



Alliance
Bank

**WHAT DO BANKERS LOOK FOR IN
A BUSINESS LOAN APPLICATION**



Whether you are applying to a bank for a line of home equity credit, a line of credit for business working capital, a commercial short-term loan, an equipment loan, real estate financing, or some other type of commercial or consumer loan, many of the same basic lending principles apply. The most fundamental characteristics a prospective lender will want to examine are:

- **Credit History** of the Borrower
- **Cash Flow History** and Projections for the Business
- **Collateral** that is Available to Secure the Loan
- **Character** of the Borrower
- **Loan Documentation**



CREDIT HISTORY

- **Commercial credit.** Before you apply for commercial credit, you should review a credit report on your own business, if your business has been in existence for a while. You can obtain a free Business Information Report on your own business from Dun & Bradstreet, by calling 1-800-234-3867. If D&B does not yet have any information on you, they will allow you to voluntarily obtain a listing by providing them with some basic information about your business.
- Most conventional lenders will expect a minimum of four or five trade experiences listed on a business report before they consider the business's creditworthiness. If you have been operating your business without credit, or with personal assets, you should consider making some trade credit purchases in order to establish a credit history for your enterprise.
- It's often a wise decision to obtain a credit report on yourself and your business before you apply for credit. If you discover any inaccuracies or problems, you can correct them before any damage to your loan application has occurred. If you can, find out which credit reporting company your prospective lender uses and request a report from that company.



CASH FLOW

- The cash flow from your business's operations — the cycle of cash flow, from the purchase of inventory through the collection of accounts receivable — is the most important factor for obtaining short-term debt financing. A lender's primary concern is whether your daily operations will generate enough cash to repay the loan. In addition, cash flow shows how your major cash expenditures relate to your major cash sources. This information may give a lender insight into your business's market demand, management competence, business cycles, and any significant changes in the business over time.
- While a variety of factors may affect cash flow and a particular lender's evaluation of your business's cash flow numbers, a small community bank might consider an acceptable working cash flow ratio — the amount of available cash at any one time in relationship to debt payments — to be at least 1.15:1.
- As most lenders are aware, cash flow also presents the most troubling problem for small businesses, and they will typically require both historic and projected cash flow statements. In preparing cash flow projections for newer businesses, you may want to refer to any one of several sources that publish sales/expense ratios for specific industries. The ratios will help you compute realistic sales revenues and the proportion of expenses typically necessary, in that industry, to generate the projected sales revenue.



CASH FLOW

Warning

- A business's cash flow will usually include not only the money that goes in and out of the business from its operations (sales less expenses), but also any cash flow from investments or financial activities (e.g., payments and receipts of interest and dividends, long-term contracts, insurance, sales or purchase of machinery and other capital changes, leases, etc.) However, the most important component to a lender is simply whether the business's ongoing sales and collections represent a sufficient and regular source of cash for repayment on a loan.



SUGGESTIONS FOR IMPROVING CASH FLOW

- **Pay off, or delay paying, debt.** If possible, pay off existing debt or refinance the debt for a longer maturity with lower payments. For other debts, try to renegotiate payment lengths; some creditors may allow some delinquencies as long as some money is coming in. In some situations, you may simply have to prioritize those creditors who must be paid because they are providing necessities, e.g., utilities, certain suppliers, payroll, etc., and try to delay payments to creditors who are less likely to halt your business, e.g., secondary suppliers.
- **Collect Receivables.** Try to quickly collect overdue accounts. Revenues are lost when a firm's collection policies are not aggressive. The longer your customer's balance remains unpaid, the less likely it is that you will receive full payment.
- **Reduce Credit Allowances and Accelerate Cash Receipts.** If you can tighten credit terms without losing good customers, you can increase available cash on hand and reduce the bad debt expense. You can also encourage cash sales through discounting and pricing policies. In addition, try to reduce the float time on customer payment checks. You can do this by undertaking prompt processing of checks as you receive them (or using a bank lockbox arrangement in which you pay a fee for the bank to collect and process all incoming payments), and by shopping for a bank that quickly processes negotiable instruments.
- **Increase Revenues.** While this suggestion is an obvious goal of every business, a poor cash flow may indicate that you need to seriously reconsider what steps you can take to increase sales revenues by either raising sales volume and/or altering prices. In reviewing ways to increase cash flow through increased sales, guard against allowing too many credit purchases; extending credit will increase your accounts receivable, not your cash.
- **Reduce Inventory.** If you can reduce the amount of inventory you maintain, your cash outflow should decrease.
- **Review Tax Strategies that may help cash flow with your accountant.** For instance, a tax credit may be available for job opportunities you create for certain disadvantaged employees, "qualified research" (research and development) costs, or the expenses of property renovation or rehabilitation of certain qualified buildings. In addition, accelerated depreciation on certain equipment and tangible property may be available to increase your short-term tax deductions.



COLLATERAL

- Collateral may be defined as property that secures a loan or other debt, so that the property may be seized by the lender if the borrower fails to make proper payments on the loan.
- When lenders demand collateral for a secured loan, they are seeking to minimize the risks of extending credit. In order to ensure that the particular collateral provides appropriate security, the lender will want to match the type of collateral with the loan being made.
- Because a creditor wants to have a priority claim against the collateral being offered to secure the loan, the creditor will search the public records to make sure that prior claims have not been filed against the collateral. If the collateral is *real estate*, the search of public records is often done by a title insurance company. The company prepares a "title report" that reveals any pre-existing recorded secured interests or other title defects. If the loan is secured by *personal property*, the creditor typically runs a "U.C.C. search" of the public records to reveal any pre-existing claims. The costs of a title search or a U.C.C. search is often passed on to the prospective borrower as part of the loan closing costs.



COLLATERAL – LOAN TO VALUE RATIO

- To further limit their risks, lenders usually discount the value of the collateral so that they are not extending 100 percent of the collateral's highest market value. This relationship between the amount of money the bank lends to the value of the collateral is called the loan-to-value ratio. The type of collateral used to secure the loan will affect the bank's acceptable loan-to-value ratio. For example, unimproved real estate will yield a lower ratio than improved, occupied real estate. These ratios can vary between lenders and the ratio may also be influenced by lending criteria other than the value of the collateral; e.g., a healthy cash flow may allow for more leeway in the loan-to-value ratio.

A representative listing of loan-to-value ratios for different collateral at a small community bank is:

- Real estate: If the real estate is occupied, the lender might provide up to 75 percent of the appraised value. If the property is improved, but not occupied (e.g., a planned new residential subdivision with sewer and water, but no homes yet), up to 50 percent. For vacant and unimproved property, 30 percent.
- Inventory: A lender may advance up to 60 percent to 80 percent of value for ready-to-go retail inventory. A manufacturer's inventory, consisting of component parts and other unfinished materials, might be only 30 percent. The key factor is the merchantability of the inventory — how quickly and for how much money could the inventory be sold.
- Accounts Receivable: You may get up to 75 percent on accounts that are less than 30 days old. Accounts receivable are typically "aged" by the borrower before a value is assigned to them. The older the account, the less value it has. Some lenders don't pay attention to the age of the accounts until they are outstanding for over 90 days, and then they may refuse to finance them. Other lenders apply a graduated scale to value the accounts so that, for instance, accounts that are from 31-60 days old may have a loan-to-value ratio of only 60 percent, and accounts from 61-90 days old are only 30 percent. Delinquencies in the accounts and the overall creditworthiness of the account debtors may also affect the loan-to-value ratio.
- Equipment: If the equipment is new, the bank might agree to lend 75 percent of the purchase price; if the equipment is used, then a lesser percentage of the appraised liquidation value might be advanced. However, some lenders apply a reverse approach to discounting of equipment: they assume that new equipment is significantly devalued as soon as it goes out the seller's door (e.g., a new car is worth much less after it's driven off the lot). If the collateral's value is significantly depreciated, loaning 75 percent of the purchase price may be an overvaluation of the equipment. Instead, these lenders would use a higher percentage loan-to-value ratio for used goods because a recent appraisal value would give a relatively accurate assessment of the current market value of that property. For example, if a three-year-old vehicle is appraised at \$15,000, that's probably very close to its immediate liquidation value.
- Securities: Marketable stocks and bonds can be used as collateral to obtain up to 75 percent of their market value. Note that the loan proceeds cannot be used to purchase additional stock



CHARACTER

- The weight given to a lender's assessment of a borrower's character can vary tremendously between lending institutions and between individual lending officers. Many small businesses have found more success "selling" their reputation and good character to smaller community banks who may be more directly affected by the economic health of the surrounding community.
- The following traits are typically cited as important to a bank's consideration of your character:
 - successful prior business experience,
 - an existing or past relationship with the lender (e.g., prior credit or depositor relationship),
 - referrals by respected community members,
 - references from professionals (accountants, lawyers, business advisors) who have reviewed your proposals,
 - and community involvement.
 - In addition, evidence of a borrower's care and effort in the business planning process suggests that the borrower is committed and confident about the new business proposal.
- One additional factor that many banks consider as evidence of a borrower's "character" is the amount of investment that the owners themselves are committing to the business. Many commercial lenders want the owner to finance between 25 percent to 50 percent of the projected cost of a startup business or new project. An insignificant investment by an owner may suggest a lack of both owner confidence and dedication to the business.



CHARACTER

Warning

- One banker noted that he often relies upon reaching a personal "comfort level" with a borrower before making a loan. This comfort level is based upon the degree of trust or confidence that the banker has in the accuracy of the information and documentation being presented to him. He observed that in their zeal to "sell" him on the profitability of their business, small business borrowers sometimes talk him out of this comfort level by disclosing that their tax returns underreport income and overstate expenses. Such disclosures cast doubt upon the credibility of the loan applicant, and impair any sort of trust or confidence between the banker and the prospective borrower.



LOAN DOCUMENTATION FOR START UPS

- a personal financial statement (usually lender's own form) and personal federal income tax returns (one to three years)
- projected startup cost estimates
- projected balance sheets and income statements for at least two years
- projected cash flow statement for at least the first 12 months
- evidence of ownership interests in assets (e.g., leases, contracts) and collateral
- a business plan that includes a narrative explaining the specific use for the requested funds, how the money will assist the business, and how the borrowed funds will be repaid (repayment sources and duration of repayment period). Any assumptions used in developing your projected financial statements should also be identified. A personal resume, or at least an written explanation of your relevant past business experience, is often submitted with, or in addition to, the business plan. Letters of reference recommending you as a reputable and reliable business person may also help your chances for a loan approval.
- Some lenders will also want you to submit a breakeven analysis in the form of a financial statement or a graph. A breakeven analysis shows the point at which the company's expenses will match the sales or service volume. The breakeven point can be expressed in terms of dollars or units sold



LOAN DOCUMENTATION FOR AN EXISTING BUSINESS

- income statements and business balance sheets for the past three years
- projected balance sheets and income statements for two years
- projected cash flow statements for at least the next 12 months
- personal and business tax returns for the last three years
- a business plan (Depending upon the credit history of your business and the purpose for the loan, a business plan for a loan to an existing business may be unnecessary, and a brief narrative of your intentions may suffice.)
- **Other items to include.** Depending upon the specific type of loan you are seeking, you should also address certain issues relevant to that loan type.
 - If money is requested for working capital, your documentation should include: the amount that will be used for accounts payable, along with an accounts receivable aging report to disclose the current amounts overdue 30-60 days or older; the amounts that will be used for inventory and any increase in the number of days that inventory on hand will be held; the amount your cash balances will be increased; and a contingency amount that is equal to at least 10 percent but preferably 25 percent.
 - If money is needed for machinery or equipment, include information that addresses: whether the assets will be immediately available or if a delay is anticipated; the price of the assets and how installation will be performed; whether installation will interfere with current production and the cost of any interruptions.
 - Documentation for an acquisition of land financing should include the real estate's cost, location and size, intended use, and whether any of the land is for future expansion.



HOW BANKS JUDGE YOUR APPLICATION

- For short-term debt, the cash flow statement and projected income and balance sheets will be most relevant. The institution will want to know what the funds are being used for and whether the business's earnings will be sufficient to repay the loan. Banks do not want to enforce their rights to foreclosure or repossess collateral, and such actions merely highlight a poor lending decision. Nevertheless, banks still place considerable emphasis upon collateral, especially when the projected cash flow of the debtor is as fragile as it often seems to be in a small business.
- The lender will dictate the repayment terms of your loan, but your explanation of the source of the funds for repayment and how you will manage your overall debt will be crucial to the lender.
- Some lenders rely heavily upon certain financial ratios, such as debt-to-equity, quick ratio, current ratio, etc., in assessing the creditworthiness of a prospective borrower. With many small businesses, however, these ratios may misrepresent the overall value of the enterprise. The most important assets of a small business are often:
 - the experience of the owners,
 - the potential value of prospective customers,
 - and other non-balance sheet items.
 - In addition, because of tax or strategic business purposes, some entrepreneurs may choose *not* to list assets on personal statements or they may list important assets on the financial statements of different businesses that they own. In these situations, the financial ratios of the borrowing company may be understated.



HOW BANKS JUDGE YOUR APPLICATION

Work Smart

- If your loan application is denied:
 - find out as much as you can about the review of your loan,
 - which factors hurt you the most,
 - how you can improve your chances for obtaining a loan in the future,
 - and whether the bank would consider being a secondary financier if a primary lender were obtained.



12 TIPS FOR GETTING YOUR BANK LOAN APPROVED

- **1. Keep in mind that to stay in business banks need to make loans.** Do not be afraid to ask for one. That is what the loan officer wants you to do. To increase your chances of getting a loan, look for a bank that is familiar with your industry and who has done business with companies like yours. Seek out banks that are active in small business financing.
- **2. As an entrepreneur, make sure that you are thoroughly prepared when you go to your banker's office to request a loan.** You need to show your bankers that a loan to you is a low-risk proposition. Have on hand a completed loan application, copies of cash flow and financial statement projections covering at least three years, and your cover letter.
- **3. Learn to anticipate every question that he or she has.** Remember, the combination of information and preparation is the most powerful negotiating tool in the world. A confident and thoroughly prepared borrower is four times more likely to have his or her loan approved than a borrower who does not know the answer to some of the basic questions a banker asks. To show the extent of your preparedness, your business plan should also include answers to your banker's questions. These questions normally are:
 - How much money do you need? Be as exact as possible; although adding a little extra for contingencies will not hurt.
 - How long do you need it for? Be prepared to go into detail about what the money will do for you and why your business is a good risk.
 - What are you going to do for it? Businesses use loans for three things: to buy new assets, pay off old debts, or pay for operating expenses.
 - When and how you will repay for it? Your cash flow projections should provide a repayment time frame. Convince the banker of the long-term profitability of your business and your ability to repay the loan by using your financial projections and business plan.
 - What will you do if you do not get the loan?
- **4. Do not take an apologetic and negative attitude.** Keep your negativity in check. Present yourself as an entrepreneur who can and will repay the loan. Boost your image by providing your loan officer with any promotional materials about your business, such as brochures, ads, articles, press releases, etc.
- **5. Dress in a professional manner for the interview.** This is a business transaction, so treat it as such.
- **6. Do not stretch the truth in your loan application.** Broad, unsubstantiated statements should be avoided. The lender can easily check many of the facts on your application. If you cannot support statements with solid data, then don't make them.



12 TIPS FOR GETTING YOUR BANK LOAN APPROVED

- **7. Be sure all your documents are neat, legible and organized in a cohesive and attractive manner.** Type all your loan documents. Handwritten documents look unprofessional. Don't forget to include a cover letter.
- **8. Do not push the loan officer for a decision.** Doing so might result in a rejection. Your banker cannot make a decision until all your documentation is complete. To ensure a speedy decision, make sure that your application is complete.
- **9. Be confident.** An attitude of confidence enhances your chance of getting the loan. Show that you can make a success out of the money that the bank will lend to you. Visualize in your mind the positive results of your bank application.
- **10. Ask someone to give you a good referral.** To improve your position as you change bankers and banks, the best way is to ask for a referral from a successful entrepreneur. Before you decide to approach a bank directly, find an associate, friend or acquaintance that is in good standing with the bank to give you a good referral. Bankers tend to deal more favorably those who were referred to them by their best customers.
- **11. Failure to discuss risk in your application.** You must remember one thing: there is no business without risk. If you do not discuss risk, the bankers will assume that you haven't thought about risk. Let's face it - try as we might, we cannot plan for everything, for every contingency, for every turn of events. Bankers would want to know if you have planned for the major risks and how you intend to manage it.
 - Then, there is also the risk of too much success. The demand for your products or service may exceed well beyond your expectations, and they would want to know how you intend to handle success.
- **12. Remember that the first loan is usually the hardest to get.** Bankers prefer to lend money to borrowers who have borrowed at least once and have paid back at least one loan on time. They are not venture capitalists that make high-risk loans regardless of the profit prospects of your business. Bankers prefer to lend to low-risk, low profit ventures than to high risk businesses or those with no record of accomplishment.

