

Managing Debt

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Outline

- This presentation is based on common themes from multiple sources
- Types of financing encountered
- Common bank guidelines
- How much should I borrow?
- Preparing for the debt load
- Has the business model changed?

Types of Financing typically encountered

- Family and friends
- Credit cards
- Private Investors
- Suppliers
- Unpaid taxes
- Government financing programs
- Traditional Bank

Family, Credit cards & Investors

- Family, Friends, and investors
 - Choose the individual carefully: Can they offer skills and understand the plan. Show you have worked through the details. Think about the relationship
 - Be realistic in your needs
 - Will they want equity?
 - Make sure the repayment plan is in writing
- Be careful with credit card usage

Suppliers and taxes

- Riding the trade often happens, instead; stay within the terms provided or negotiate better terms with the supplier. Open lines of communication. Keep them as a partner.
- Do not skip government obligations, payroll, unemployment, sales taxes, etc.

Government Programs

- Typically have specific guidelines
- May offer interest rate or flexible terms
- Prepayment penalties
- Read the fine print

Bank Financing

- Traditional Commercial loans
 - The Credit C's of banking
 - Capacity: Can you pay it back
 - Capital: Do you have skin in the gain
 - Collateral: Assets to pledge
 - Conditions: Terms of the loan
 - Character: Credit, management ability
 - There is an individual component involved: DI ratio
 - Have your business plan ready and reviewed
 - Know what type of loan you need and if it matches the use and repayment in your business model.

Main considerations

Collateral

- Normally you will need to be able to pledge something for the loan.
- Additional collateral needed unless there is a large equity injection
- Banks discount collateral based on the type of asset
 - Receivables 75%, Inventory 50%, Equipment 50% -75%
 - A lot depends on how specialized it is, and how fast it could be converted into cash.
 - Keep the length of the loan less than the useful life of the asset

Main considerations

Capacity

- Can you pay the loan request back as you projected or have a back up plan in case something happens
- Cash flow is king. Forecast your cash flow using accepted techniques. Looks at historical performance with UCA based approaches
- Many look at a simple cash flow measure called EBITDA

EBITDA

Net income	\$100,000
Interest	\$ 10,000
Taxes	\$ 10,000
Depreciation	\$ 20,000
Amortization	<u>\$ 0</u>
EBITDA	\$140,000

Or \$11,667 per month

Be careful as it ignores:

Changes in working capital

Required capital expenditures for expansion or replacement of equipment

Ongoing quality of earnings

Variance in results during the period calculated

Using EBITDA

So you just calculated that for the 12 month period in 2017 your company had EBITDA of \$11,667 per month

Typically a creditor will want a cushion of 1.25 based on this number

This would mean that monthly debt service should not exceed \$9,334 per month ($\$11,667 / \$9,334 = 1.25$ times)

Up to you to figure out if it will continue in the future, if it is stable, or if there are efficiencies available.

Examples

Flip a house

Purchase price \$50,000

Improvements \$10,000

Total cost \$60,000

Sales price \$70,000

Net after costs \$68,000

Profit \$ 8,000

Loan is commonly \$48,000 or 80% of \$60,000



Why just \$48,000 as a loan when it is going to sell for \$70,000, not the \$60,000 invested

Additional costs, interest, unexpected items, and ability to cash flow in case something happens

What if it doesn't sell. You will need to make the payments or it will need to be rented. Lets see if it can be a rental property instead of the planned flip

Purchase Price	\$50,000	Land	\$ 15,000
Construction costs	\$10,000	Building	\$ 45,000
total costs	\$60,000	Total value	\$ 60,000
Loan fees			
Cost of project	\$60,000	Market Value	\$ 70,000

Depreciation	27.5
Annual depr	\$ 1,636
Loan amount	\$ 48,000
LTV	80%
Required down	\$ 12,000
Term in months	240
Rate	4.90%
P&I	\$314.13

Rental analysis:	per month	units
	\$ 650.00	1
Monthly rent	\$ 650	\$ -
		\$ 650.00 Total

Number of units	1
Ave Mth rent/unit	\$ 650
Cost per unit	\$50,000

Potential Gross Rent	\$ 7,800	
Vacancy %	5% \$ 575	
Effective rent	\$ 7,225	
CAM Reimbursed		
Prop Taxes	\$ 1,300	17%actual
Insurance	\$ 700	9%estimate
Flood Ins	\$ -	0%
Misc	\$ -	0%
Repairs	\$ 500	6%estimate
Utilities	\$ -	0%
Advertising	\$ 150	2%
Pro/mgmt	\$ 275	4%estimate
Reserves	\$ 100	1%

Comparables

Total operating expense	\$ 3,025	39%
Depreciation expense	\$ 1,636	21%
Interest Expense	\$ 2,320	30%
	\$ 3,956	51%
Taxable income	\$ 819	10%

NOI	\$ 4,775	Cap rate	7.00%
NOI with vacancy	\$ 4,200	Cash on Cash	
Annual P&I	\$3,770	after int expense	\$ 2,455
DSC	1.11	CC % investment	20%

Working capital example

- Need to finance a large job which will result in a large receivable
- May need to borrow in case suppliers don't help out.
- Determine profitability and collectability
- Reasonable collection time after completion, sale or delivery to match the loan maturity
- Back up plan if not paid

Vehicle example

- Buying a replacement vehicle
- Usually fairly simple
- Look at your EBITDA

New equipment example

- Look at your historical EBITDA
- Are there efficiencies or cost savings to be obtained?
- Will labor or operating costs be reduced?
- Quantify:

Labor	40 hours	\$15 per hr	\$300
Fuel	10 gallons	\$3 per gal	\$ 30
Insurance	costs more		<u>-\$ 5</u>
Efficiencies			\$325

Loan of \$25,000 for 5% for 5 years is \$470 per month. Savings are \$325 per month for a net increase in debt obligations of \$147 per month. Now you just need to prove the operation can cover the \$147 payment with a cushion.

Payback analysis

- A machine will cost \$25,000 and would have a useful life of 10 years with zero salvage value. The expected annual cash inflow of the machine is \$10,000.
- The payback is 2.5 years; we can simply divide the initial investment by the annual cash inflow to compute the payback period. Payback period = $\$25,000 / \$10,000$
- Take some time to understand how this works with various assumptions. Has advantages and disadvantages

Considerations for debt

- What is the real reason you are borrowing?
 - is it due to timing or magnitude?
 - purchasing equipment?
 - financing a new project?
 - operating losses?
 - Start up funds. may need different types of loan structures instead of one large loan.
- Always have a back up plan

Refinancing or restructuring

- Refinancing is completely different depending on rate or terms
- One to reduce rates keeps the terms the same or shorter
- If the goal is lower payments than it is a term refinance. Will need to explain why the current payments are too much to handle. Is it temporary or structural. Maybe time to look at the business model and see if improvements can be made instead of refinancing.
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Changes in the operation

- Lower payments may hide the true problem. Eventually you owe more on depreciated assets and it will limit future borrowings.
- Look at the business model and cut costs, improve revenues, or both.
- If it appears a term refinance is needed contact your creditor early on in the process. Have financial information current, be able to explain, and show what can be done to improve the situation.



Discussion