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Planning Essentials

Economic Development Finance and Deal Structuring

by Kaizer Rangwala, AICP

Much of what has been constructed in the past 50 years has produced development with a low shelf life â€” these structures and their uses are unsustainable over a long period and will have to be redeveloped. The next 50 years will see a surge in new development as we house and employ the next 100 million people. Whether it's redevelopment or development, planners working in economic development are going to be busy.

Economic development creates jobs and wealth in our neighborhoods, cities, and region. Economic development finance programs are generally designed to create and retain jobs, as well as create, retain, and expand businesses. Business development finance programs usually provide financial assistance to new and expanding small businesses that are facing limitations in their ability to raise debt and equity financing from traditional sources.

While planners are comfortable participating in long-term, strategic economic development planning, they seldom have a seat at the table when it comes to implementation and structuring a deal with potential companies. This lack of involvement increases the potential for a disconnect between gains from structuring individual deals and holding true to the long-term overall vision of a sustainable economy.

Planners often are baffled at the finer points of financing a project and making a deal. The good news is that business financial analysis and structuring deals are art forms, not science. Given the same facts, different people will come up with different answers. The best deal-makers are healthy skeptics with an innate sense to ask the right questions. With a little effort, planners can become financially literate. While planners may not speak the financial language fluently, they should know the basic concepts to understand and participate at the deal-making table. This article describes a few basic elements of financial deal-making for business ventures.

WHY DO BUSINESSES NEED FINANCING?

There are two types of economic development financing: financial assistance to businesses and programs, and financial assistance for projects such as construction of a downtown parking garage. Both components promote economic development goals. This article will focus primarily on the financing of business ventures.

Successful businesses create jobs and increase the tax base in the community. To be successful, new and expanding or struggling existing businesses need financing to fund their normal operations (working capital) or to purchase fixed assets such as equipment.

WHO IS INVOLVED?

Structuring a deal involves both the private sector and public sector. The private sector involves two main forms of financial capital: debt and equity financing. The most common type of debt includes loans made by commercial banks based on the value of assets offered as collateral. Any money that the owner invests in the venture is considered equity. A popular form of equity finances is stocks. Equity financing makes the investor partial owner in the business and does not obligate the repayment of the investment. The investor expects an appreciation of the value of the share and payment of a portion of earnings when the venture makes a profit.

The public sector often bridges the capital gap in private-sector financing. The public sector, which can include federal, state, and local governments, can provide technical assistance, increase access to capital by packaging a loan, guarantee a loan, provide a loan, lower the credit risk of a company, or lower the cost of borrowing. All of these should be targeted to specific areas, populations, or activities that support the community's overall economic development goals. The public sector should invest in business ventures when the economic and social benefits from the business venture outweigh the risk of financing. The public sector involvement is best defined by what it should not do â€" it should not give financial assistance to businesses that have access to and qualify for conventional financing for their capital needs. Sometimes this is labeled the "but for" approach (i.e., but for the public financing, this project would not happen).

WHAT ARE THE BASIC STEPS OF STRUCTURING A FINANCIAL DEAL?

Financial deal structuring is the organization of a business transaction governing the relationship among the parties who are interested in a company. A good financial deal structure balances the risk with the return ratio for all parties.

We know why businesses borrow money, and we know who some of the key players are. If a business walks into the office seeking financial assistance, what do you do? How do you determine if this business is a healthy, viable businesses deserving of a prominent role for the public sector in deal structuring.

To understand the various steps in financing a deal, consider the following example. I describe the steps of structuring a financial deal and refer again to Green Hi-Tech for illustrative purposes:

> *Green Hi-Tech, an emerging technology firm, is interested in building a 10,000-square-foot addition to the existing solar and green roof manufacturing plant in the community and has contacted the mayor requesting financial and technical assistance. After a few ups and down in the past decade, the company has experienced significant growth in the past two years. The company currently employs 10 people. The new building will cost $800,000 and add 10 new jobs. The average employee's annual wage will be $50,000. A national bank has expressed an interest in the project, but at this time will finance only $400,000.*

Be a cynic and ask a series of questions. Rocky Wade with the Economic Development Institute (EDI) has developed an eight-step process that helps organize the information collected on the business and set a structure for better analyzing the information.[1]

Step One: Collect the initial information about the business

The first step is to gather the facts about the deal. Carefully consider the quality of information available. Determine what questions you have after reviewing the information. Define the players and their motivation. Do any red flags appear? Based on the basic information gathered thus far, if the churning acids in your gut say this is a "no go" situation, then guide the business towards private financing steps, identify the process, and send them away. If you decide to proceed and want to arrange for financing, then move to step two.

> *Green Hi-Tech is interested in expanding its operations within a 10,000-square-foot addition to its existing facility. The deal will bring 10 new jobs at a $50,000 average wage. No financial information is provided. Management background and business history explaining the ups and down will have to be evaluated.*

Step Two:Assess the business history and management

Review the existing management structure and business plan. Identify the type of business â€” a technology-based company is evaluated differently than a manufacturing plant. Identify the stage of business growth: Is it a start-up business, a growing business, or a business experiencing decline? Financing a start-up business is difficult because there is no business history to review.

> *Green Hi-Tech is an established technology business that has experienced growth in the past three years. Request a business plan that will demonstrate how the business is constantly looking at itself and has an eye on moving forward. Review the business plan to see what change has occurred in the past few years. Has the business met its goals? What new direction is needed? Inquire about the legal and management structure (corporation, partnership, sole proprietorship) and evaluate if the legal and management structure is strong enough to support the expansion efforts.*

Step Three: Assess the financial condition of the business

At this step, request financial statements, i.e., balance sheets and income statements. A balance sheet is a statement of what the business owns and owes. The balance sheet allows us to review the current financial situation of the business. It will typically show if the owners have invested any cash in the business (demonstrating a stake in the business), and if the business in the past three years has maintained a solid cash position. A single balance sheet will not demonstrate a trend or pattern, however. A minimum of three annual statements is necessary. This is also why start-ups, which do not have a demonstrated record of performance, are high-risk investments.

Assess the market for the product line, its competition and customer base, while looking for any untapped market opportunities to develop additional products or expand the customer base.

An income statement will suggest how the company manages cash, controls expenses, and pays bills in their operation. The income statement also will contain information needed to calculate basic ratios, such as sales growth, gross profit, and operating profit. Such ratios can be compared to standard ratios available for similar industries to see how the business compares with similar businesses.[2]

> *Green Hi-Tech has submitted audited financial and income statements for the past three years.*

Table 1. Balance Financial Spreadsheet for Green Hi-Tech

Fiscal Year	Year 1	Year 2	Year 3
Assets			
Cash	43,000	67,000	135,000
Accounts Receivable	62,000	74,000	207,000
Inventory	54,000	55,000	190,000
Other	3,000	2,000	1,000
Total Current Assets	162,000	198,000	533,000
Equipment	175,000	175,000	175,000
Land	12,000	12,000	12,000
Building	250,000	265,000	265,000
Accumulated Depreciation	80,000	120,000	160,000
Net Fixed Assets	357,000	332,000	292,000
Total Assets	**519,000**	**530,000**	**825,000**
Liabilities & Net Worth			
Notes Payable â€” Bank	68,000	94,000	293,000
Payable â€” Trade	40,000	23,000	145,000
Accrued Expenses	12,000	14,000	28,000
Current Portion of Long-Term Debt	88,000	128,000	88,000
Total Current Liabilities	208,000	259,000	554,000
Long-Term Debt	338,000	249,000	162,000
Total Liabilities	**546,000**	**508,000**	**716,000**
Capital Stock	1,000	1,000	1,000
Equity	8,000	8,000	8,000
Retained Earnings	34,000	15,000	100,000

Total Net Worth	(25,000)	24,000	109,000
Total Liabilities & Net Worth	**521,000**	**532,000**	**825,000**

Source: Rocky Wade

Table 2. Income Statement (Profit & Loss)

Fiscal Year	**Year 1**	**Year 2**	**Year 3**
Income/Sales Revenue	446,000	719,000	1,113,000
Cost of Goods	218,000	347,000	557,000
Gross Profit	228,000	372,000	556,000
Administrative Expenses	120,000	144,000	220,000
Officer's Compensation	48,000	62,000	95,000
Depreciation	40,000	40,000	40,000
Subtotal Operating Expenses	208,000	246,000	355,000
Operating Profit	20,000	126,000	201,000
Interest	46,000	51,000	72,000
Profit Before Tax	(26,000)	75,000	129,000
Income Tax	Â	(26,000)	44,000
Profit After Tax	(26,000)	49,000	85,000

Source: Rocky Wade

Based on the financial and income statements we can calculate a series of ratios that begin to give us clues on the financial health of the company and help identify questions to ask the company related to core problems associated with their operations. The ratios help establish if the business has demonstrated the ability to make a profit, control expenses, and manage its cash flow.

> *Working Capital Ratio[3] indicates how much liquid capital (cash) remains after the company pays its bills in the next 12 months for daily operations. For example, in Year 3 the current liabilities ($554,000) exceeded the current assets ($533,000). This is interesting because if you look at the income statement (Table 2) the sales are going up â€" they should have more cash. It is only when you look at the financial statement (Table 1) that you begin to understand why they are not more liquid: They have not been collecting money for goods sold (accounts receivables has gone up consistently). Sales are not cash until they are collected.*

Step Four:Identify the project to be financed

Determine costs for land, building equipment, professional fees, and working capital needed for ongoing operations associated with the project.

Review the project schedule. In many cases, the business's perception of its timetable is different from the lender's â€” often the lender's timetable is more realistic. Determine if the project makes sense for the business at this time and how the project will help the business.

In our case, the total project cost is $800,000.

Step Five:Review the potential for private-sector financing

Consider whether the deal can be privately financed. Always pursue private financing alone, wherever feasible. Private financing is easier for businesses and preserves scarce public resources for the community.

Where does a business get money? Generally, project costs are paid through a combination of debt (source of short-term fund that must be paid back) and equity (source of long-term funds invested by the owners that may never get paid back).

Lending institutions such as banks, insurance companies, and pension funds look at the three "Cs" when lending short-term money: credit history, collateral, and character â€” and sometimes a fourth "C," the cash flow situation of the business. A satisfying financing negotiation involves considering various terms of the loan, down payment options, and interest rates. A good deal pushes for a longer-term, low down payment, and reasonable rates. A long repayment term is often better than a lower rate, as resulting lower monthly payments mean more working capital to run the business.

Long-term equity sources are business partners or "angels," venture capital corporations, and investment funds.

Public lenders are more likely to lend if the bank is willing to make a loan. If there is a gap in financing, then keep the bank involved and review ways to make the deal stronger. If the business does not need public lenders or gap financing, then we are done. Move to Step Eight, and close the deal. If the business requires incentives (tax abatements, tax credits), put them in place.

The bank has assessed the company and at this point is willing to loan $400,000. Encourage the company to also explore long-term equity sources.

Step Six:Determine any remaining gap in financing

Determine if the gap is a credit gap, a capital gap, or a cash flow gap. Can the gap be closed with public financing? Does the business meet the criteria for receiving a public-sector loan? Does the timing work?

The gap is $400,000.

Step Seven:Structure the deal using public-sector financing

If the numbers will not work and the deal cannot be privately financed, then determine the type of gap financing. The gap could be caused by a business' bad credit history, lack of value in the collateral available to pledge against the loan, temporary or seasonal inability to generate cash flow to repay debt, or limited available equity.

Public-sector financing programs help private-sector lenders make loans that they otherwise would not make. The purpose of the public sector is to overcome the lender's perceived risk. There are few "free money" public-sector programs, except for incentive programs designed to lure new businesses or maintain existing businesses.

Since public-sector money is taxpayer dollars, limitations are placed on its use to achieve certain goals such as job creation and taxes generated.
The public-sector financing can fill the gap in two basic ways: loan money (usually 40 percent of a project cost) for a long term at a fixed rate, or loan guarantees (guarantee between 75 percent and 80 percent of the bank's loan).

Example of typical (50-40-10 deal) financing with federal financing SBA 504 direct loan program:

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50% bank loan amount:	*$400,000*	*Debt 1*
40% SBA 504 loan amount:	*$320,000*	*Debt 2*
Remaining for borrower to fund:	*$80,000*	*Equity*
Total Project Cost:	*$800,000*	Â

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SBA 504 is long-term, fixed-rate financing for healthy, growing companies. Besides the SBA 504 direct loan program, other sources of public financing are:

- CDBG: Locally managed revolving loan fund, which can provide flexible financing for long-term, fixed-rate financing, variable-rate financing, or working capital;
- SBA 7a: A guarantee of bank loan for working capital, fixed assets, or equipment for riskier projects;
- Tax-exempt bonds: Tax-exempt, lower-rate, long-term financing for larger manufacturing projects;
- Linked deposits: Funds deposited in bank that receive low or no interest on the deposit in exchange for a reduction of rate for the borrower on the bank loan;
- Employee stock ownership plans: Can qualify for specialized treatment in bank loans.

Step Eight:Close the deal

Identify conditions and covenants that should be included in the loan agreement. Covenants are red flags and other items identified in the earlier steps. Close the deal.

> *Typical conditions at closing (called loan covenants) include hiring the 10 new employees from within the city at an average salary of $50,000, improving collections on sales, submitting annual reports, requiring project to be designed and built by licensed professionals, and a specified timeframe for ground-breaking and opening.*

CONCLUSION

The prompt analysis at the first two steps can establish trust with the business. Steps three through seven involve negotiation, research, and scheduling. The final step puts performance guaranties in place. Rocky Wade warns those eager to get to the ribbon-cutting part "to avoid the EDP (economic development professional) Syndrome," which is the tendency to jump ahead to step four or step seven without doing the analysis.

Analysis and deal structuring is an art, not a science. Different people can reach very different conclusions reading the same numbers. Good dealmakers are good cynics who ask the right questions. Sid White, AICP, Ventura's Economic Development Manager, notes that "the 'art' is in creatively structuring the deal from the ground up and serving as a gracious mediator among several stakeholders' individual interests, which includes the public interest and the business bottom line."

Planners rely primarily on policies (plans) and laws (ordinances) to facilitate desirable outcomes. Financial deal-structuring is where the rubber meets the road â€" it is a stage where not only city support but also public funding could be bestowed on a project. Deal structuring historically has not been a mainstream planning task. We usually leave this to the economic development officers. While planners may not structure a deal, it is beneficial for planners to know the various steps and recognize the different questions to ask during structuring a deal.

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GLOSSARY[4]

Accounts payable
Represents the claims of suppliers related to goods or services they have furnished to an entity but for which they have not yet been paid. It is part of the current liabilities of an entity.

Accounts receivable
Money owed to the entity by its customers. It is part of the current assets of an entity.

Assets
The economic resources owned by an entity that have commercial or market value.

Balance sheet
A financial statement that summarizes the financial position of an entity by outlining its assets, liability, and equity. Assets must equal liabilities and equity.

Capital gap
The difference between the supply of private-sector financial capital and the demand for that capital.

Cash flow
A financial statement showing all the actual cash receipts and disbursements of an entity for a specified period of time.

Debt service

The cash required in a given period, usually one year, for payment of interest and the current payment of loan principal on outstanding debt. Also, the borrower's ability to meet debt and interest obligations.

Equity capital
Funds that the owners have personally invested in an entity, as distinguished from debt capital, as well as residual value of an entity after deducting liabilities from assets and paying dividends.

Income statement
A financial statement that derives the net income of an entity by summarizing the sources of current revenues and costs associated with obtaining that revenue.

Loan packaging
Help a business structure on an overall financial plan and prepare the application package to apply for financing.

Operating cycle
The process of packaging a product or service, getting it to market and collecting the proceeds from its sale. It is also defined as the flow of cash through the normal operation of a company.

Return on Investment (ROI)
Net income divided by dollars invested.

Working capital
Current assets of an entity including cash, marketable securities, accounts receivables, inventory, and prepaid expenses. Net working capital is current assets less current liabilities.

NOTES
1. EDI is a multi-year, professional level program that provides professional economic developers with up-to-date knowledge and tools necessary to succeed in today's constantly changing economic development marketplace.

2. The Risk Management Association (RMA) is a private business that collects annual financial statements from more than 165,000 companies and compiles information from the financials into charts to streamline comparative ratio analysis. They produce two ratio books: *Financial Ratio Benchmarks*, and *Industry Default Probabilities and Cash Flow Measures*.

3. Working Capital Ratio is cash remaining after all operating (current) assets are collected and all operating (current) liabilities are paid. The ratio is calculated by subtracting the current liabilities from the current assets.

4. The source of this short glossary is the *Economic Development Finance Manual* produced by International Economic Development Council. For a complete list of glossary terms, see the *Economic Development Finance Manual*.

ADDITIONAL REFERENCES

Neale, Corky, and Shari Garmise. January 2006. *Economic Development Finance.* International Economic Development Council.

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