

## Key Points to Borrowing Money

Borrowing money is one of the most common sources of funding for a small business, but obtaining a loan isn't always easy. Before you approach your banker for a loan, it is a good idea to understand as much as you can about the factors the bank will evaluate when they consider making you a loan. This discussion outlines some of the key factors a bank uses to analyze a potential borrower. Also included is a self-assessment checklist at the end of this section for you to complete. Here are some key points to consider:

### 1. Ability to Repay/Capacity

The ability to repay must be justified in your loan package. Banks want to see two sources of repayment – cash flow from the business, plus a secondary source such as collateral. In order to analyze the cash flow of the business, the lender will review the business's past financial statements. Generally, banks feel most comfortable dealing with a business that has been in existence for a number of years because they have a financial track record. If the business has consistently made a profit and that profit can cover the payment of additional debt, then it is likely that the loan will be approved. If however, the business has been operating marginally and now has a new opportunity to grow or if that business is a start-up, then it is necessary to prepare a thorough loan package with detailed explanation addressing how the business will be able to repay the loan.

### 2. Credit History

One of the first things a bank will determine when a person/business requests a loan is whether their personal and business credit is good. Therefore before you go to the bank, or even start the process of preparing a loan request, you want to make sure your credit is good.

First get your personal credit report. You can obtain a report by calling TransUnion, Equifax, TRW or another credit bureau. It is important that you initiate this step well in advance of seeking a loan. Personal credit reports may contain errors or be out of date. In many cases, people find that they paid off a bill but that it has not been recorded on their credit report. It can take 3 to 4 weeks for this error to be corrected -- and it is up to you to see that this happens. You want to make sure that when the bank pulls your credit report that all the errors have been corrected and your history is up to date.

Once you obtain your credit report, how do you know what it says? Many people receive their credit reports yet have no idea what the strange numbers signify. The following should help in interpreting and checking your personal credit report.

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First, check your name, social security number and address at the top of the page. Make sure these are correct. There are people who have found that they have credit information from another person because of mistakes in their identification information.

On the rest of your credit report you will see a list of all the credit you have obtained in the past - credit cards, mortgages, student loans, etc. Each credit will be listed individually with information on how you paid that credit. Any credit where you have had a problem in paying will be listed towards the top of the list. These are the credits that may affect your ability to obtain a loan.

If you have been late by a month on an occasional payment, this probably will not adversely affect your credit. However, if you are continuously late in paying your credit, have a credit that was never paid and charged off, have a judgment against you, or have declared bankruptcy in the last 7 years, it is likely that you will have difficulty in obtaining a loan.

In some cases, a person has had a period of bad credit based on a divorce, medical crisis, or some other significant event. If you can show that your credit was good before and after this event and that you have tried to pay back those debts incurred in the period of bad credit, you should be able to obtain a loan. It is best if you write an explanation of your credit problems and how you have rectified them and attach this to your credit report in your loan package.

Each credit bureau has a slightly different way of presenting your credit information. You can get specific information on "how to read the report" from the appropriate company, but here's a few tips to get you started:

#### TRW

In the last few years TRW has prepared credit reports with words and not numbers. Good credits should read "Never Late", "Paid as Agreed".

#### TransUnion

On the right side of the page on the credit report are number and letter combinations. "I" means installment credit. "R" means revolving credit. The key information is in the numbers. A "1" means perfect credit since you have always paid your bills on time. "2" or "3" means you have been 2 to 3 months late in paying your bills. Too many of these will hurt your chances in obtaining credit. A "9" means delinquency in paying your bills and a charge off. This could make it difficult in obtaining a loan

If you need assistance in interpreting or evaluating your credit report you can ask your accountant or a friendly banker. If your credit report has a few problems on it, you may find that another bank may evaluate your credit report differently.

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### 3. Equity

Financial institutions want to see a certain amount of equity in a business. Equity can be built up in a business through retained earnings or the injection of cash from either the owner or investors. Most banks want to see that the total liabilities or debt of a business is not more than 4 times the amount of equity. (Or stated differently, when you divide total liabilities by equity, your answer should not be more than 4.) Therefore if you want a loan you must ensure that there is enough equity in the company to leverage that loan.

Don't be misled into thinking that start-up businesses can obtain 100% financing through conventional or special loan programs. A business owner usually must put some of her/his own money into the business. The amount an individual must put into the business in order to obtain a loan is dependent on the type of loan, purpose and terms. For example, most banks want the owner to put in at least 20 - 40% of the total request.

Example: A new business needs a \$100,000 to start. The business owner must put \$20,000 of her own money into the new business as equity. Her loan will be \$80,000. The debt to equity ratio is 4:1. Note also that this is only one of many factors used to evaluate the business -- just having the right debt/equity ratio does not guarantee you'll get the loan.

The balance sheet indicates the amount of equity or net worth of a business. The net worth of the business is often a combination of retained earnings and owner's equity. In many cases, owner's equity will be shown as a loan from shareholders and therefore a liability. If a business owner wishes to obtain a loan, she will be obligated to pay the bank back first and not herself. Consequently, it may be necessary to restructure the liability so that it becomes owner's equity or subordinate the loan. If the current debt to net worth is 4 or over it is unlikely that the business will be able to obtain additional debt/loan.

### 4. Collateral

Financial institutions are looking for a second source of repayment, which often is collateral. Collateral are those personal and business assets that can be sold to pay back the loan. Every loan program, even many microloan programs, requires at least some collateral to secure a loan. If a potential borrower has no collateral to secure a loan, she/he will need a co-signer that has collateral to pledge. Otherwise it may be difficult to obtain a loan.

The value of collateral is not based on the market value. It is discounted to take into account the value that would be lost if the assets had to be liquidated.

The following table gives a general approximation on how different forms of collateral are valued by a typical bank and the SBA:

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## COLLATERAL TYPE

COLLATERAL TYPE	BANK	SBA
HOUSE:	Market Value x .75 - Mortgage balance	Market Value x .80 - Mortgage balance
CAR:	nothing	nothing
TRUCK & HEAVY EQUIPMENT:	Depreciated Value x .50	same
OFFICE EQUIPMENT:	nothing	nothing
FURNITURE & FIXTURES:	Depreciated Value x .50	same
INVENTORY: Perishables	nothing	nothing
JEWELLERY	nothing	nothing
OTHER	10%-50%	10%-50%
RECEIVABLES	Under 90 days x .75	Under 90 days x .50
STOCKS & BONDS	50%-90%	50%-90%
MUTUAL FUNDS	nothing	nothing
IRA	nothing	nothing
CD	100%	100%

### Collateral Coverage Ratio

The bank will calculate your collateral coverage ratio as part of the loan evaluation process. This is calculated as follows:

$$\frac{\text{Total Discounted Collateral Value}}{\text{Total Loan Request}}$$

## 5. Experience

A client that wants to open a business and has no experience in that business should not seek financing let alone start the business unless they intend to hire people who know the business or take on a partner that has the appropriate experience.

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Regardless, the client should be advised to take some time to work in the business first and take some entrepreneurial training classes.

**The key questions the banker will be seeking to answer are as follows:**

- Can the business repay the loan? (is cash flow greater than debt service?)
- Can you repay the loan if the business fails? (is collateral sufficient to repay the loan?)
- Does the business collect its bills?
- Does the business control its inventory?
- Does the business pay its bills?
- Are the officers committed to the business?
- Does the business have a profitable operating history?
- Does the business match its sources and uses of funds?
- Are sales growing?
- Does the business control expenses?
- Are profits increasing as a percentage of sales?
- Is there any discretionary cash flow?
- What is the future of the industry?
- Who is your competition and what are their strengths and weaknesses?

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