

SMALL AND EMERGING CONTRACTORS
WEBINAR SERIES:

BANKING AND FINANCING FOR CONTRACTORS

**Presented by: Jason Bakke, CPA, CCIFP, Partner
CliftonLarsonAllen LLP**



Webinar Objectives

- Provide an overview of the commonly available lending options for capital equipment financing and working capital needs of contractors
- Review budgeting and management of cash flows
- Discuss the factors that banks and other credit providers commonly use to evaluate a small business for underwriting and lending purposes
- Provide suggestions on successfully managing the banking relationship
- Review best practices for cash-related processes and controls



OVERVIEW – LOAN TYPES AND CONSIDERATIONS

- Long-Term Loans
 - Equipment / vehicle notes
 - Mortgages
 - Capital equipment line of credit
- Operating / Working Capital Lines of Credit
 - Evaluation of needs - borrowing capacity
 - Terms and rates
- Small Business Administration (SBA) Loan Programs
- Security, Terms and Rates



Purchase vs. Lease

EQUIPMENT LEASING:

Advantages:

- Minimal initial expenditure and impact on cash flow
- Easier to obtain
- Flexible terms and conditions
- Balance sheet impact / ratios

Disadvantages

- Higher overall cost
- Lack of ownership

EQUIPMENT PURCHASE

Advantages:

- Ownership
- Tax incentives – Section 179 or Bonus Depreciation

Disadvantages

- Ownership – risk of obsolescence or utilization
- Impact on cash flows and borrowing capacity

Suggestion: Have a defined and process in place to evaluate whether purchase and financing is appropriate



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Equipment Financing

Equipment and Vehicle Notes:

- **Common Terms:**
 - Generally 3 to 5 years; fixed monthly payment
 - Interest at fixed rates based upon market and credit considerations
 - Security:
 - Specifically identified equipment
 - Personal guarantee from the corporation / related businesses / owners?
 - Covenants



Equipment Financing

Equipment Financing Considerations:

- **Equipment consolidation loans:**
 - Reduced interest rates
 - Increased terms; improved cash flow implications
 - Increased flexibility – interest-only periods
 - Increased collateral – blanket security agreement; personal guarantees probable
- **Equipment Acquisition Line of Credit:**
 - Fixed line to provide for multiple planned purchases over a period of time
 - Interest initially at variable rate; converts to fixed, amortized loan at maturity
- **SBA Loans**



Lines of Credit - Operating

Operating / Working Capital Lines of Credit

- **Used to finance the day-to-day operations of the business**
 - Purchase materials or inventory
 - Pay operating costs – labor, fringes, subcontracts, overhead, etc.
- **Security:**
 - Accounts receivable
 - All business assets
 - Personal guarantees from owners / management / related parties
- **Terms & Considerations**
 - Interest – generally variable rate (Prime Rate, LIBOR, etc)
 - Interest rate floors
 - Commitment fee – unused capacity
 - Covenants

Lines of Credit - Operating

Critical Questions:

How much short-term borrowing capacity do I need?

How do I secure the necessary financing capacity?



CASH FLOW BUDGETING AND MANAGEMENT

Lines of Credit - Operating

Cash Flow Projections & Budgeting – not an event; a process

- Every business must utilize cash flow projections as a key tool to manage their operations and evaluate their financing needs
- Be thorough and realistic
- Monitor and revise cash flow assumptions:
 - Revenue and billings
 - Collections on AR and retentions
 - Timing of payments to vendors, employees, subs
 - Fixed costs and overhead
 - Taxes and distributions



ILLUSTRATION – CASH FLOW PROJECTION

CASH FLOW PROJECTION - ASSUMPTIONS

Collections Assumptions:

	<u>Existing A/R</u>	<u>Future Billings</u>
Current Month	25%	0%
30-days	25%	60%
60-days	25%	25%
90-days	25%	10%
120-days	0%	5%
Retentions	180	180 Days

Gross Profit / Vendor Payment Assumptions

Costs of Sales	<u>% of Sales</u>	<u>Current</u>	<u>30 Days</u>	<u>60 Days</u>
Labor & Fringe	28%	100%		
Materials	27%	0%	75%	25%
Subcontractors	18%	0%	25%	75%
Equipment - Various	7%	0%	75%	25%
Other	8%	0%	75%	25%
Gross Profit:	12%			



CASH FLOW PROJECTION - ACTIVITY

Current Accounts Receivable

- December 31, 2012

	<u>January</u>	<u>February</u>	<u>March</u>	<u>April</u>	<u>May</u>	<u>June</u>	<u>TOTAL</u>
Contract Billings	360,000	-	-	-	-	-	360,000
Retention	40,000	-	-	-	-	-	40,000
Total Billings	400,000	-	-	-	-	-	400,000
Cash Flows - Current Receivables:	-	-	-	-	-	-	-
Cash Flows - Future Billings & Retention:	-	144,000	126,000	54,000	36,000	40,000	400,000
Total Cash Flows - In:	-	144,000	126,000	54,000	36,000	40,000	400,000
<u>Costs of Sales</u>							
Labor	112,000	-	-	-	-	-	112,000
Materials	-	81,000	27,000	-	-	-	108,000
Subcontractors	-	18,000	54,000	-	-	-	72,000
Equipment - Various	-	21,000	7,000	-	-	-	28,000
Other	-	24,000	8,000	-	-	-	32,000
Total:	112,000	144,000	96,000	-	-	-	352,000



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Current Accounts Receivable	400,000	December 31, 2012					
	<u>January</u>	<u>February</u>	<u>March</u>	<u>April</u>	<u>May</u>	<u>June</u>	<u>TOTAL</u>
Contract Billings	360,000	1,080,000	3,150,000	1,980,000	1,080,000	450,000	8,100,000
Retention	40,000	120,000	350,000	220,000	120,000	50,000	900,000
Total Billings	400,000	1,200,000	3,500,000	2,200,000	1,200,000	500,000	9,000,000
Cash Flows - Current Receivables:	100,000	100,000	100,000	100,000	-	-	400,000
Cash Flows - Future Billings & Retention:	-	216,000	738,000	2,196,000	2,101,500	1,552,000	6,803,500
Total Cash Flows - In:	100,000	316,000	838,000	2,296,000	2,101,500	1,552,000	7,203,500
<u>Costs of Sales</u>							
Labor	112,000	336,000	980,000	616,000	336,000	140,000	2,520,000
Materials	-	81,000	270,000	789,750	681,750	391,500	2,214,000
Subcontractors	-	18,000	108,000	319,500	571,500	351,000	1,368,000
Equipment - Various	-	21,000	70,000	204,750	176,750	101,500	574,000
Other	-	24,000	80,000	234,000	202,000	116,000	656,000
Total:	112,000	480,000	1,508,000	2,164,000	1,968,000	1,100,000	7,332,000
<u>General & Administrative</u>							
Payroll	8,500	12,500	16,000	16,000	16,000	12,500	81,500
Benefits	3,400	5,000	6,400	6,400	6,400	5,000	32,600
Rent	7,000	7,000	7,000	7,000	7,000	7,000	42,000
Utilities	750	750	750	750	750	750	4,500
Insurance	1,200	1,200	1,200	1,200	1,200	1,200	7,200
Miscellaneous	1,000	1,000	1,000	1,000	1,000	1,000	6,000
Total:	21,850	27,450	32,350	32,350	32,350	27,450	173,800
Cash Flows from Operations:	(33,850)	(191,450)	(702,350)	99,650	101,150	424,550	(302,300)
<u>Debt Service</u>							
Principal & Interest - Term Debt	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(72,000)
Interest - Line of Credit - Average Balance	-	(146)	(1,571)	(6,583)	(6,015)	(5,433)	(19,748)
NET CASH FLOWS:	(45,850)	(203,596)	(715,921)	81,067	83,135	407,117	(394,048)

LOC SUMMARY:

Cash / LOC Advances - Beginning	25,000	(20,850)	(224,446)	(940,367)	(859,300)	(776,165)
Cash / LOC Advances - Ending	(20,850)	(224,446)	(940,367)	(859,300)	(776,165)	(369,048)




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CASH FLOW PROJECTION - ASSUMPTIONS

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90-days	25%	15%	
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Gross Profit / Vendor Payment Assumptions

Costs of Sales	<u>% of Sales</u>	<u>Current</u>	<u>30 Days</u>	<u>60 Days</u>
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Gross Profit:	12%			



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	<u>January</u>	<u>February</u>	<u>March</u>	<u>April</u>	<u>May</u>	<u>June</u>	<u>TOTAL</u>
Contract Billings	360,000	1,080,000	3,150,000	1,980,000	1,080,000	450,000	8,100,000
Retention	40,000	120,000	350,000	220,000	120,000	50,000	900,000
Total Billings	400,000	1,200,000	3,500,000	2,200,000	1,200,000	500,000	9,000,000
Cash Flows - Current Receivables:	100,000	100,000	100,000	100,000	-	-	400,000
Cash Flows - Future Billings & Retention:	-	144,000	558,000	1,692,000	2,092,500	1,745,500	6,232,000
Total Cash Flows - In:	100,000	244,000	658,000	1,792,000	2,092,500	1,745,500	6,632,000
<u>Costs of Sales</u>							
Labor	112,000	336,000	980,000	616,000	336,000	140,000	2,520,000
Materials	-	81,000	270,000	789,750	681,750	391,500	2,214,000
Subcontractors	-	18,000	108,000	319,500	571,500	351,000	1,368,000
Equipment - Various	-	21,000	70,000	204,750	176,750	101,500	574,000
Other	-	24,000	80,000	234,000	202,000	116,000	656,000
Total:	112,000	480,000	1,508,000	2,164,000	1,968,000	1,100,000	7,332,000
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Payroll	8,500	12,500	16,000	16,000	16,000	12,500	81,500
Benefits	3,400	5,000	6,400	6,400	6,400	5,000	32,600
Rent	7,000	7,000	7,000	7,000	7,000	7,000	42,000
Utilities	750	750	750	750	750	750	4,500
Insurance	1,200	1,200	1,200	1,200	1,200	1,200	7,200
Miscellaneous	1,000	1,000	1,000	1,000	1,000	1,000	6,000
Total:	21,850	27,450	32,350	32,350	32,350	27,450	173,800
Cash Flows from Operations:	(33,850)	(263,450)	(882,350)	(404,350)	92,150	618,050	(873,800)
<u>Debt Service</u>							
Principal & Interest - Term Debt	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(12,000)	(72,000)
Interest - Line of Credit - Average Balance	-	(146)	(2,075)	(8,350)	(11,323)	(10,841)	(32,735)
NET CASH FLOWS:	(45,850)	(275,596)	(896,425)	(424,700)	68,827	595,209	(978,535)
LOC SUMMARY:							
Cash / LOC Advances - Beginning	25,000	(20,850)	(296,446)	(1,192,871)	(1,617,571)	(1,548,744)	
Cash / LOC Advances - Ending	(20,850)	(296,446)	(1,192,871)	(1,617,571)	(1,548,744)	(953,535)	



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CASH IS KING: CASH FLOW MANAGEMENT

Job Profitability

- Bidding / estimating – project scope
- Understanding true burdened costs

Customer Billing Practices

- Customer credit
- Commitment to timely and accurate billing practices
- Core expectation of operations personnel
- Understand contract provisions and billing requirements
- Opportunities to pre bill / overbillings
- Timely close-out / punch-list



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CASH IS KING: CASH FLOW MANAGEMENT

Change Order Management – get paid for the work you do!

- Documentation is critical to timely payment
- Know owner's requirements for approval and processing of extras
- Timely billing – the longer you wait, the less likely you are to collect

Diligent Collection Practices

- The squeaky wheel gets the grease
- Retain leverage: Monitor lien rights; timely documentation and filing
- Retention balances – don't let these fall under the radar



CASH IS KING:

CASH FLOW MANAGEMENT

Equipment / purchases / maintenance and repair

- Rent vs. purchase
- Evaluate financing and/or rental terms to minimize cash flow requirements
- Timing of new purchases, maintenance and non-essential repairs
- Monitor utilization of equipment; evaluate past decisions

Purchases and Vendor management

- “Lean” management of material purchases, supplies and tools
- Evaluate and negotiate payment terms with suppliers and vendors
- “Pay when paid” clauses and practices
- Subcontractor quality



CASH IS KING: CASH FLOW MANAGEMENT

Tax Planning / Accounting Methods

- Tax planning
- Accelerated depreciation methods
- Accounting Method Selection:
 - Accrual versus cash basis of accounting
 - Contract methods: % of completion; completed contract; accrual-less-retention
 - other
- Understand and anticipate “Deferred” income taxes / timing differences

Distributions and Capital



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Small Business Administration (SBA) Guarantees and Loans

SBA Loans - Overview

Variety of loan programs:

- Working capital / Cap-ex / Refinance – 7(A) Program
- Building / Equipment – 504 Loan

Shared Risk:

- Small Business Administration provides a guarantee to the lender for a portion; government assumes the risk of default
- Loans are achievable in circumstances where conventional financing is not possible.

SBA approved lenders – many traditional lenders



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SBA Loans - Overview

Advantages:

- Less down payment or equity needed
- Longer amortizations – 10 to 25 years; 7 for working capital
- Flexibility
- Less continuing documentation and fewer covenants

Drawbacks:

- Cumbersome application process
- Costs – guarantee fee / servicing fee
- Limitations – qualifications and capacities
- Highly collateralized



LENDING EVALUATION PROCESS: ***Demonstrating your*** ***Creditworthiness to a Lender***

The 5 “C”’s for Lending Evaluation:

- **Capacity / Cash Flows**
- ***Collateral***
- ***Capital***
- ***Conditions***
- ***Character***

CAPACITY

Capacity represents the businesses ability to repay the loan.

Underwriting Considerations:

- Best evidence: Historical profitability and cash flows;
Significant working capital and liquidity
- Strength of your business plan; convince the bank to invest in your operation
- Prepare detailed budgets and forecasts; be prepared to discuss how you are going to achieve the results
- Cash flow projections – how and when will the lender get paid?
- Business practices – marketing, cash flow management and expense management



Financial Analysis & Benchmarking – How do you stack up?

Key Ratios – Liquidity – your company's ability to satisfy short-term obligations:

- Working capital = total current assets – total current liabilities
- Current ratio = current assets / current liabilities

Key Ratios – Leverage – how much does your company rely on debt and financing?:

- Debt to equity ratio: total liabilities / total equity
- Tangible net worth = total equity



Financial Analysis & Benchmarking – How do you stack up?

Key Metrics and Ratios – Efficiency – how well do you manage your business practices?

- Accounts receivable aging
- Days sales in accounts receivable
- Over/under billings
- Gross profit / profit-fade on estimates

Key Metrics – Cash Flow

- EBITDA – Net Income + interest + taxes + depreciation & amortization
- Coverage ratios - various



Financial Analysis & Benchmarking – How do you stack up?

Take Away – You should understand the criteria that banks and underwriters are using to evaluate your creditworthiness; proactively manage the results whenever possible

Considerations:

- Importance of quality and timely financial information
- Benchmark your company against others in the industry
- Structure financing and lease agreements to maximize working capital and liquidity
- Retain capital - manage distributions, tax methods
- Consult regularly with your CPA, banker and other advisors



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COLLATERAL & SECURITY

**Collateral has a direct correlation to capacity.
Provides security to the lender**

Examples:

- Pledge business assets – equipment, receivables, inventory, life insurance, etc
- Mortgage
- Personal or non-business assets
- Guarantees – personal or related-party business



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COLLATERAL & SECURITY

Commonly Discounted or Disregarded Assets:

- Receivables/advances from ***owners*** or ***related parties***
- Non-current receivables – 60/90+ days outstanding
- Bonded receivables
- Underbillings
- Intangibles

Equipment Valuation – Maximizing Borrowing Capacity:

- Equipment – lives and methods; salvage value
- Consider desktop appraisal
- Lender philosophy



CAPITAL

Capital represents the owner's investment in the business

Owners must have significant personal and financial investment in the business before a lender will consider a business loan

Examples:

- Net worth and Equity
- Subordinated loans to the company



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Conditions

Economic and industry considerations

- Overall economic climate
- Factors influencing the company's industry (competition, outlook)
- The company's reputation and customer relationships
- Factors influencing the bank; industry exposure & regulatory

Loan Terms and Conditions

- Purpose of the loan – expansion, refinance, working capital, etc.
- Credit history of the company and guarantors
- Relevant terms of the loan



Character

Trustworthiness: Aside from capacity, character could be the most important factor influencing lending decisions and underwriting

- Highly subjective judgment made about you and your company
- Character and reputation are earned over time
 - Difficult to earn and easy to loose
- Can be effectively managed - focus of the “banking relationship “ section



Banking Relationship



Banking Relationship

Choosing the “Right Bank”

- Assessment of products, services and capacity
- Character and trust
- Construction industry experience
 - Understands your business and the unique challenges and considerations of the industry
 - Active in trade events and industry associations
 - Referrals from trusted advisors, peers and others in the industry
- Customer service and convenience



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Building and Maintaining the Relationship

Treat lender as a business partner, not an adversary

Open and effective communication

- Maintain and provide quality, timely and accurate financial information
- Regular meetings with your lender; include other advisors when possible
- No surprises!
- Be conservative – exceed projections vs. explaining why forecasts were not achieved

Discuss significant business decisions with your lender early-on

Provide required information timely and accurately



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DEPOSIT ACCOUNTS

Overview of cash controls and considerations

Internal Controls - Cash

A properly designed system of internal control will ensure that no single individual would have control over two or more phases of a significant transaction or operation.

Benefits:

- deliberate fraud is more difficult because it requires collusion of two or more persons
- it is much more likely that innocent errors will be found and corrected in the ordinary course of business.

Challenge: Limited personnel = concentration of responsibility



Internal Controls - Cash

Examples of Basic Controls and Procedures:

- **Bank statements (or copies):** sent to the home of the owner
- **Bank reconciliations:**
 - Review and approval by owner or someone independent of cash process
 - Selective testing and review of transactions
- **All disbursements** supported by supporting documentation & approval
- **Blank checks / signature stamps:** Secured
- **Expense reports / credit cards:** Documentation, review & approval
- **Positive pay**



Contact Information

Questions



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Jason C. Bakke, CPA, CCIFP

Partner – Construction & Real Estate
CliftonLarsonAllen LLP

Jason.Bakke@cliftonlarsonallen.com
612-376-4638