BORROWING FOR SMALL BUSINESS OWNERS

Quick Guide

This Quick Guide was prepared by Truebridge

Member FDIC

EQUAL HOUSING OPPORTUNITY

366845-1/1

V 3.8

Table of Contents

Overview

Bank loans are a source of capital for many small businesses. Loans may be needed for a variety of reasons, beginning with the fact that expenses and income don't always happen at the same time. By knowing the criteria that a bank uses, you will be able to go through the process in a manner that will be easier and quicker for both you and the bank.

How Much Should You Borrow?

This is an important question that revolves to a great extent on your cash flow situation. Some of the expenses that might need to be considered include buying supplies and inventory while waiting to get paid, paying payroll and rent, and buying equipment and fixtures.

Prioritize those areas where your options are limited to paying in cash, and review your alternatives where you may have other options. Then review what might serve as collateral for your loans.

Preparation is Key

To be successful in obtaining a loan, you must be prepared and organized. Be ready to answer questions about your business, and be ready to highlight your financial performance. Having a good business plan and a loan proposal that has been carefully thought out can be very helpful. You must know exactly how much money your company needs, why you need it and how you will pay it back. Be prepared to explain (in some detail) why you need the money. Some key variables as to what kind of loan terms you can get are length of time in the business (your track record), and the amount needed in relation to the size of your company.

You want to include the following:

- Other key personnel involved in running the business and their responsibility for using the loan proceeds
- How you plan to repay the loan and over what time frame
- That you are willing to take a significant financial risk in the business
- An overview of the market including your projected customer base and competition
- Personal and business tax returns and financial statements and, if possible, collateral that can secure the loan.

You may also be asked to supply additional supporting documentation. Bring your accountant if you need help.

You must also be able to show your lender that you and your business are a good credit risk. Most small businesses are closely tied to the know-how and overall character of the owner(s). Therefore, you need to make sure that you get your own financial records in order before asking a bank (or any lender) for money to operate your business.

Secured Loans / Collateral

The type of loan you select can have a big impact on your bank's lending decisions. Secured loans mean that there are assets pledged (collateral) to secure the payment in the event you are not able to pay. Common types of collateral are equity in your home, accounts receivable, inventory of the business and equipment. Lenders go through an evaluation of the collateral to determine how much they can lend against it. The assets that are pledged are usually discounted by a certain percentage. The bank wants some protection should those assets fall in value during the term of the loan. Since you are offering collateral, the lender's risk is reduced significantly, and it's more likely that your loan will be approved.

You may also look to secure a loan guarantee from the Small Business Administration.

What the Lender Wants to Know

When reviewing a loan request, the lender is primarily concerned about repayment. The criteria for making a loan are based on several things, including:

- Business cash flow
- Business credit report
- Owner's personal cash flow
- Owner's personal credit report

Business Cash Flow

After the loan is made, will your business have adequate cash on hand to repay the debt? You will need to make a realistic assessment of your cash flow, and determine how much money you can pay back. Be conservative when making your evaluation.

Business Credit Report

Many loan officers will order a copy of your business credit report from a credit-reporting agency. Therefore, you should work with these agencies to help them present an accurate picture of your business.

Dun and Bradstreet (D&B) is the agency that most banks use to look at your firm's creditworthiness. Their report can include details about ownership, initial date of operation, inventory value and description, and financial condition, and may also include information regarding payment records based on collection experience. The report will generally also include an opinion regarding the creditworthiness of the company, or enough information to help the bank make a prudent judgment.

Owner's Personal Cash Flow

Do you have an adequate cash flow from the business to take care of your personal needs? The bank doesn't want to see that you will have to draw more cash from the business than it can afford to pay.

Owner's Personal Credit Report

Do you have a sound record of creditworthiness as indicated by your credit report, work history and references? Together with your firm's business credit history, a solid personal credit rating is very important since the small business is typically an extension of the individual operating it. Most sources of financing or credit now rely on your 'credit score' (known as FICO) to evaluate your credit worthiness. (In fact, although a business plan is a recommended component of the loan request process, given the increasing importance of the credit score, it may now be possible to obtain loan approval in certain instances based on your score in lieu of a business plan). FICO is a numeric method that uses three digits to predict the likelihood of meeting your credit obligations. The score evaluates your credit payment history, number of open accounts, overall credit balances and public records, including judgments and liens.

A FICO score approaching 700 will generally be looked upon favorably, while a lower score (e.g. below 650) will cause lenders to be increasingly cautious. Several sources will charge a modest fee to calculate your score, which is based on your credit report. Services like www.myfico.com will provide you with several report formats and notify you of credit inquiries that could affect your score.

Also, thanks to the 2003 Fair and Accurate Credit Transactions Act, every American now has the right to a free copy of his or her credit report (upon which the FICO score is based) every year from each of the three major credit bureaus - Equifax, Experian and TransUnion. To obtain your report, go to www.annualcreditreport.com, which is the only authorized source for consumers to access their annual credit report online for free, or call toll free 877-322-8228.

Small Business Administration Loans

If you are having difficulty obtaining money through the more traditional avenues, you can look into getting a loan from the U.S. Small Business Administration (SBA). Please note that the SBA only provides assistance if you are unable to get reasonable, approved financing through traditional channels. Most SBA loans are, in fact, made through banks and other private lenders, which administer and service these loans while not exposing themselves to default risks.

Two Most Common Types of Loan Programs:

Guaranteed Loans—These are actually loans by banks and other private lenders that are guaranteed by the SBA, which enables you to obtain needed financing. You must put up collateral to secure the loan. With this type of loan, you deal with the bank, and the bank deals with the SBA, although you will need to provide information and do paperwork in order to apply for the loan. Your accountant should be able to help you with these tasks.

Direct Loans—In some cases, if all else fails, you may be able to obtain a loan directly from the SBA. These loans are very difficult to get, and depend—among other things—on the amount of money that is available for lending. If you are lucky enough to be approved, a bank will usually be involved in servicing the loan.

In addition to the above, there are often other programs available through the SBA. These programs are often dependent on new legislation and may target minorities, the disadvantaged, specific industries, firms attempting to recover from a natural disaster, etc. Consult your local bank or SBA office for more information.

After Your Loan Request Is Approved

Once you have been approved for a loan, you need to work with the lender to obtain terms with which you feel comfortable. The due date and manner of payment will need to be determined. Will you pay the loan back in one lump sum or in various payments on a set schedule? Make sure such a payment schedule will work for your business in conjunction with your projected cash flow.

You will also want to look at other fees associated with the loan and what is considered a default of the terms of the loan. Read the loan agreement carefully and have a lawyer review it as well.

Repayment Plans

Propose a repayment plan. Examples of different methods are a line of credit, payable at your discretion but subject to renewal annually by the bank, and a term loan payable monthly over a number of years.

Additional Considerations for Success

- Be a good customer so you can get cooperation if you need help later. Stick to your agreement. Make sure you understand the requirements and perform to them as much as possible. In a business relationship, lenders will ask for regular financial statements, which you should produce on time.
- Be proactive. Contact the lender if there is a problem. Stay in touch even if nothing new is going on.
- Most lenders have some flexibility. They appreciate that you are thinking about paying them back instead of just getting the money.
- Being well dressed and neat in appearance at bank meetings will reflect well on you.
- Keep your lenders informed on the status of your business.
- Be prepared to discuss any prior credit issues/problems.
- Stay focused on your business needs, and be conservative and realistic. Avoid giving the impression of being overly optimistic.
- The primary purpose of the borrowed funds should be to grow your business. Don't spend the money on expensive entertainment, etc.
- Evaluate your financial situation regularly to minimize your risks and to limit losses to a predetermined limit.
- It is advisable to start by approaching institutions where you already do business (e.g. your mortgage lender). They already know you and you should have a track record that is established with them. ♦