

# The Need for Capital

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Obtaining capital for your Company is an important process and should be well thought out before you begin. Often business leaders look at financing as a way to initially capitalize a business. During the first several years of operation, as the business grows, you may need financing to fund inventory, equipment, or finance the increases in accounts receivable.

There are many varieties of financing available from a wide array of sources. Bank debt usually provides the lowest rate, but often comes with very restrictive debt covenants. On the other hand, private placements and subordinated debt usually give borrowers a lot of flexibility in running their businesses, but the rates are considerably higher. Sales of securities can be expensive at the onset, but a successful offering may provide the best mix of cost and flexibility.

**Consider the following:**

## **Bank Loans**

Banks and savings and loans generally provide the cheapest financing rate. With the competitive rates of these financial institutions, however, expect some degree of inflexibility. This tier of lenders is looking for a solid and relatively safe return on their funds. Most of them are not willing to finance start-up companies, which have no track record.

Traditional financial institutions usually have some similarities in their underwriting standards. These lenders usually look for a *debt to net worth* ratio of no more than 4 to 1. For example, if a Company has \$100,000 of net worth, the Bank may consider lending up to \$400,000 in aggregate. It may be wise to increase your company's net worth prior to your Bank visit, since every dollar that is included in equity may pay four fold. Traditional financial institutions also use an underwriting ratio called *debt coverage*. Banks usually like to have annual debt coverage of 1.5 times the scheduled annual principal and interest payments. Annual debt coverage is usually calculated from *Income Available for Debt Service*, which is net income before depreciation, amortization and interest expense. In other words, the lender wants the Company to generate enough cash flow to cover the debt. Another common ratio, even if somewhat less standard, is *Maximum Allowable Debt*. Maximum Allowable Debt is usually calculated as a factor of earnings before interest, depreciation and amortization ("EBIDA"). A popular multiple of EBIDA is four times.

## **Semi-Public Debt**

Another very viable source of financing is offered through Carolina Capital Investment Corporation (CCIC), an affiliate of South Carolina Jobs-Economic Development Authority (JEDA). CCIC's motivation is to generate jobs and/or capital investments in South Carolina. CCIC's programs are available for small for-profit businesses to acquire, expand or renovate real estate, purchase machinery and equipment and increase working capital. Loans are up to \$5,000,000, depending on location, and generally require sufficient collateral and personal guarantees.

## **Private Placements and Subordinated Debt**

Other less traditional sources of financing are private placements and subordinated debt. Private placements are usually more flexible than bank debt. The required yields to the lender, however, may be double the bank rate. Likewise, subordinated debt is usually more flexible than bank debt, but it usually comes with some form of “equity kickers.” Equity kickers can be options and/or warrants and the debt may be convertible to equity. The financing party is usually looking for a small portion of ownership in your company. Many financial institutions will consider subordinated debt as equity because of its junior position to other liabilities.

Most major financial institutions have a Capital Markets Division, which can assist you with private placements or subordinated debt. Generally, a company must be considering financing packages of \$5 million for subordinated debt and \$25 million for private placements, with an EBIDA of at least \$5 million before a Capital Markets Division will be interested.

## **Going it Alone**

If you are looking to raise small levels of capital through debt or equity, you may be able to handle such an undertaking without the assistance of banks. There are at least three primary challenges to the company as it proceeds to finance its operations by raising private debt or equity capital:

1. effectively communicating the company’s “story” through a well-developed business plan,
2. locating and convincing potential investors that the company’s “story” is compelling enough for their investment,
3. ensuring compliance by the company with the various regulations governing the offering and sale of securities. Every sale of securities (even the sale of a single share) is required to be registered at both the federal level (with the Securities and Exchange Commission – the “SEC”) and with each state in which the securities are offered or sold. Registration of a securities offering is extraordinarily complex, expensive and time consuming. Fortunately, state and federal securities laws provide multiple exemptions from registration as long as the offering and sale of securities meets certain criteria. Anyone attempting to pursue this route would be well advised to have a reputable corporate securities attorney involved.

## **Anticipating the Lender’s Needs**

Before you contact any source of financing, you should have a well thought out business plan. The business plan should identify the strengths and even weaknesses of the business and its people. The plan should also address competitors and reasons the company stands out from others. Be brief, concise, and informative. Clearly demonstrate how the loan proceeds would enhance the business. Do not be tempted to try to play up to what you think the lender wants to hear. Do not ask for more money than the business plan can demonstrate it requires. Likewise, the lender will be wary of a plan that does not request enough money to carry out the business strategy. Lenders do not want companies to continually submit new requests for more money to meet unanticipated needs.

Another important item you will need is several years of financial statements of the business and two years of tax returns. The major executives of the company should include personal financial statements and tax returns as well. Don't wait for your potential financing source to ask you for this information; you want to make the best impression. Banks typically like to see that a CPA was involved in the preparation of the company's financial statements. For up to a \$1 million credit extension, a bank probably will be satisfied with a compilation. A compilation does not give any assurances on the accuracy of the financial statements. The CPA simply prepares the financial statements into the proper format. Footnotes to the financial statements are usually helpful so that the lender can more fully understand the business.

For up to a \$3 million credit extension, a bank probably expects a reviewed set of financial statements. A review provides the reader of the financial statements with a negative assurance about the accuracy of the financial statements. The CPA states that he or she is not aware of any material departures from generally accepted accounting principles (GAAP). We usually find that as a product, a review can provide a lot of value to your company. A CPA will inquire about certain accounts and perform analytical procedures on the financial statements. Instead of confirming cash on deposit directly with the depository, a CPA may just look at the end of the month bank statement and compare this to the cash reconciliation. Company executives going through the review process with the CPA usually gain a different viewpoint of their business. Because of the economy of performing a review instead of an audit, (reduced audit risk for the CPA), there usually is some room in the fee to have some great one-on-one consulting.

At the \$10 million plus level of sales, a company should consider investing in an audit; it is an investment in the company. The CPA is providing an affirmation to the accuracy of the financial statements. The audit should provide the company's officers with items which will prove to be helpful to the company's operations. It is usually wise to keep the same level of service from year-to-year once you decide on an audit.

Communicating in the finance world is an art and a science. Know what your current and future needs are, and match your suitors with your needs. When you are ready to really talk finance, shop for your best strategic fit.

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