work, which is valued at $700k of annual profit. With the addition of Paula's Print Shop, which specializes in offset printing, that profit would now go to Paula's and benefit its ownership.

To be clear, this model presumes that the $100k investment would be for a stake in Paula's Print Shop only – not a combined entity including Paula's and Dan's. Even so, the ownership of Dan's Digital Printing would have every reason to direct work to an offset printer in which it is the majority owner.

The model then projects the balance sheet, holding cash constant and increasing A/R, inventory, other current assets, and A/P at the same rate as sales. Property, Plants, and Equipment (PP&E) and accumulated depreciation vary with the CAPEX assumptions made below. The principal balances of the 7a debt used to purchase the business are added as a new liability.

These combine to adjust EBITDA to Free Cash Flow (FCF) available to the new ownership.

Finally, we are in a position to calculate the IRR for a given investment. The model assumes that the new ownership will operate Paula's Print Shop for five years before selling. This means that an investor will make an equity capital contribution, in this case $100k. The business will then generate FCF through operations for five years. The business will then be sold for 4x average EBITDA over the five-year operating period. The proceeds of that sale will first be used to settle the outstanding principal on the 7a acquisition debt. The ownership will then distribute the remaining proceeds and the accumulated cash from FCF to its owners on a pro rata basis.

SHAREHOLDER VALUE							
Total Equity Infusion of Capital at Closing Table	$ 116,000						
Investor Initial Equity / Exit Value @ 4x Average Last Five Year EBITDA)	$ 100,000	for	7.70%				$ 329,540
Cash Flow	$ 100,000	$ -	$ -	$ -	$ -	$ (329,540)	
IRR (Target 25% to 28%)	**27%**						
	=IRR(cash flow range, guess)						

Above is an illustration of how to calculate IRR in Excel. The total equity required at the closing table is $116k. Our prospective investor will contribute $100k in exchange for 7.70% ownership, despite $100k being 8.62% of the $1.16mm purchase price. This works because it results in an IRR for the investor of 27%, which is generally deemed adequate for an illiquid small business investment.

Excel determines the IRR by tallying up the cash flows to and from the investor. The investor contributes $100k at the time of closing, shown as a positive number (cash flow *to* the business). The business makes no profit distributions during its five-year operating period, allowing its FCF to accumulate in its bank accounts. The business is then sold for 4x adjusted EBITDA, the debt settled, and all remaining cash distributed, 7.70% ($329,540) going to our investor.

The Excel formula for IRR is:

$$=IRR(cash\ flow\ range, guess)$$

for the initial portion, simply select the cells indicating annual cash flows. The guess is unimportant – entering zero will do just fine.

These three valuation methodologies (book value of equity, Shark Tank method, and IRR hurdle rate method) will help calculate a fair ownership stake for a given investment. From that starting point, you will be poised to negotiate for the equity capital you need to close the deal.

Sea Story

Debt Storm

I typed furiously. CenTrust Bank was about to be hit with as much wrath as a harshly worded email can muster. We never wanted to bank with them in the first place. Local banks have their advantages, but CenTrust's online interface was cumbersome and transferring funds was a nightmare. But, they had agreed to provide the SBA 7a loan for Riverside Printing, our third acquisition; so, we were stuck.

A silver lining had been CenTrust's willingness to leave Riverside's accounts receivable out of the lien placed on business assets. This enabled them to use the A/R as collateral for a working capital line of credit. This line of credit was a revolver allowing us to borrow up to 80% of our accounts receivable balance. While interest was paid monthly, principal payments were required only when our A/R decreased such that the borrowed principal exceeded the 80% mark.

Even so, I had opted to payback a large principal amount (over $50k) several months prior when our businesses were flush with cash. Besides saving on interest payments, I hoped that clearing a large principal balance would give CenTrust confidence in our ability to make good on our debts.

It didn't work… My recent request to draw on the line had been met with new demands for financial documents. CenTrust had decided to reassess our credit worthiness. I understood that the bank had been spooked by the ongoing COVID-19 pandemic, but we had been approved for this line of credit! What good is a bank that, without warning, reneges on a prior approval when you most need the money!

The suspended line of credit wasn't the only aspect of our debt profile challenging the enterprise. Every month we serviced three SBA 7a loans – one for each of our acquisitions. The purchase price of our ballot printing company was almost $5mm; the business carried over $2mm in SBA debt and owed over $30k in monthly repayments. That hefty amount, combined with the cyclicality of elections, made budgeting for debt service a difficult, high-stakes exercise.

Complicating matters further, we held a $260k Seller Note that was subordinate to this 7a debt. The provisions of the senior debt allowed note payments only so long as our *debt service coverage ratio (DSCR)* remained above 1.25. Unfortunately, the ebbs and flows of the election cycle periodically placed that covenant in jeopardy.

Three years prior, we had offset these cash flow challenges by drawing $250k on an SBA Express Line of Credit. This product required interest only payments for three years, then principal and interest for the final four years of the seven-year term. We had just reached that transition. Monthly payments on this debt were no longer trivial. While the borrowed cash had been crucial in the early going, it now felt as though a debt timebomb had exploded in my lap.

Complicating matters further were two business development projects – each requiring additional financing.

The first was refinancing our newest printing press. This equipment was expensive – over $1mm purchase price. We had financed it with a commercial capital lease - $150k down followed by a seven-year term. Monthly payments were about $18k. However, relief was available if we could refinance into the SBA 504 program. An SBA 504 loan would stretch the amortization period to as much as 25-years, drastically reducing our payments.

The second project was more complicated. We were working to acquire a large ballot printer in Ohio. This target was larger than our three companies combined. If the deal closed, we would instantly have national scope. My afternoon calendar was filled with back-to-back meetings with potential lending partners. We hoped to use a large amount of interest-only mezzanine debt. The question was whether we could find a lender interested in a subordinate debt position with terms we could stomach.

As I hit send on the email, I knew the futility of my frustration. In the midst of COVID uncertainty, CenTrust wasn't taking any chances. Regardless, there was no time cry over spilled milk. Our debt position had become complex and I needed to manage it.

The Process

Raising Debt Capital

In most cases, the majority of cash paid to the seller at close will be from debt. This is both a blessing and a curse. While debt service is a cash burden, the financial leverage it applies enables the returns that make small and medium sized businesses attractive investments. To source debt effectively, a buyer must understand how debt is structured and where to get it.

Debt Considerations

***Senior vs. Subordinate* Debt -** When any creditor issues debt to a business, it assumes a position of priority relative to the business' other creditors. Should the business go into default, the creditors are paid in order of seniority with available funds. The debt raised to acquire the business will always be most senior; subsequent debt, usually taken for working capital or for investments in the business, will be subordinate. Subordinate debt is risker for a creditor, so expect a higher interest rate.

P&I vs. Interest Only – For many business owners, a main concern with debt is the monthly cash burden it presents. Most readers will be familiar with debt that requires principal and interest (*P&I)* to be paid each month according to a schedule. This, of course, is how a home mortgage works. While P&I payments puts a firm timeframe on debt retirement, it reduces flexibility and burdens working capital with monthly principal paydown.

In addition to standard P&I debt, certain debt products are *interest only*. These products typically require the borrower to only pay interest on the borrowed principal until a) some agreed upon timeframe during which principal will be paid down, b) indefinitely, or c) the loan is called by the lender. Interest only debt reduces the business' cash burden; but, if the borrower isn't disciplined in paying down principal over time, continues to drain cash through interest expense without improving the balance sheet by reducing the debt liability.

Mezzanine Debt – When a business owner desires debt financing but doesn't have collateral against which to borrow. Mezzanine (or *mezz)* debt is an option. Mezz debt is secured by equity. Should the borrow default, the lender will convert the debt to an equity stake in the company by exercising *warrants* or *options* provided to them in the lending agreement.[ii]

Debt Covenants – These are restrictions that creditors put on lending agreements to limit the actions of borrowers.[iii] Covenants are often triggered by failing to meet specified financial metrics. Debt Coverage Service Ratio (DCSR) is one such metric. DSCR is calculated using the formula below:

$$DSCR = \frac{Net\ Operating\ Income}{Total\ Debt\ Service}$$

In the sea story above, the senior lender, which had provided the SBA 7a loan, enforced a debt covenant that prevented payments on the (subordinate) seller note should DSCR fall below 1.25.

Revolver – Revolving credit is an agreement that allows an account holder to borrow money repeatedly up to a set dollar limit.[iv] In the sea story above, the credit revolver allowed us to borrow up to 80% of our account receivable balance. While interest payments were made monthly, principal payments were required only when our accounts receivable no longer supported the borrowed amount. To verify that no principal payments were due, the bank required monthly A/R updates.

Notable Debt Products

SBA 7a Program – This is the Small Business Administration's primary program for providing financial assistance to small businesses. The standard 7a loan has a maximum amount of $5mm. Though the loan is provided by a bank, the SBA guarantees a large portion of the principal – 75% at the time of this writing. 7a loans have a very favorable 10-year term and an interest rate to be negotiated with the lender.[v] The interest rate I have seen most often is the *prime rate*[1] plus 2.75%.[vi] The SBA guarantee makes lenders much more comfortable with *cash flow lending*, which is very helpful when acquiring an asset-light business.

SBA 504 Program – This program offers favorable financing for fixed assets that promote business growth and job creation. 504 loans have long-term, fixed interest rates. Small businesses can borrow up to $5mm. 504 loans can be used for the renovation of existing buildings, the construction of new facilities, and investment in machinery and equipment.[vii] With terms of 10, 20, or 25 years depending on intended use, 504 loans are a great way to grow or modernize while limiting impact on cash flow.

SBA Express LOC – This product is a pathway to SBA working capital and can be useful to businesses with few assets to collateralize. The maximum loan amount is $500k, the maximum SBA guarantee is 50%, and the term can be up to 7 years.

Seller Notes – In addition to traditional bank lending, sellers can provide debt financing directly. This is done with a *note* obligating the buyer to pay the seller according to agreed upon terms. While terms are at the discretion of the involved parties, I have typically seen notes with a 5-year term, 5% fixed interest rate, and monthly P&I payments.

Whether a seller note is *guaranteed* or *subject to performance provisions* is likely to be a point of contention. Performance provisions typically reduce the value of the note should the business fail to perform in accordance with specified financial metrics. This protects buyers against business volatility and sell-side misrepresentations.

A/R Working Capital LOC – So long as your accounts receivable are unencumbered by liens, you can likely find a creditor willing to lend against your A/R balance. As mentioned in the sea story above, the line of credit I had allowed us to draw 80% of A/R. These products tend to be revolvers, requiring principal payment only when the A/R balance falls such that the borrowed principal exceeds the allowed threshold.

Equipment Financing – For manufacturers and other asset-heavy businesses, equipment financing is key to operations. In the print industry, I negotiated equipment leases with terms between 48 and 72 months with interest rates of 5% or less.

[1] The Wall Street Journal Prime Rate is an aggregate average of the various prime rates that 10 of the largest banks in the United States charge to their highest credit quality customers for loans with relatively short-term maturities. This combined rate is obtained by way of a market survey and published regularly by *The Wall Street Journal* (WSJ).

For accounting purposes, you will need to decide if a lease is an *operating lease* (payments recorded directly to the P&L as an expense) or a *capital lease* (the equipment listed as a balance sheet asset, offset by the lease value recorded as a liability - the principal of which is reduced each payment while the interest is expensed on the P&L). If monthly payments are less than $2,500, I recommend treating as an operating lease. Otherwise, capitalize the equipment.

Sea Story

The Company is Unsellable

"The answer is *no*…" Ron said with a grimace I could sense over the phone, "but give him time. He may come around."

"I understand," I replied, "I'm disappointed but not surprised."

"Well, the people around Jim think the company is worth more than just the value of the assets. They like you though and think you would be able to run the business."

Ron was the broker representing Jim, owner of Wildcat Water Chemical Service. I didn't bother to point out that my valuation was *not* simply based on company assets – he understood that.

I couldn't make a standard offer due to the characteristics of the business. Wildcat operated with almost absolute customer concentration – over 80% of revenues coming from just three customers. Also, customer relationships were maintained by the owner, who visited the key customers weekly. Making matters worse, the general manager, who handled all scheduling and office administration, planned to retire as soon as the business sold.

Any one of these issues should cause a buyer to walk away. *This business had all three of them!* Believing the company to be unsellable, I wondered if I could use the business' flaws to my advantage.

I figured there was only a 50% chance that I could acquire the business and retain the three top customers. That being the case, I couldn't put debt on the business. If just one of these customers left, I would be in default… and in personal bankruptcy shortly thereafter.

I decided to offer a deal structure that might work for both sides. I would pay the value of company assets, which I believed to be around $200k, at the closing table. I would then pay Jim 10% of revenues until he had collected a total of $1.5mm. If the transition was successful, Jim would receive a fair price for his business, albeit over an extended period of time. If the acquisition failed, I would be in a position to close up shop without creditors in hot pursuit.

"They just think Jim should be compensated for some goodwill…" Ron continued, but I don't recall the rest of the conversation. It was moot at that point. We weren't going to do this or any other deal.

Goodwill was the sticking point. In this case, goodwill consisted entirely of the three large customer relationships. Jim wanted to paid for at least some of that goodwill at the closing table. I agreed he should be paid for goodwill, but only as it performed its intended function, *which is producing cash*.

Unfortunately, Jim wasn't prepared to accept an *earn out*.

The Process

Seller Earnout

A *seller earnout* is a form of seller financing.

In a *seller note*, the seller provides financing directly to the buyer, forgoing a portion of the purchase price at close. That portion is paid with interest over time. Performance provisions on a seller note protect the buyer in the event the business' financial performance fails to meet expectations. However, even when a note is subject to such provisions, the investment thesis presumes that the business will perform and the entirety of the note will be paid.

Seller earnouts are not so optimistic. Most earnouts come about because a company is at risk or is in a declining industry. An earnout arrangement makes the business earn the seller some portion of the purchase price by continuing to perform at agreed upon levels. Earnouts are open about shifting risk to the seller.

Sellers always assure buyers that the business is sound. An earnout lets them put their money where their mouth is.

Chapter Summary

The Essential Process

1. Businesses are usually acquired with a combination of equity, outside debt, and seller financing.

2. Your own personal savings, friends and family, high-net worth individuals, family offices, and investment firms are all typical sources of equity capital.

3. When selling an equity stake for investment dollars, the equity of the company must be valued. Valuation methods include *book value of equity*, percentage of enterprise value (*Shark Tank Method*), and ownership needed to produce adequate returns (*IRR Hurdle Rate Method*).

4. In most acquisitions, the majority of the purchase price will be funded with debt capital. Debt payments place a cash burden on the business, but also create high investment returns.

5. Earnout structures pay the seller over time – so long as the business performs to agreed upon metrics. Earnouts transfer risk to the seller and are appropriate for businesses with a high risk of underperformance or failure.

The Essential Partners

- BizBuySell.com – find businesses for sale
- Axial.net – aggregates businesses for sale and tracks deal progress
- Tri-Merit Specialty Tax Professionals – cost segregation study that can accelerate depreciation tax benefits on purchased real estate
- Guidant Financial – leading ROBS provider

The Essential Library

- HBR Guide to Buying a Small Business by Richard S. Ruback and Royce Yudkoff
- The E Myth Revisited: Why Most Small Businesses Don't Work and What to Do About It by Michael E. Gerber
- Buy Then Build by Walker Deibel

[i] https://www.nerdwallet.com/article/small-business/rollovers-as-business-startups-robs
[ii] https://www.investopedia.com/terms/m/mezzaninedebt.asp
[iii] https://corporatefinanceinstitute.com/resources/knowledge/finance/debt-covenants/
[iv] https://www.investopedia.com/terms/r/revolvingcredit.asp
[v] https://www.sba.gov/partners/lenders/7a-loan-program/types-7a-loans
[vi] https://www.investopedia.com/terms/w/wall-street-journal-prime-rate.asp
[vii] https://www.sba.gov/funding-programs/loans/504-loans