Banking Small Business

Course 2097

Mike Milan

2019 Session
Banking Small Business

A C&I Lending Course

Graduate School of Banking at Louisiana State University
COURSE OUTLINE

Introduction
- Success principles
- Watch it
- Bar Napkins

Redefining Relationship Banking
- Creating a migration strategy
- Relational versus transactional banking
- Bridging the communication gap

Developing a Personal Brand
- Define value proposition
- Competitive advantage
- Two-thirds compromise
- Holistic banker
- Measurement of strong personal brand

Understanding the Client
- 5 types of business
- Business entities
- Dealing with personalities
- Understanding the business lifecycle
- Using big data to enhance customer experience
- Estate planning considerations

C & I Lending
- Case study
- Ratio analysis
- Initial financial indicators
- Financial impact
- Financial cause and effect
- Problem and solution identification
- Working capital cycle

Valuation
- Asset approach
- Earnings approach

Putting the Tools to Use
- Add value to the relationship through selling
- Four elements of time management
- Client connection tools
COMPONENTS OF RELATIONSHIP BANKING

Small Business Relationship

Type
Segment
Sales Seams
Personality
Life Cycle

Personal Brand
Knowledge
Care/Service
Quarterback
Bank Infrastructure
IFIs
Network

Personal Value Proposition = Relationships

• Product/Customer
• Following
• Referral Business

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VALUE PROPOSITION

Value Proposition = Perceived Benefit - Perceived Price

Bank Marketing

+ 

Bank Infrastructure Systems

Personal Competitive Advantage

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Individual Personal Brand

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1. What are Small Business Owner's (SBOs) three main complaints about bankers?

2. _____% of SBOs never called on by banks.

3. _____% of SBOs never called on by their own bank.

4. _____ Which category of small businesses are most profitable to the bank?  
   Annual Sales:  
   A) $1 to $10 million  
   B) $10 to $100 million

5. _____% of small business clients that also do their personal banking with the same bank that holds their business deposits.

6. _____% of businesses that are over $5 million in sales in the US.

7. _____% of millionaires in the US that accumulated their wealth through small business ownership.

8. _____% of unhappy customers that their bank never hears from.

9. _____ The average number of bank products used by SBOs.

10. What is the most significant EVENT in building or sustaining customer relationships?

11. Give three reasons banks are having trouble building sales cultures.

12. What is the most vulnerable time in the SBO/banker relationship?

13. Name five driving forces in the US today.
BUSINESS LIFE CYCLE

GROWTH

Creation of Myths

Hard Work

Teach & Share

Hard

Comfort Liquidation

TIME

WONDER
* Begins at Age 30-40
* Has a dream
* High mortality

Products:

BLUNDER
* High Growth
* Out of Control
* IRS – University
* Secrecy
* ID Crisis

Products:

THUNDER
* Wealth
* Power
* Respect
* Myths

Products:

UNDER
* Wear & Tear
* Age Controls
* Lonely
* Personality Change
* One Rider Horse
* Mentally Retire

Products:
PERSONALITY PROFILES

ANALYTIC
* Tends to be cautious
* Tends to be very orderly
* Likes controlled environment
* Generally checks accuracy
* Generally agreeable
* Tends to be serious/persistent
* Likes to be assured of security
* Often soft spoken
* Likes status quo
* Generally dislikes change
* Tends to be diplomatic
* Tends to be humble/obliging
* Follows prescribed standards
* Performs precise work

DRIVER
* Competitive
* Independent
* Tends to dominate
* Wants immediate results
* Likes power and authority
* Wants freedom from authority
* Wants direct answers
* Very decisive
* Can be argumentative
* Tends to be persistent
* Often outspoken
* Usually restless/causes action
* Tends to be adventurous
* Tends to be vigorous

AMIABLE
* Dislikes conflict
* Very generous
* Tends to be thorough
* Takes time to listen
* Has demonstrated loyalty
* Generally considerate of others
* Tends to be accommodating
* Takes time to make a decision
* Wants guarantee before change
* Wants agreement
* Tends to be patient
* Likes security/stability
* Tends to like status quo

EXPRESSIVE
* Tends to generate enthusiasm
* Tends to be exciting/stimulating
* Very confident
* Likes working with people
* Wants freedom of expression
* Wants freedom from detail
* Likes stimulating ideas
* Likes change
* Often very optimistic
* Very talkative/playful
* Likes to participate in groups
* Has a desire to help others
* Likes recognition
* Tends to be persuasive

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DEALING WITH PERSONALITIES

Dealing with **ANALYTICS:**
- Be systematic, exact, organized and prepared and have data for them.
- List advantages/disadvantages of the proposal.
- Give analytic time to verify words and actions.
- Provide solid, tangible, factual evidence.
- Follow up in writing to verify the discussion.
- Do not rush the decision-making process.

**ANALYTICS** are:
- Conservative
- Exacting
- Objective
- Black and White
- Logical
- Time Tested

Dealing with **DRIVERS:**
- Dominance respects dominance – stand your ground. Be self-confident.
- Be precise, efficient, time-disciplined and well organized.
- Give recognition to their ideas, not to them personally.
- Keep relationship business-like. Do not attempt to develop a personal relationship unless customer wants it.
- If you disagree, argue facts toe-to-toe; however, do not over-dominate.

**DRIVERS** are:
- Results Oriented
- Performance Oriented
- Professional
- Relentless
- Incisive
- Impacters

Dealing with **AMIABLES:**
- Build a strong, sincere relationship.
- Be interested in customer as a person and listen.
- Take away from office for coffee, lunch, etc.
- Offer personal assurance of support.
- Do not overstate guarantees.
- If you disagree, do not debate facts and logic; discuss personal feelings and opinions.

**AMIABLES** are:
- Loyal
- Team Players
- Prudent/Dependable
- Comfortable
- Supportive

Dealing with **EXPRESSIVES:**
- Give them center stage.
- Summarize in writing to verify agreed upon discussion.
- Use referrals from important people and companies. Drop names.
- Be entertaining and fast-moving.
- Talk about opinions, ideas and dreams.

**EXPRESSIVES** are:
- Creative
- Innovative
- Revolutionary
- Dynamic
- Dramatic
- Achievers
# SUMMARY OF BEHAVIORAL STYLES

<table>
<thead>
<tr>
<th>Behavior Pattern:</th>
<th>Amiable</th>
<th>Analytic</th>
<th>Driver</th>
<th>Expressive</th>
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<tbody>
<tr>
<td></td>
<td>Open, Direct</td>
<td>Self-Contained, Indirect</td>
<td>Self-Contained, Direct</td>
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<td>Appearances:</td>
<td>Casual, Conforming</td>
<td>Formal, Conservative</td>
<td>Business-like, Functional</td>
<td>Fashionable, Stylish</td>
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<td>Pace:</td>
<td>Slow, Easy</td>
<td>Slow, Systematic</td>
<td>Fast, Decisive</td>
<td>Fast, Spontaneous</td>
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<td>Priority:</td>
<td>Maintaining Relationships</td>
<td>The Task: The Process</td>
<td>The Task: The Results</td>
<td>Relationships Interacting</td>
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<td>Fears:</td>
<td>Confrontation</td>
<td>Embarrassment</td>
<td>Loss of Control</td>
<td>Loss Of Prestige</td>
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<tr>
<td>Under Tension Will:</td>
<td>Submit, Acquiesce</td>
<td>Withdraw, Avoid</td>
<td>Dictate, Assert</td>
<td>Attack, Be Sarcastic</td>
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<td>Seeks:</td>
<td>Attention</td>
<td>Accuracy</td>
<td>Productivity</td>
<td>Recognition</td>
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<tr>
<td>Needs to Know:</td>
<td>How It Will Affect His/Her Personal Circumstances</td>
<td>How To Justify The Purchase Logically, How It Works</td>
<td>What It Does, By When/What It Costs</td>
<td>How It Enhances His/Her Status, Who Else Uses It</td>
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<tr>
<td>Gains Security By:</td>
<td>Close Relationships</td>
<td>Preparation</td>
<td>Control</td>
<td>Flexibility</td>
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<tr>
<td>Wants to Maintain:</td>
<td>Relationships</td>
<td>Credibility</td>
<td>Success</td>
<td>Status</td>
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<td>Support His/Her:</td>
<td>Feelings</td>
<td>Thoughts</td>
<td>Goals</td>
<td>Ideas</td>
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<tr>
<td>Achieves Acceptance By:</td>
<td>Conformity Loyalty</td>
<td>Correctness, Thoroughness</td>
<td>Leadership, Competition</td>
<td>Playfulness, Entertaining</td>
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<td>Likes You To Be:</td>
<td>Pleasant</td>
<td>Precise</td>
<td>To The Point</td>
<td>Stimulating</td>
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<tr>
<td>Wants To Be:</td>
<td>Liked</td>
<td>Correct</td>
<td>In Charge</td>
<td>Admired</td>
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<tr>
<td>Irritated By:</td>
<td>Insensitivity, Impatience</td>
<td>Surprises, Unpredictability</td>
<td>Inefficiency, Indecision</td>
<td>Inflexibility, Routine</td>
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<tr>
<td>Measures Personal Worth By:</td>
<td>Compatibility with Others, Depth of Relationships</td>
<td>Precision, Accuracy, Activity</td>
<td>Results, Track Record, Measurable Progress</td>
<td>Acknowledgement, Recognition, Applause, Compliments</td>
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<td>Decisions Are:</td>
<td>Considered</td>
<td>Deliberate</td>
<td>Definite</td>
<td>Spontaneous</td>
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# Management Styles

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<td>Management</td>
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<td><strong>Communication Methods</strong></td>
<td>One-Way Down</td>
<td>Two-Way</td>
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<td>Centralized</td>
<td>De-Centralized</td>
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<td><strong>Organization</strong></td>
<td>Rake</td>
<td>Formal</td>
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<td><strong>Decision Making</strong></td>
<td>Intuitive</td>
<td>Planned</td>
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<td><strong>Control</strong></td>
<td>Observation</td>
<td>Exception</td>
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</tbody>
</table>

*Personal Continuum*  

|   | 1 | 10 |

*Company Continuum*  

|   | 1 | 10 |
### SMALL BUSINESS OWNER TRANSITION

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
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<tr>
<td><strong>Entrepreneur</strong></td>
<td><strong>Technician</strong></td>
<td><strong>Manager</strong></td>
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<tr>
<td>Lives in:</td>
<td>Future</td>
<td>Present</td>
</tr>
<tr>
<td>See things as:</td>
<td>Opportunity</td>
<td>Work to be done</td>
</tr>
<tr>
<td>Control:</td>
<td>Needs control</td>
<td>Low needs</td>
</tr>
<tr>
<td>Sees world:</td>
<td>Over abundance of opportunities and dragging feet</td>
<td>More work</td>
</tr>
<tr>
<td>Methods:</td>
<td>Bully, harass, cajole flatter</td>
<td>Head down - Work harder</td>
</tr>
<tr>
<td>Creates:</td>
<td>New ideas</td>
<td>Completed tasks</td>
</tr>
<tr>
<td>Systems:</td>
<td>To be ignored</td>
<td>Get in the way</td>
</tr>
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</table>
FORMS OF BUSINESS

Generally speaking, structure or tax-related problems occur either in start-up or rapid growth firms — and they are normally caused by errors of omission, not commission.

The area of business form and taxation is a highly legal one. The best advice is to hire an expert and pay the price, otherwise, business owners risk learning the lessons after the fact.

Following is a brief outline, which provides the basic issues for the most common forms of business:

1. Sole Proprietorship
2. Partnership
3. Regular Corporation (C Corp.)
4. Subchapter S Corporation (S Corp.)
5. Limited Liability Company (LLC)
**BUSINESS ENTITIES**

**Sole Proprietorship**

- **Number of Owners:** One

- **Organization and Administration:** A sole proprietorship is the easiest business to organize. Complete intermingling of business and personal funds is allowed (although not recommended). A business return is filed along with the owner's individual income tax return.

- **Income Tax Consideration:** Income/expenses of business are reported on the owner's personal tax return. Business is not a separate tax paying entity and will not reflect tax items on its statements.

- **Bookkeeping and Accounting:** There are fewer requirements on what type of bookkeeping system or accounting method is used in sole proprietorships. The system must be consistent, clearly show income and expenses, and allow the taxpayer to file an accurate return. The sole proprietorship must follow the same tax year as its owner.

- **Owner Control and Flexibility:** The owner is free to make all business decisions.

- **Salary Expense:** Owner's compensation reflected as withdrawals — thus no owner salary expense on income statement.

- **Transfer of Ownership:** A sole proprietorship is not a separate entity from its owner. "Sale" of a sole proprietorship is actually a sale of assets.

- **Taxation:** Net profit is computed on Schedule C and is reported as income on the owner's Form 1040.
General Partnership

- **Number of Owners:** Two or more

- **Organization and Administration:** A partnership is easy to organize. A written partnership agreement is recommended, but not required. The partnership agreement determines how income and losses are allocated to the partners. If a partnership agreement does not exist, partnership items pass through based on each partners' ownership interest.

- **Income Tax Consideration:** Partnerships report income on Form 1065, but do not pay taxes directly nor reflect tax items on financials. Income/expenses flow through to partners who report and pay taxes on their share of partnership's taxable income on their personal tax returns.

- **Bookkeeping and Accounting:** Depending on income and assets, the partnership may be required to include a balance sheet with its income tax return. Therefore, the partnership should use the double-entry method for bookkeeping purposes. If a partner exchanges property or anything other than cash in exchange for an interest in a partnership, special accounting rules apply.

- **Owner Control and Flexibility:** Control of the business operations is divided among partners.

- **Salary Expense:** Owner's compensation is reflected as withdrawals, thus no owner salary expense on income statement.

- **Transfer of Ownership:** The partnership agreement may restrict the sale of a partnership interest, and may control the terms of sale.

- **Taxation:** Partnership income and expenses flow through to the individual partners. Income is taxed to the partner whether or not it is actually distributed. Pass-through items retain the same character in the hands of the partner as they had in the hands of the partnership.
Corporation (C Corp.)

- **Number of Owners:** One plus shareholders

- **Organization and Administration:** A corporation is difficult and expensive to organize. Corporations must hold periodic board meetings and keep minutes. Corporations must comply with federal and state regulations.

- **Income Tax Consideration:** Corporations report income and expenses on Form 1120, pay taxes directly and reflect tax items on financial statements.

- **Bookkeeping and Accounting:** The balance sheet on the corporation’s tax return must agree with the corporate books. The corporation must use a double-entry bookkeeping system. The corporation also must file all necessary employment tax returns.

- **Owner Control and Flexibility:** Shareholders have control over the corporation to the extent that they own voting stock.

- **Salary Expense:** Owner's salary expense, if they participated in business operations is included in the income statement. Owners may also be compensated with dividends.

- **Transfer of Ownership:** Ownership is easily transferred by selling shares of stock. The corporate charter may place certain restrictions on the sale of stock by shareholders.

- **Taxation:** A C corporation pays tax on its profits. When the owners (shareholders) take profits from the corporation, the distributions take the form of taxable dividends (double taxation). Personal service corporations are taxed at a higher rate.
Sub S Corporation (S Corp.)

- **Number of Owners:** Up to 75 shareholders

- **Organization and Administration:** An S corporation is set-up as a regular corporation. S corporations must then make an election to receive sub-chapter S status. Certain events will cause automatic termination of S status.

- **Income Tax Consideration:** Like a partnership, a sub-S corporation is a tax reporting entity, but not a tax paying entity. Taxable income is passed through to shareholders and is reported on their personal tax returns.

- **Bookkeeping and Accounting:** The S corporation must use double-entry bookkeeping and must file all required payroll tax and reporting forms.

- **Owner Control and Flexibility:** Shareholders have control over the corporation to the extent that they own voting stock.

- **Salary Expense:** Owner’s salary expense, if they participated in business operations is included in the income statement. Owners may also be compensated with dividends.

- **Transfer of Ownership:** Ownership is easily transferred by selling shares of stock. The corporate charter may place certain restrictions on the sale of stock by shareholders.

- **Taxation:** An S corporation is taxed in the same manner as a partnership. Income and expenses flow through to shareholders. Pass-through items retain the same character in the hands of the shareholder as they had in the hands of the corporation.
**BUSINESS ENTITIES (cont.)**

**Limited Liability Company (LLC)**

- **Number of Owners:** One plus members

- **Organization and Administration:** An existing partnership can generally register for LLC status in the state in which it conducts business. Registration is generally less complicated than forming a corporation.

- **Income Tax Consideration:** Usually taxed liked a partnership, a limited liability company is a tax reporting entity, but not a tax paying entity. Taxable income is passed through to members and is reported on their personal tax returns. Single member LLC’s are ignored for tax purposes.

- **Bookkeeping and Accounting:** Depending on income and assets, the LLC may be required to include a balance sheet with its income tax return. Therefore, the LLC should use the double-entry method for bookkeeping purposes. If a member exchanges property other than cash in exchange for an interest in the LLC, special accounting rules apply.

- **Owner Control and Flexibility:** Control is divided among members.

- **Salary Expense:** Generally, same as partnership.

- **Transfer of Ownership:** The operating agreement may restrict transfer of ownership interest.

- **Taxation:** An LLC is taxed as a partnership. Income and expenses flow through to members.
TYPES OF BUSINESS

Manufacturing
1. 
2. 
3. 

Wholesale/Distribution
1. 
2. 
3. 

Retail
1. 
2. 
3. 

Service
1. 
2. 
3. 

Contractor
1. 
2. 
3.
MANUFACTURING COMPANIES

- Does the company manage from a metrics? If so, what are the top three measurements and how are they performing compared to the established benchmarks?
- **Capacity** - Is the company at capacity, below capacity, or are there plans to expand?
- **Costing** - How does the company establish costing and pricing?
- **Inventory** - What percentages of inventory is raw materials, work in progress, finished goods?
- How are the materials purchased; what are the terms, and who and how many vendors does the company have?
- What is the company's supply chain strategy?
- How has the company managed availability and price problems with raw materials?
- How successfully has the company passed rising costs to buyers?
- **Production** - walk through the area and ask production questions: How long, how many shifts, downtime, etc.?
- Labor - number of employees, union or non-union, and does the company offer a retirement program?
- What is the impact of the loan on future operations?
- **Capital Investment** - how much was invested to put out the finished product?
- **Cost Controls** – control and monitoring of expenses & cash is critical to understanding the business.
- **Margins** – discuss the trends and compare them to industry standards.
- Who is the company’s biggest competition, now and in the future?
- What are their proprietary products?
- How does the company sell?
- How many product lines are produced?
- Does the company participate in trade shows?
- How does the company determine and implement new designs?
WHOLESALE OR DISTRIBUTION COMPANIES

- Does the company manage from a metrics? If so, what are the top three measurements and how are they performing compared to the established benchmark?

- **Routing** - How is routing planned and how efficient is it? Is Roadnet or another type of routing efficiency software used? How is it performing?

- How could computer-assisted distribution routing benefit the company?

- **Fleet** - Does the company have a fleet or contract carriers?

- How many trucks are there, and are the trucks leased or owned? Is there a need for more, and how often are trucks replaced?

- **Sales** - How many cases, trucks, drops or pounds per day? What is the average driver drop size? What is the average profit per drop?

- How does the company sell?

- **Inventory** - What is their picking system? Are orders filled manually or through an automated warehouse system?

- What is the cost to warehouse excess inventory?

- How many manufacturers does the company buy from? How many foreign manufacturers? Is the company a member of a buying group?

- How does the distributor maintain good relations with the manufacturers? Have they negotiated volume discounts?

- Does the company have formal distributorship agreements with manufacturers? With how many? What requirements do these impose?

- What is the number of SKUs (stock keeping units) they handle? How are the average sales and profits per SKU measured?

- What are the typical gross profit and operating profit margins?

- What is the typical gross profit and operating profit (in dollars)?

- What is the contribution margin?

- What is their trade territory? What types of computer & software technology does the company use to improve operations? What obstacles prevent the company from purchasing technology?

- What is the average time from order to delivery? What is the average fill-rate?

- How does the company deliver filled orders to customers?

- How often is the company out of stock when an order arrives?

- Does the company take orders through an Internet site?

- Does the company provide credit itself or through a third-party lender?

- What is the annual bad debt expense as a percent of sales? It should be less than 1%

- Does the distributor have any merger or acquisition plans?
BUSINESS TYPE CONSIDERATIONS

RETAILERS

- Do they manage from a metrics? If so what are the top three measurements and how are they performing compared to established benchmarks?
- What are the average sales per customer? per day? per square foot?
- Where does the company go to market? What are they "open to buy" when at the show?
- How many stores now and in the future?
- Do they own or lease? If they lease, what are the terms?
- Is the company part of a buying group?
- How long has the company been in the same location? Is it a good location? What type of shopper is the company trying to sell to?
- What is the annual employee turnover rate? Average is 50%.
- How much do inventories vary throughout the year? Do they have seasonal products?
- How many SKU’s?
- Do they have a Point of Sale system?
- **Inventory control** - how do they sell excess or stale inventory?
- Does the company use, or plan to use, the Internet to sell? How do returns of online purchases affect profits?
- How is the business promoted?
- How is new staff educated?

SERVICE BUSINESSES

- Does the company manage from a metrics? If so what are the top three measurements and how are they performing compared to established benchmarks?
- What is the company's Value Proposition?
- What is the productivity per employee?
- How many employees? What is the number of fulltime employees?
- How is billing structured?
- What is staff turnover?
- How are service charged for?
- How do they promote their business?
- How long in business?
- Are they able to increase prices? What is the total number of customers & what percentage of sales are the top 10 (concentration issue)?
CONTRACTORS

- Does the company manage from a metrics? If so, what are the top three measurements and how are they performing compared to established benchmarks?
- Buzz Words: Earthwork, Demo, Foundation, Framing, Electrical, Plumbing, Heating
- What is the average mark up or overhead?
- What is the value of the average project?
- How is pricing established? Bid process/stipulated sum or cost plus with a guaranteed maximum?
- How is the client billed - monthly or bi-weekly?
- What percentage of the project are general conditions (fixed cost)? (i.e. 12% supervisor, honey bucket, etc.)
- Is the company bonded? Get the name and telephone of their insurance and bonding agent. If a contractor cannot get bonded, it is a sign of financial weakness.
- What trades are handled in house? Subcontracted? When are subcontractors paid?
- How many jobs does the company work on at one time? How many jobs can be run at the same time efficiently?
- What is the number of full time employees?
- Get a list of area projects you can check on.
Spectrum Manufacturing Company is a paint manufacturing business that is owned and operated by a 62 year-old named Sammy. Sammy's father started the business over 60 years ago, with Sammy assuming ownership of the Company about 30 years ago. Sammy's son is in line to eventually take over the Company.

Sammy has called on a new bank asking for a line of credit in the amount of $300,000. With very little information about the business and its owner, the bank has asked you to visit Sammy at his place of business. The bank would like you to profile the customer and decide if it would be worthwhile to proceed with discussions regarding Sammy's loan request.

**Required:**

**Step 1:** Calculate the Financial Ratios as of 12/31/x5.

**Step 2:** Compare Company Ratios to the Industry Ratios.

**Step 3:** Analyze the Financial Impact of the problems (in dollars) to determine the size of them.

**Step 4:** Determine financial condition of the company on the Financial Cause and Effect Diagram to isolate the areas that need attention.

**Step 5:** Determine the steps that need to be taken to correct the situation. Explain these in the comments section of the Problems and Solutions Identification worksheet.
Page intentionally left blank
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<th>Year x2</th>
<th>Year x3</th>
<th>Year x4</th>
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<td>1</td>
<td>ASSETS</td>
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<td>Total Current Assets</td>
<td><strong>$1,992</strong></td>
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<td>Land &amp; Building</td>
<td>1,085</td>
<td>1,540</td>
<td>1,560</td>
<td>1,600</td>
</tr>
<tr>
<td>8</td>
<td>Vehicles</td>
<td>104</td>
<td>129</td>
<td>138</td>
<td>165</td>
</tr>
<tr>
<td>9</td>
<td>Equipment</td>
<td>576</td>
<td>866</td>
<td>883</td>
<td>900</td>
</tr>
<tr>
<td>10</td>
<td>Furniture &amp; Fixtures</td>
<td>89</td>
<td>118</td>
<td>129</td>
<td>176</td>
</tr>
<tr>
<td>11</td>
<td>Gross Fixed Assets</td>
<td><strong>$1,854</strong></td>
<td><strong>$2,653</strong></td>
<td><strong>$2,710</strong></td>
<td><strong>$2,841</strong></td>
</tr>
<tr>
<td>12</td>
<td>Less Accumulated Dep.</td>
<td>(682)</td>
<td>(828)</td>
<td>(978)</td>
<td>(1,154)</td>
</tr>
<tr>
<td>13</td>
<td>Net Fixed Assets</td>
<td><strong>$1,172</strong></td>
<td><strong>$1,825</strong></td>
<td><strong>$1,732</strong></td>
<td><strong>$1,687</strong></td>
</tr>
<tr>
<td>14</td>
<td>TOTAL ASSETS</td>
<td><strong>$3,164</strong></td>
<td><strong>$3,795</strong></td>
<td><strong>$3,811</strong></td>
<td><strong>$3,623</strong></td>
</tr>
<tr>
<td>15</td>
<td>LIABILITIES &amp; EQUITY</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Notes Payable - Bank</td>
<td>$211</td>
<td>$656</td>
<td>$599</td>
<td>$619</td>
</tr>
<tr>
<td>17</td>
<td>Accounts Payable</td>
<td>558</td>
<td>630</td>
<td>691</td>
<td>764</td>
</tr>
<tr>
<td>18</td>
<td>Accrued Expenses</td>
<td>203</td>
<td>188</td>
<td>191</td>
<td>170</td>
</tr>
<tr>
<td>19</td>
<td>Total Current Liabilities</td>
<td><strong>$972</strong></td>
<td><strong>$1,474</strong></td>
<td><strong>$1,481</strong></td>
<td><strong>$1,553</strong></td>
</tr>
<tr>
<td>20</td>
<td>Long-Term Debt</td>
<td>814</td>
<td>903</td>
<td>876</td>
<td>614</td>
</tr>
<tr>
<td>21</td>
<td>TOTAL LIABILITIES</td>
<td><strong>$1,786</strong></td>
<td><strong>$2,377</strong></td>
<td><strong>$2,357</strong></td>
<td><strong>$2,167</strong></td>
</tr>
<tr>
<td>22</td>
<td>Common Stock</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
</tr>
<tr>
<td>23</td>
<td>Retained Earnings</td>
<td>1,128</td>
<td>1,168</td>
<td>1,204</td>
<td>1,206</td>
</tr>
<tr>
<td>24</td>
<td>EQUITY</td>
<td><strong>$1,378</strong></td>
<td><strong>$1,418</strong></td>
<td><strong>$1,454</strong></td>
<td><strong>$1,456</strong></td>
</tr>
<tr>
<td>25</td>
<td>TOTAL LIABILITIES &amp; EQUITY</td>
<td><strong>$3,164</strong></td>
<td><strong>$3,795</strong></td>
<td><strong>$3,811</strong></td>
<td><strong>$3,623</strong></td>
</tr>
</tbody>
</table>
Page intentionally left blank
### Income Statement

#### Spectrum Manufacturing Company

**Income Statement (000's)**

<table>
<thead>
<tr>
<th>Item</th>
<th>Year x1</th>
<th>Year x2</th>
<th>Year x3</th>
<th>Year x4</th>
<th>Year x5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Sales</td>
<td>$8,100</td>
<td>$7,500</td>
<td>$7,600</td>
<td>$6,800</td>
<td>$7,100</td>
</tr>
<tr>
<td>3 Gross Profit</td>
<td>$2,632</td>
<td>$2,430</td>
<td>$2,348</td>
<td>$2,142</td>
<td>$2,180</td>
</tr>
</tbody>
</table>

| 4 Operating Expenses          |         |         |         |         |         |
| 5 Owners Salary               | $90     | $70     | $50     | $50     | $50     |
| 6 Other Salaries              | 778     | 673     | 620     | 515     | 508     |
| 7 Commissions                 | 405     | 375     | 380     | 340     | 350     |
| 8 Salary Related Expense      | 316     | 298     | 262     | 226     | 220     |
| 9 Advertising                 | 83      | 75      | 72      | 70      | 67      |
| 10 Bad Debts                  | 22      | 16      | 19      | 11      | 18      |
| 11 Business Taxes & Licenses  | 80      | 76      | 77      | 69      | 73      |
| 12 Depreciation               | 105     | 146     | 150     | 176     | 183     |
| 13 Insurance                  | 95      | 94      | 96      | 102     | 105     |
| 14 Legal & Accounting         | 21      | 23      | 22      | 26      | 24      |
| 15 Maintenance & Repair       | 59      | 51      | 60      | 63      | 65      |
| 16 Office Expense             | 25      | 23      | 24      | 22      | 23      |
| 17 Telephone & Utilities      | 129     | 135     | 143     | 149     | 158     |
| 18 Travel & Entertainment     | 54      | 40      | 41      | 49      | 52      |
| 19 Vehicle Expense            | 47      | 49      | 52      | 61      | 64      |
| 20 Other Admin Expenses       | 81      | 77      | 83      | 79      | 80      |

| 21 Total Operating Expenses   | $(2,390)| $(2,221)| $(2,151)| $(2,008)| $(2,040)|
| 22 Operating Profit           | $242    | $209    | $197    | $134    | $140    |
| 23 Interest Expense           | (116)   | (162)   | (155)   | (131)   | (129)   |
| 24 Net Profit Before Tax      | $126    | $47     | $42     | $3      | $11     |
| 25 Income Tax                 | (32)    | (7)     | (6)     | (1)     | (2)     |
| 26 Net Profit After Tax       | $94     | $40     | $36     | $2      | $9      |

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<table>
<thead>
<tr>
<th>Asset Size</th>
<th>Number of Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>500M-2BMM</td>
<td>69</td>
</tr>
<tr>
<td>2-10MM</td>
<td>36</td>
</tr>
<tr>
<td>10-50MM</td>
<td>79</td>
</tr>
<tr>
<td>50-500MM</td>
<td>4</td>
</tr>
<tr>
<td>ALL</td>
<td>134</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash &amp; Equivalents</td>
<td>9.7</td>
</tr>
<tr>
<td>Inventory</td>
<td>26.0</td>
</tr>
<tr>
<td>All Other Current</td>
<td>1.4</td>
</tr>
<tr>
<td>Total Current</td>
<td>68.2</td>
</tr>
<tr>
<td>Fixed Assets (net)</td>
<td>23.4</td>
</tr>
<tr>
<td>Intangibles (net)</td>
<td>0.6</td>
</tr>
<tr>
<td>All Other Non-Current</td>
<td>7.8</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liability Category</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Notes Payable – Short-Term</td>
<td>8.7</td>
</tr>
<tr>
<td>Cur. Mkt./LT D</td>
<td>3.0</td>
</tr>
<tr>
<td>Trade Payables</td>
<td>16.7</td>
</tr>
<tr>
<td>Income Taxes Payable</td>
<td>1.1</td>
</tr>
<tr>
<td>All Other Current</td>
<td>8.6</td>
</tr>
<tr>
<td>Total Current</td>
<td>38.1</td>
</tr>
<tr>
<td>Long-Term Debt</td>
<td>14.1</td>
</tr>
<tr>
<td>Deferred Taxes</td>
<td>0.9</td>
</tr>
<tr>
<td>All Other Non-Current</td>
<td>7.8</td>
</tr>
<tr>
<td>Total Liabilities &amp; Net Worth</td>
<td>100.0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income Category</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Sales</td>
<td>32.6</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>28.1</td>
</tr>
<tr>
<td>Operating Expenses</td>
<td>4.5</td>
</tr>
<tr>
<td>Operating Profit</td>
<td>0.8</td>
</tr>
<tr>
<td>All Other Expenses (net)</td>
<td>3.8</td>
</tr>
<tr>
<td>Profit Before Taxes</td>
<td>Quick</td>
</tr>
<tr>
<td>Current</td>
<td>1.9</td>
</tr>
<tr>
<td>Quick</td>
<td>1.6</td>
</tr>
<tr>
<td>1.4</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales/Receivables</td>
<td>10.1</td>
</tr>
<tr>
<td>Cost of Sales/Inventory</td>
<td>7.9</td>
</tr>
<tr>
<td>Cost of Sales/Inventory</td>
<td>7.6</td>
</tr>
<tr>
<td>Sales/Payables</td>
<td>10.1</td>
</tr>
<tr>
<td>Sales/Working Capital</td>
<td>6.8</td>
</tr>
<tr>
<td>EBIT/Interest</td>
<td>0.9</td>
</tr>
<tr>
<td>Net Profit + Dep.</td>
<td>2.3</td>
</tr>
<tr>
<td>Asset/Cur. Mkt./LT D</td>
<td>3.8</td>
</tr>
<tr>
<td>Fixed/Worth</td>
<td>0.3</td>
</tr>
<tr>
<td>Debt/Worth</td>
<td>1.2</td>
</tr>
<tr>
<td>Profit Before Taxes</td>
<td>2.5</td>
</tr>
<tr>
<td>Terrible Net Worth</td>
<td>6.6</td>
</tr>
<tr>
<td>Total Assets</td>
<td>2.4</td>
</tr>
<tr>
<td>Sales/Net Fixed Assets</td>
<td>21.8</td>
</tr>
<tr>
<td>Sales/Total Assets</td>
<td>2.3</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Ratio</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Officers'</td>
<td>2.9</td>
</tr>
<tr>
<td>% Owners'</td>
<td>6.4</td>
</tr>
<tr>
<td>% Net Sales</td>
<td>0.2</td>
</tr>
<tr>
<td>% Total Assets</td>
<td>2.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Financial Ratio</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>% Officers', Directors'</td>
<td>0.2</td>
</tr>
<tr>
<td>Net Income/Net Sales</td>
<td>0.2</td>
</tr>
<tr>
<td>% Total Assets</td>
<td>2.9</td>
</tr>
</tbody>
</table>

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### Ratio Analysis Worksheet

**Solvency Ratios**

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>Calculations</th>
<th>Company</th>
<th>Industry (Target)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Current</td>
<td>Current Assets / Current Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Quick</td>
<td>Cash + Accounts Receivable / Current Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Safety Ratio**

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>Calculations</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Debt to Equity</td>
<td>Total Liabilities / Equity</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Profitability Ratios**

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>Calculations</th>
<th>Company</th>
<th>Industry (Target)</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Gross Profit Margin</td>
<td>Gross Profit / Sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Net Profit Margin</td>
<td>Net Profit Before Tax / Sales</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Return on Assets (ROA)</td>
<td>Net Profit Before Tax / Total Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Return on Investment (ROI)</td>
<td>Net Profit Before Tax / Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Asset Management Ratios**

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>Calculations</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Sales to Assets</td>
<td>Sales / Total Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Inventory Turnover</td>
<td>Cost of Goods Sold / Inventory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Inventory (Days)</td>
<td>365 Days / Inventory Turnover</td>
<td>365 Days</td>
<td></td>
</tr>
<tr>
<td>11. A/R Turnover (x)</td>
<td>Sales / Accounts Receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Collection Period (Days)</td>
<td>365 Days / A/R Turnover</td>
<td>365 Days</td>
<td></td>
</tr>
<tr>
<td>13. A/P Turnover (x)</td>
<td>Cost of Goods Sold / Accounts Payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. A/P (days)</td>
<td>Accounts Payable Turnover / 365 Days</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

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### FINANCIAL IMPACT WORKSHEET

#### 1. GROSS PROFIT

\[
\text{Sales $} \times \frac{\text{Target Gross Profit Margin %}}{} = \frac{\text{Target Gross Profit $}}{\text{Actual Gross Profit $}} = \text{Financial Impact $}
\]

#### 2. NET PROFIT BEFORE TAX

\[
\text{Sales $} \times \frac{\text{Target Net Profit %}}{} = \frac{\text{Target Pre-Tax Profit $}}{\text{Actual Net Profit Before Tax $}} = \text{Financial Impact $}
\]

#### 3. SALES

\[
\text{Total Assets $} \times \frac{\text{Target Sales to Assets}}{} = \frac{\text{Target Sales $}}{\text{Actual Sales $}} = \text{Financial Impact $}
\]

#### 4. INVENTORY

\[
\text{Cost of Goods Sold $} + \frac{\text{Target Inventory Turnover}}{} = \frac{\text{Target Inventory $}}{\text{Actual Inventory $}} = \text{Financial Impact $}
\]

#### 5. ACCOUNTS RECEIVABLE

\[
\text{Sales $} - \frac{\text{Target Accts. Rec. Turnover}}{} = \frac{\text{Target Accounts Receivable $}}{\text{Actual Accts. Receivable $}} = \text{Financial Impact $}
\]

#### 6. ACCOUNTS PAYABLE

\[
\text{Cost of Goods Sold $} + \frac{\text{Target Accts. Payable Turnover}}{} = \frac{\text{Target Accounts Payable $}}{\text{Actual Accounts Payable $}} = \text{Financial Impact $}
\]

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## Problem & Solution Identification

<table>
<thead>
<tr>
<th>Financial Problems</th>
<th>Financial Solutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>1.</td>
</tr>
<tr>
<td>2.</td>
<td>2.</td>
</tr>
<tr>
<td>3.</td>
<td>3.</td>
</tr>
<tr>
<td>4.</td>
<td>4.</td>
</tr>
<tr>
<td>5.</td>
<td>5.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Management Problems</th>
<th>Management Solutions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>1.</td>
</tr>
<tr>
<td>2.</td>
<td>2.</td>
</tr>
<tr>
<td>3.</td>
<td>3.</td>
</tr>
<tr>
<td>4.</td>
<td>4.</td>
</tr>
<tr>
<td>5.</td>
<td>5.</td>
</tr>
</tbody>
</table>

Comments

---

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WORKING CAPITAL

The inventory and accounts receivable turnover ratios can be better understood by visualizing how working capital interacts with sales.

It is advantageous to spin the working capital wheel as fast as possible, since every time it revolves it produces cash and hopefully profits. This can be achieved by reducing the size of the left wheel (reducing inventory and accounts receivable), or by increasing sales while maintaining the same levels of account receivable and inventory.

The Spectrum Manufacturing Company collects accounts receivable every 34 days, turns inventory every 90 days and pays accounts payable every 56 days. If sales increased by $1,100,000, how much additional financing would be required to support the increased sales amount?

<table>
<thead>
<tr>
<th># of Days × Sales Per Day × Percent = $ Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Accounts Receivable</td>
</tr>
<tr>
<td>2. Inventory</td>
</tr>
<tr>
<td>3. (Accounts Payable)</td>
</tr>
<tr>
<td>4. Additional Financing Needed</td>
</tr>
</tbody>
</table>
I. Asset Approach
   A. Book Value
   B. Adjusted Book Value
   C. Liquidation Value

II. Earnings Approach
   A. Current Earnings
   B. Average Earnings
   C. Future Earnings

III. Capitalization Rate
   A. Risk Classification
   B. Cap Rate Versus Business Type

IV. Rules Of Thumb
   A. Newspapers – Multiple Of Gross Revenues
   B. Insurance Agency – Percent Of Gross Premium
   C. Beer Distributor – Amount Per Case Sold Per Year

V. Miscellaneous Concepts
   A. Fair Market Value Versus Worth
   B. Science Versus Art
   C. Discounts
      1. Minority Interest
      2. Non-Marketability
   D. Hire Expert Help When You Need It
A. Assess business suitability

B. Get financial statements

C. Analyze financial statements and make adjustments

D. Determine R.O.I. needed and establish range of values

E. Study taxability of sale:
   1. Stock vs. Assets
   2. Expensible vs. Non-Expensible Sale Price
   3. Redemption vs. Outright Purchase
   4. Bootstraps

F. Set negotiating range and terms
VALUATION

ASSET APPROACH

A. Book Value
   $ 

B. Adjusted Book Value
   (Assume fixed assets are worth $1,000,000 over book value; all other assets are worth book value.)
   $ 

C. Liquidation Discount
   - Accounts Receivable (20%)
     $ 
   - Inventory (50%)
   - Fixed Asset Selling Cost (10%)
   - 3 Month Operating Cost
   Sub Total: Liquidated Discount
     $ 
   TOTAL LIQUIDATED VALUE (B-C)
     $ 

EARNINGS APPROACH

A. EBITDA Multiple
1. Net Profit After Tax
   $ 
2. + Interest
3. + Taxes
4. + Depreciation
5. = EBITDA
6. - Cap X
7. + Family Excess
8. = Free Cash Flow
9. x Multiple
10. = Enterprise Value
11. - Funded Debt
12. = EQUITY VALUE
    $ 

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# Initial Financial Indicators

<table>
<thead>
<tr>
<th>Financial Indicator</th>
<th>Calculation (should be done in your head)</th>
<th>Possible Issues (but not all)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Trend Analysis</strong></td>
<td>- Sales Trends $/%</td>
<td>Indicates possible growth issues, increased costs of goods sold, increased operating costs, etc.</td>
</tr>
<tr>
<td>- Gross Profit $/%</td>
<td>- Operating Exp. $/%</td>
<td>Compare to the industry average.</td>
</tr>
<tr>
<td>- Net Profit $/%</td>
<td>Look at the performance over the past few years. Are trends increasing, decreasing or staying the same?</td>
<td></td>
</tr>
<tr>
<td>- What is driving the trends?</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2. Expense Control</strong></td>
<td>A decrease in sales/gross profit from one year to the next must be matched by a decrease in operating expenses.</td>
<td>If expenses did not go down by the same or a greater amount, then an expense control issue exists.</td>
</tr>
<tr>
<td><strong>3. Debt to Tangible Net Worth</strong></td>
<td>Total liabilities divided by total tangible net worth less intangible assets. This ratio measures leverage and solvency.</td>
<td>Indicates financial risk and if the company is borrowing too much. The company might be growing assets too fast and/or not growing retained earnings proportionately.</td>
</tr>
<tr>
<td><strong>4. EBITDA</strong></td>
<td>EBITDA = Earnings before: Interest, Taxes, Depreciation, &amp; Amortization.</td>
<td>Funds available to service long term debt (principal and interest), taxes, and make investments.</td>
</tr>
<tr>
<td><strong>5. Debt Coverage Ratio</strong></td>
<td>Net Profits + Non-Cash - Distributions + Int, CPLTD + Int. + (New CPLTD + Int.)</td>
<td>Benchmark is 1.25. The higher the coverage the better.</td>
</tr>
<tr>
<td><strong>Note</strong>: Tailored to bank’s ratio</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>6. Mis-Financing</strong></td>
<td>Historical growth of gross fixed assets &amp; permanent working capital must be paid for by retained earnings, long-term debt, and depreciation.</td>
<td>If the growth of GFA is not paid for by RE, LTD, or Depreciation than mis-financing might be present. The business might be using short-term money for long-term debt.</td>
</tr>
</tbody>
</table>

# Debt Structure

<table>
<thead>
<tr>
<th>Three Types of Assets:</th>
<th>Financed By:</th>
<th>Paid Back By:</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Seasonal Working Capital (WC)</td>
<td>1. Line of Credit</td>
<td>1. Conversion of seasonal WC to cash</td>
</tr>
<tr>
<td>2. Permanent Working Capital</td>
<td>2. LTD 3-5 years</td>
<td>2. NP that turn to cash</td>
</tr>
<tr>
<td>3. Fixed Assets</td>
<td>3. LTD 3-20 years</td>
<td>3. NP plus depreciation that turn to cash</td>
</tr>
</tbody>
</table>

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