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FINANCING A BUSINESS

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NEGOTIATING THE PRICE GAP BETWEEN BUYERS AND SELLERS

Sellers generally desire all-cash transactions; however, partial seller financing is necessary in typical middle market company transactions. Furthermore, sellers who demand all-cash deals typically receive a lower purchase price than they would have if the deal were structured differently.

Although buyers may be able to pay all-cash at closing, they often want to structure a deal where the seller has left some portion of the price on the table, either in the form of a note or an earnout. Deferring some of the owner's remuneration from the transaction will provide leverage in the event that the owner has misrepresented the business. An earnout is a mechanism to provide payment based on future performance. Acquirers like to suggest that, if the business is as it is represented, there should be no problem with this type of payout. The owner's retort is that he or she knows the business is sound under his or her management, but does not know whether the buyer will be as successful in operating the business.

Moreover, the owner has taken the business risk while owning the business; why would he or she continue to be at risk with someone else at the helm? Nevertheless, there are circumstances in which an earnout can be quite useful in recognizing full value and consummating a transaction. For example, suppose that a company had spent three years and vast sums developing a new product and had just launched the product at the time of a sale. A certain value could be arrived at for the current business, and an earnout could be structured to compensate the owner for the effort and expense of developing the new product if and when the sales of the new product materialize. Under this scenario everyone wins.

The terms of the deal are extremely important to both parties involved in the transaction. Many times the buyers and sellers, and their advisors, are in agreement with all the terms of the transaction, except for the price. Although the variance on price may seem to be a "deal killer," the price gap can often be resolved so that both parties can move forward to complete the transaction.

Listed below are some suggestions on how to bridge the price gap.

- If the real estate was originally included in the deal, the seller may choose to rent the premise to the acquirer rather than sell it outright. This will decrease the price of the transaction by the value of the real estate. The buyer might also choose to pay a higher rent in order to decrease the "goodwill" portion of the sale. The seller may choose to retain title to certain machinery and equipment and lease it back to the buyer.
- The purchaser can acquire less than 100% of the company initially and have the option to buy the remaining interest in the future. For example, a buyer could purchase 70% of the seller's stock with an option to acquire an additional 10% a year for three years based on a predetermined formula. The seller will enjoy 30% of the profits plus a multiple of the earnings at the end of the period. The buyer will be able to complete the transaction in a two-step process, making the purchase easier to accomplish. The seller may also have a "put" which will force the buyer to purchase the remaining 30% at some future date.
- A subsidiary can be created for the fastest growing portion of the business being acquired. The buyer and seller can then share 50/50 in the part of the business that was "spun-off" until the original transaction is paid off.
- A royalty can be structured based on revenue, gross margins, EBIT, or EBITDA. This is usually easier to structure than an earnout.
- Certain assets, such as automobiles or non-business-related real estate, can be carved out of the sale to reduce the actual purchase price.

Although the above suggestions will not solve all of the pricing gap problems, they may lead the participants in the necessary direction to resolve them. The ability to structure successful transactions that satisfy both buyer and seller requires an immense amount of time, skill, experience and most of all - imagination.

SELLER FINANCING: IT MAKES DOLLARS AND SENSE

When contemplating the sale of a business, an important option to consider is seller financing. Many potential buyers don't have the necessary capital or lender resources to pay cash. Even if they do, they are often reluctant to put such a hefty sum of cash into what, for them, is a new and untried venture.

Why the hesitation? The typical buyer feels that, if the business is really all that it's "advertised" to be, it should pay for itself. Buyers often interpret the seller's insistence on all cash as a lack of confidence--in the business, in the buyer's chances to succeed, or both.

The buyer's interpretation has some basis in fact. The primary reason sellers shy away from offering terms is their fear that the buyer will be unsuccessful. If the buyer should cease payments--for any reason--the seller would be forced either to take back the business or forfeit the balance of the note.

The seller who operates under the influence of this fear should take a hard look at the upside of seller financing. Statistics show that sellers receive a significantly higher purchase price if they decide to accept terms. On average, a seller who sells for all cash receives approximately 70 percent of the asking price. This adds up to approximately 16 percent difference on a business listed for \$150,000, meaning that the seller who is willing to accept terms will receive approximately \$24,000 more than the seller who is asking for all cash.

Even with these compelling reasons to accept terms, sellers may still be reluctant. Selling a business can be perceived as a once-in-a-lifetime opportunity to hit the cash jackpot. Therefore, it is important to note that seller financing has advantages that, in many instances, far outweigh the immediate satisfaction of cash-in-hand.

- Seller financing greatly increases the chances that the business will sell.
- The seller offering terms will command a much higher price.
- The interest on a seller-financed deal will add significantly to the actual selling price. (For example, a seller carry-back note at eight percent carried over nine years will double the amount carried. Over a nine-year period, \$100,000 at eight percent will result in the seller receiving \$200,000.)
- With interest rates currently the lowest in years, sellers can get a much higher rate from a buyer than they can get from any financial institution.
- The tax consequences of accepting terms can be much more advantageous than those of an all-cash sale.
- Financing the sale helps assure the success of both the sale and the business, since the buyer will perceive the offer of terms as a vote of confidence.

Obviously, there are no guarantees that the buyer will be successful in operating the business. However, it is well to note that, in most transactions, buyers are putting a substantial amount of personal cash on the line--in many cases, their entire capital. Although this investment doesn't insure success, it does mean that the buyer will work hard to support such a commitment.

There are many ways to structure the seller-financed sale that make sense for both buyer and seller. Creative financing is an area where your business broker professional can be of help. He or she can recommend a variety of payment plans that, in many cases, can mean the difference between a successful transaction and one that is not. Serious sellers owe it to themselves to consider financing the sale. By lending a helping hand to sellers, they will, in most cases, be helping themselves as well.

VENTURE FINANCING: THE HARD FACTS

Government financing and venture capital financing account for less than one percent of all new business financing. Sixty-seven percent of all small to mid-sized businesses are financed by personal saving or friends; thirty-three percent are financed by lending institutions. The facts about venture capital financing are especially cold and hard...

- Venture capital is limited to high-growth potential, high capital-absorbing businesses.
- Venture capital benefits as few as 1000 businesses a year, and then...

- The average investment is \$2.3 million, divided between 3-4 venture capital funds, which take 40-50-60 percent or more of the business's equity.
- Venture capital investors expect the business to grow to \$25-50 million within 5 years--at which time the business will go public or be sold.

FRIENDS AND FAMILY: A FINANCING OPTION

The first job facing many prospective business owners is rounding up the cash necessary to make the purchase. They may find that banks have made borrowing difficult (or all but impossible), and that even SBA loans have requirements too stringent to meet. One viable option is obtaining financing from the seller; another is to seek help from family and friends.

Borrowing money from family members and/or friends is one of the most frequently-used methods of small business financing. The pluses are obvious--there is trust, familiarity, and a general comfort level when dealing with those you know. The drawbacks are self-evident as well: "doing business" with family and friends comes with cautionary notes of legendary proportions. Everybody knows that family ventures can be complex and stressful, stirring up "bad blood" and lingering ill will. However, by taking the right preventive steps, buyers can take advantage of friendly financial help.

1. Set up an informal meeting to introduce your ideas.

This is the time to "feel out" friends and relatives casually, being sure they understand that this is strictly a fact-finding (and fact-presenting) meeting. Anyone who is not interested or cannot afford to be involved has plenty of opportunity to say so without feeling obligated--or emotionally "blackmailed."

2. Follow up with a professional business plan.

Those who have indicated interest should now be treated with utmost professionalism. A formal business plan, including detailed financials, and a carefully-drafted business contract should be presented at this subsequent gathering. Consult a business professional for help in establishing a schedule for repayment based on the appropriate interest rates. Nothing will inspire more confidence in lenders than the care taken with this vital paperwork.

3. Be clear about the structure of the business envisioned.

How much voice are investors to have in the business? This is a vital question. Be sure that all parties understand whether this is to be a simple investment or some sort of partnership, and put this agreement in writing.

4. Take care in identifying your borrowing "targets."

Sometimes willing and eager family members can't really afford to invest. If possible, try to spread the borrowing around so that no one person bears the crux of the loan. It may take more energy to get smaller amounts from a larger circle of people, but the safety factors for all concerned will more than compensate for the time spent.

5. Keep your investors involved.

Once the buyer becomes an owner and the new business is in operation, friends and family lenders are due more than their repayment. They will want to be informed and updated about the progress of the business. Keeping in touch is a cost-free way to return the vote of confidence your friendly investors have placed in you.

FINANCING THE BUSINESS ACQUISITION

The epidemic of corporate downsizing in the US has made owning a business a more attractive proposition than ever before. As increasing numbers of prospective buyers embark on the process of becoming independent business owners, many of them voice a common concern: how do I finance the acquisition?

Prospective buyers are aware that the credit crunch prevents the traditional lending institution from being the likely solution to their needs. Where then, can buyers turn for help with what is likely to be the largest single investment of their lives? There are a variety of financing sources, and buyers will find one that fills their particular requirements. (Small businesses - those priced under \$100,000 to \$150,000 - will usually depend on seller financing as the chief source.) For many businesses, here are the best routes to follow:

Buyer's Personal Equity

In most business acquisition situations, this is the place to begin. Typically, anywhere from 20 to 50 percent of cash needed to purchase a business comes from the buyer and his or her family. Buyers should decide how much capital they are able to risk, and the actual amount will vary, of course, depending on the specific business and the terms of the sale. But, on average, a buyer should be prepared to come up with something between \$50,000 to \$150,000 for the purchase of a small business.

The dream of buying a business by means of a highly-leveraged transaction (one requiring minimum cash) must remain a dream and not a reality for most buyers. The exceptions are those buyers who have special talents or skills sought after by investors, those whose business will directly benefit jobs that are of local public interest, or those whose businesses are expected to make unusually large profits.

One of the major reasons personal equity financing is a good starting point is that buyers who invest their own capital start the ball rolling - they are positively influencing other possible investors or lenders to participate.

Seller Financing

One of the simplest - and best - ways to finance the acquisition of a business is to work hand-in-hand with the seller. The seller's willingness to participate will be influenced by his or her own requirements: tax considerations as well as cash needs.

In some instances, sellers are virtually forced to finance the sale of their own business in order to keep the deal from falling through. Many sellers, however, actively prefer to do the financing themselves. Doing so not only can increase the chances for a successful sale, but can also be helpful in obtaining the best possible price.

The terms offered by sellers are usually more flexible and more agreeable to the buyer than those offered from a third-party lender. Sellers will typically finance 50 to 60 percent - or more - of the selling price, with an interest rate below current bank rates and with a far longer amortization. The terms will usually have scheduled payments similar to conventional loans.

As with buyer-equity financing, seller financing can make the business more attractive and viable to other lenders. In fact, sometimes outside lenders will usually have scheduled payments similar to conventional loans.

As with buyer-equity financing, seller financing can make the business more attractive and viable to other lenders. In fact, sometimes outside lenders will refuse to participate unless a large chunk of seller financing is already in place.

Venture Capital

Venture capitalists have become more eager players in the financing of large independent businesses. Previously known for going after the high-risk, high-profile brand-new business, they are becoming increasingly interested in established, existing entities.

This is not to say that outside equity investors are lining up outside the buyer's door, especially if the buyer is counting on a single investor to take on this kind of risk. Professional venture capitalists will be less daunted by risk; however, they will likely want majority control and will expect to make at least 30 percent annual rate of return on their investment.

Small Business Administration

Thanks to the US Small Business Administration Loan Guarantee Program, favorable financing terms are available to business buyers. Similar to the terms of typical seller financing, SBA loans have long amortization periods (ten years), and up to 70 percent financing (more than usually available with the seller-financed sale).

SBA loans are not, however, a given. The buyer seeking the loan must prove stability of the business and must also be prepared to offer collateral - machinery, equipment, or real estate. In addition, there must be evidence of a healthy cash flow in order to insure that loan payments can be made. In cases where there is adequate cash flow but insufficient collateral, the buyer may have to offer personal collateral, such as his or her house or other property.

Over the years, the SBA has become more in tune with small business financing. It now has a program for loans under \$150,000 that requires only a minimum of paperwork and information. Another optimistic financing sign: more banks and lending institutions are now being approved as SBA lenders.

Lending Institutions

Banks and other lending agencies provide "unsecured" loans commensurate with the cash available for servicing the debt. ("Unsecured" is a misleading term, because banks and other lenders of this type will aim to secure their loans if the collateral exists.) Those seeking bank loans will have more success if they have a large net worth, liquid assets, or a reliable source of income. Unsecured loans are also easier to come by if the buyer is already a favored customer or one qualifying for the SBA loan program.

When a bank participates in financing a business sale, it will typically finance 50 to 75 percent of the real estate value, 75 to 90 percent of new equipment value, or 50 percent of inventory. The only intangible assets attractive to banks are accounts receivable, which they will finance from 80 to 90 percent.

Although the terms may sound attractive, most business buyers are unwise to look toward conventional lending institutions to finance their acquisition. By some estimates, the rate of rejection by banks for business acquisition loans can go higher than 80 percent.

With any of the acquisition financing options, buyers must be open to creative solutions, and they must be willing to take some risks. Whether the route finally chosen is personal, a seller, or third-party financing, the well-informed buyer can feel confident that there is a solution to that big acquisition question. Financing, in some form, does exist out there.

FINANCING THE BUSINESS PURCHASE

Where can buyers turn for help with what is likely to be the largest single investment of their lives? For most small to mid-sized business acquisitions, here are the best ways to go:

Personal Equity

Typically, anywhere from 20 to 50 percent of cash needed to buy a business comes from the buyer and his or her family. Buyers who invest their own capital (usually an amount between \$50,000 and \$150,000) are positively influencing other investors or lenders to participate in financing.

Seller Financing

This is one of the simplest and best ways to finance the acquisition, with sellers financing 50 to 60 percent--or more--of the selling price, an interest rate below current bank rates, and a far longer amortization. Many sellers

actively prefer to do the financing themselves, thereby increasing the chances for a successful sale and the best possible price.

Venture Capital

Venture capitalists are becoming increasingly interested in established, existing entities, although this type of financing is usually supplied only to larger businesses or startups with top management and a good upside potential. They will likely want majority control, will want to cash out in three to five years, and will expect to make at least 30 percent annual rate of return on their investment.

Small Business Administration

Similar to the terms of typical seller financing, SBA loans have long amortization periods. The buyer must provide strong proof of stability--and, if necessary, personal collateral, but SBA loans are becoming more popular and more "user friendly."

Lending Institutions

Those seeking bank loans will have more success if they have a large net worth, liquid assets, or a reliable source of income. Although the terms are often attractive, the rate of rejection by banks for business acquisition loans can go higher than 80 percent.

THE ADVANTAGES OF SELLER FINANCING

Business owners who want to sell their business are often told by business brokers and intermediaries that they will have to consider financing the sale themselves. Many owners would like to receive all cash, but many also understand that there is very little outside financing available from banks, or other sources. The only source left is the seller of the business.

Buyers usually feel that businesses should be able to pay for themselves. They are wary of sellers who demand all cash. Is the seller really saying that the business can't support any debt or is he or she saying, "the business isn't any good and I want my cash out of it now, just in case?" They are also wary of the seller who wants the carry-back note fully collateralized by the buyer. First, the buyer has probably used most of his or her assets to assemble the down payment and additional funds necessary to go into business. Most buyers are reluctant to use what little assets they may have left to secure the seller's note. The buyer will ask, "what is the seller not telling me and/or why wouldn't the business provide sufficient collateral?"

Here are some reasons why a seller might want to consider seller financing the sale of his or her business:

- There is a greater chance that the business will sell with seller financing. In fact, in many cases, the business won't sell for cash, unless the owner is willing to lower the price substantially.
- The seller will usually receive a much higher price for the business by financing a portion of the sale price.
- Most sellers are unaware of how much the interest on the sale increases their actual selling price. For example, a seller carry-back note at 8 percent carried over nine years will actually double the amount carried. \$100,000 at 8 percent over a nine year period results in the seller receiving \$200,000.
- With interest rates currently the lowest in years, sellers usually get a higher rate from a buyer than they would get from any financial institution.
- Sellers may also discover that, in many cases, the tax consequences of financing the sale themselves may be more advantageous than those for an all-cash sale.
- Financing the sale tells the buyer that the seller has enough confidence that the business will, or can, pay for itself.

Certainly, the biggest concern the seller has is whether or not the new owner will be successful enough to pay off the loan the seller has agreed to provide as a condition of the sale. Here are some obvious, but important, factors that may indicate the stability of the buyer:

- How long has the buyer lived in the same house or been a home owner?
- What is the buyer's work history?
- How do the buyer's personal references check out?
- Does the buyer have a satisfactory banking relationship?

Advantages of Seller Financing for the Buyer

- Lower interest
- Longer term
- No fees
- Seller stays involved
- Less paperwork
- Easier to negotiate

FINANCING THE BUSINESS SALE - SOME QUESTIONS TO ANSWER!

Structuring the purchase of a business is an issue that should be faced early in the selling decision. Ultimately, the final structure of the sale will be determined by actual negotiations between buyer and seller, but the seller must still answer the following questions:

- What is the lowest amount of cash acceptable from the sale?
- Has consideration been given to paying off all unsecured creditors and a portion of the closing costs?
- Is there any long-term debt that can be assumed by the buyer? (This may make more cash available for the seller.)
- What is an acceptable interest rate for the seller-financed sale?
- Will the business be able to service the debt and still provide a return acceptable to a buyer in relation to the down payment required? (This is a particularly important question for the seller to address.)

Recent studies indicate that the more favorable the terms the higher the price. In fact, one study found that offering favorable terms might increase the total selling price by 30 percent. A business broker professional can advise you on the all-important issue of seller financing.

FINANCING FACTS

There still aren't too many ways to finance the purchase of a business. Here are the primary methods:

Buyer Financing

Some buyers may have the cash available to purchase the business. Some may elect to use the equity in their residence, or other real estate. Others may have other assets that they can sell or borrow against.

Bank Financing

Banks may lend against a buyer's assets as described above. They may also lend against the assets of the business, assuming there is sufficient value to support the loan. The business will also have to make sense to the bank, regardless of the asset value. In fairness to the banking system, many of the figures supplied by business owners have very little relationship to the actual earning power of the business.

Venture Capital Firms

These firms do not, as a practice, lend to small or even many mid-size businesses unless tremendous growth is anticipated. They also usually expect an equity position in the company.

SBA Loans

These have become more popular. There is now some competition among lenders for these loans. Many banks offer them, but the large non-bank companies seem to have the upper hand in both acceptance and service.

Other Sources

This category includes family, friends, relatives, credit cards and leasing companies. Some suppliers have been known to assist in the financing of a small business.

Seller Financing

This is, by far, the largest source of financing available for the purchase of a business. Many industry experts say that about 90 percent of small businesses sell with, or perhaps because of, the seller financing a good portion of the sale price. Buyers have much more confidence in the decision to purchase a business when the seller is willing to assist in the financing. The buyer has confidence that the seller believes the business will service the debt, in addition to providing a living wage.

FINANCING THE BUSINESS SALE

Structuring the purchase of a business is an issue that should be faced early in the selling decision. Ultimately, the final structure of the sale will be determined by actual negotiations between buyer and seller, but the seller must still answer the following questions-

- What is the lowest amount of cash acceptable from the sale?
- Has consideration been given to paying off all unsecured creditors and a portion of the closing costs? (Both are, in most cases, the seller's responsibility.)
- Is there any long-term or secured debt that can be assumed by the buyer? (This may make more cash available to the seller.)
- What is an acceptable interest rate for the seller-financed sale?
- Will the business be able to service the debt and still provide a return acceptable to a buyer in relation to the down payment required? (This is a particularly important question for the seller to address.)
- What are the tax consequences of the sale?

The professional business broker is a good source for assistance in structuring the sale of a business. Although they are not able to provide legal advice, business brokers are the experts of preference when the arena is the business marketplace. Brokers will use their knowledge of previous sales, current market conditions, and outside financing strategies, if applicable or available.

A business generally represents a seller's largest financial asset. How the sale is structured may mean the difference between the success or failure of the transaction. The best sale structuring will result in the best deal possible for both buyer and seller. A business broker can be the key player in accomplishing this goal.

SELLER FINANCING

Many business owners would like to receive all-cash for their business when selling. And yet they are often told that this is really not possible. Why? Most people are accustomed to financing just about everything - home, car, vacation home, even college for their children. The first question business brokers are often asked is, How much money will I have to invest to buy that business?

Seller financing is usually necessary because of the lack of outside financing available. Certainly, some is available, but less than 90 percent of small business sales receive outside financing when selling. If you are selling you may be one of the few lucky ones, but the business better be absolutely perfect.

If a seller is not willing to finance the sale, many buyers suspect a problem. After all, a business should be able to pay for itself and provide a reasonable income for a buyer. A buyer then wants to know what is wrong with the business that the seller wants all cash?

Aside from this, even if a buyer has all of the necessary funds, he or she may want to spend their money on improving the business, adding equipment, building inventory, or just keep it for working capital.

Another similar issue that is raised by sellers is that, if they are willing to finance the sale, they want some outside collateral to secure the loan on their business. They want to make sure that they get all of their money - with no risk. Buyers are very sensitive about this issue. Again, they raise the point about the business being able to pay for itself. They may feel that the seller wants additional security because of concerns about the business's ability to generate a reasonable profit. This is not a reassuring signal to the buyer. Most buyers are already using most of their capital for the down payment, and they generally are very reluctant about using their home or retirement funds for additional collateral.

The services of a business broker professional can usually provide guidance in the overall financing process. And financing is often the key to the successful selling of a business