

Buying a Mid-sized Business: Getting a Loan

So far in this series of articles, you've learned the value of engaging a business broker to conduct a private search. You have learned how to qualify and select a broker, and you've learned how to become qualified as a committed buyer. At this point, the bankers have already reviewed your finances and background. Now we will examine the loan process.

Bankers look at two aspects when considering acquisition loans – they look at you, the buyer, and they carefully examine the business you wish to buy.

In the last article, you learned that banks will examine your credit rating, income, debts, education, work experience and industry knowledge. Once you have selected a business to purchase, even before you put in an offer to purchase, you will want to have your banker review the company's financial performance and provide a preliminary authorization to fund the purchase.

Bankers believe that a firm's past financial performance is the best indicator of its future performance. If the target company generated enough excess net income (cash flow) last year to cover the loan payments AND to pay you a reasonable salary, then the bank will likely loan the money.

The size of your down-payment is important to their approval process. Some businesses can be financed with as little as 15% down, especially cash flow businesses with real estate, but most purchases require down payments of 25-35%, with some cash flow and manufacturing businesses requiring even more. Cash flow businesses are those that have no significant assets but generate a ton of cash. Accounting services, insurance agencies, mortgage and business brokerages, real estate offices – these are all examples of cash flow businesses. Bankers like to see a lot of cash flow on the financial statements, but they also like to see assets, such as real estate, to use as collateral.

Where do you get the money for a down-payment? Generally, people look to the following sources of funds:

- 1) Cash & near-cash equivalents. Convert your stocks, bonds and liquid assets to cash.
- 2) Home Equity Line of Credit ("HELOC"). Banks can loan against the equity in your home. They lend up to 90% of the net fair market value, that is, the value of your house today less anything still owed on the house.
- 3) Retirement funds. There are companies, like Guidant Financial and BeneTrends, who will help you to convert your IRA and 401(k) into cash for acquisition purposes.
- 4) Life Insurance. Some insurance policies have a cash value.
- 5) Friends and Family. The last resort is to borrow money from friends and family in exchange for an equity position on the purchased company. A lawyer can draft an agreement that will enable you to re-purchase shares from the friend or family member at some mutually agreed upon valuation process.

Most business buyers use one or more of the first three components, which, when combined, become your down-payment. You can usually multiply your down-payment by four to estimate the maximum purchase price.

An example might help. Let's say that you have the following assets available.

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- a) Cash: \$ 50,000
- b) HELOC: \$ 150,000
- c) Retirement: \$ 100,000

That gives you a total of about \$300,000 in cash. Let's hold back \$50,000 for working capital and other needs, leaving \$250,000 for a down-payment. So just how big of a company can you buy?

With \$250K down, you can probably get a loan for around \$1,000,000. If your credit history is strong, and you have a college degree and applicable work experience, then you'll probably qualify as a buyer. So how do the numbers above work in your favor? Let's look further at our example below.

Description	Input	Calculated
Company's Annual Revenues	\$ 2,500,000	
Net Income Last Year	\$ 250,000	
SP Model: X times NI plus Inv	4	\$ 1,000,000
Selling Price as % of Revenues		40%
Return on Sales % (NI/Revs)	10%	\$ 250,000
Down payment as % of SP	25%	
Down payment Funds		\$ 250,000
Loan Amount		\$ 750,000
Loan Interest Rate (prime plus 2)	10.25%	0.8542%
Loan Term in Years	10	120
Annual Debt Service		\$ (120,185)
Owner's Estimated Benefit		\$ 129,815
Return on Invested capital		51.93%

This company is generating revenues of \$2.5 million with 10% going to the bottom line. The selling price is four times the net income. With your \$250K down-payment and \$1 million selling price, the loan amount is \$750K. If the loan is for ten years at two points over prime (as of the date of writing), the APR would be 10.25%, a typical business loan rate in today's market. The annual debt service will be about \$120K, and this will come out of the net income figure leaving the buyer with an estimated annual salary over \$129,815! This model has a 10% return on sales, and a whopping 52% return on investment. Banks will line up to loan money on this investment, and you'll soon be working 90 hours a week at your new adventure!

Next month, let's continue defining and exploring the buying process.