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What is "Tangible Net Worth" and why does my bank want it in my business?

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When it comes to starting or owning a business, banks require you to have some capital, equity or money invested in the business. Banks call this the Tangible Net Worth or TNW of the business.

One of the easiest ways to understand why banks require this is to think of it in terms of real estate. When you purchase real estate, banks typically require you to put down 20% of the purchase price as your equity in the property or your "skin in the game".

The issue for banks is that if you do not put any money down and the bank finances 100% of the purchase, then they take on 100% of the risk.

How does this compare to a business? Well, think of the total value of the assets of the business (which generally comprises assets such as Accounts Receivable, inventory, machinery and equipment) as the equivalent of the total value of a piece of real estate. And like real estate, banks also want business owners to finance some of the business assets with shareholder equity.

Here are some factors to consider on this topic:

How much equity do you need?

Like real estate, the percentage banks will lend is typically driven by the type of real estate (ie: residential, commercial, industrial), banks tend to lend different percentages based on a variety of factors such as industry, the historical and financial performance of the business, current economic conditions, and the financial strength of the business owner.

As noted, while this can vary widely based on the above factors, a good l rule of thumb is banks generally require the shareholders to have at least 25% of total asset value invested in the business.

What constitutes equity?

Equity (also commonly called "Shareholder Equity") includes the amount of funding or money the business has raised from the sale or issuance of its shares. Plus, for privately owned businesses, banks will also add the amount of any shareholder loans made to the business as part of the overall shareholder equity in the business.

TNW also includes any retained earnings or profits made and/or accumulated over time BUT conversely, it is also reduced by any accumulated deficit or losses the business has incurred over time.

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TNW is also reduced by the payments of any dividends to its shareholders.

What goes into the math?

When calculating the TNW of a business, banks focus on tangible assets (ie: those that you can "touch" and/or that have some form of clear realizable value) which the bank can liquidate if the business fails. These types of assets typically include assets such as inventory, accounts receivable, plant & equipment, cash on hand and real estate.

Banks, therefore, reduce the value of the equity for assets such as goodwill, copyrights, patents, trademarks or software.

This can be quite punitive to shareholders as many technology-based businesses have a significant portion of their value in these types of intangible assets, but unfortunately, banks tend to heavily discount these values when calculating the TNW in a business.

In conclusion, when speaking with your bank regarding your ongoing business financing needs, it might be useful to consider reviewing how much equity or "skin in the game" you have in your business so that you can be better prepared to speak with your bank if this comes up as an issue in your business.

At Isaacs Advisory, we have extensive experience in advising, structuring, and sourcing financing solutions for start-up, early-stage, and growth businesses.

For more information on financing solutions please contact Adrian Isaacs at 416-835-4511 or aisaacs@isaacsadvisory.ca.