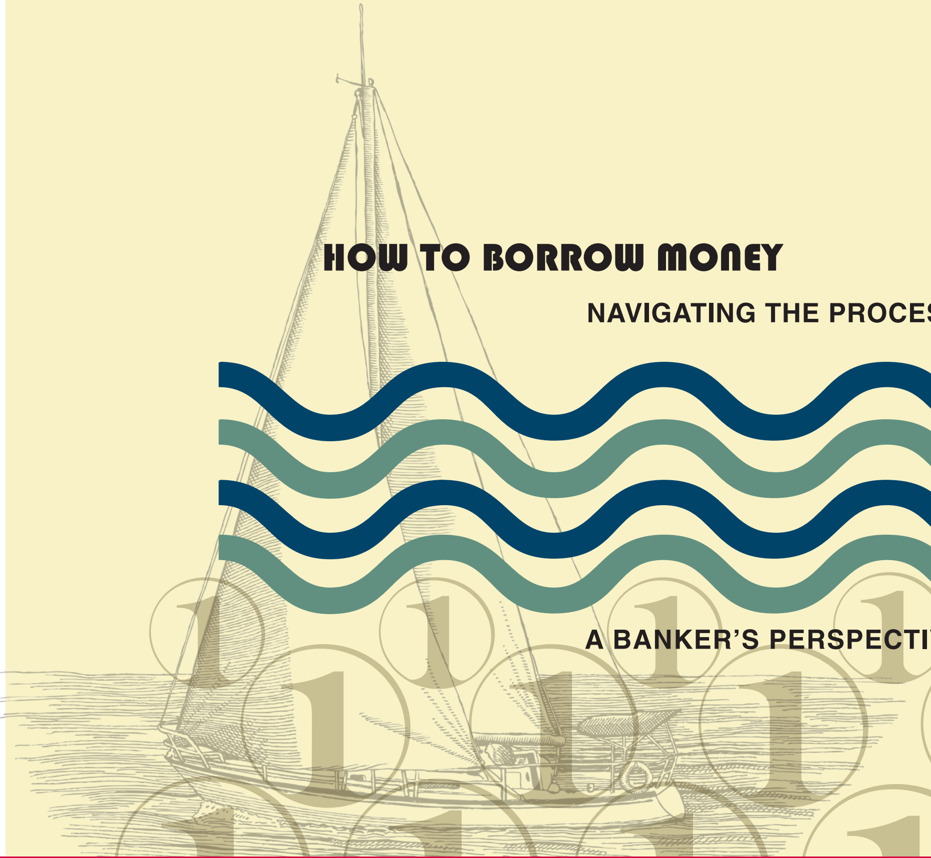
HOW TO BORROW MONEY

NAVIGATING THE PROCESS



A BANKER'S PERSPECTIVE

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Introduction

Over the last 39 years, it has been my good fortune to provide financing for a wide range of small businesses and professionals. It has been my experience that often entrepreneurs are great at sales, manufacturing, or some other aspect of starting and building a successful business; however, usually they have not learned the language of "banker-eez" that may be useful in borrowing money from a bank.

The purpose of this booklet is to invite you as borrowers, or prospective borrowers to the other side of the table and explain how bankers are looking at your loan proposal. Understanding your banker's perspective and why he or she is asking the questions that inevitably arise, may help you be more successful as a borrower. This is one important aspect of building a successful business.

I have always recommended to my entrepreneurial friends that they should FIRST find a good banker, attorney, accountant, and insurance agent to provide professional support for their companies. This book attempts to address those needs. It starts with "How to Choose a Banker" and proceeds through various related topics.

If I may be of any help as you build your company, please give me a call.
It is always a pleasure for me to talk with friends about how to successfully use money, especially loans.

Sincerely,

Thomas E. Bennett, Jr.

Chapter One

CHOOSE THE RIGHT BANKER

Someone who likes to make loans to your type of business

Someone willing to be creative and take reasonable risk

Someone you can count on if your business takes a short negative turn

Someone who is likely to stay at your bank long enough to meet your needs

Someone who either has the authority to approve your loan or has the influence in the bank to get it approved

Someone who is able to explain your loan to others; think of them as your personal advocate

Someone with whom you can get along

The difficulties of the banking industry in recent years have not been felt by many depositors because of the excellent protection of the FDIC. However, for borrowers it has been a different story.

With a large number of financial institutions failing over the last four years, and borrowers ending up with either the acquiring bank or the FDIC, more bankers and regulators have found themselves re-evaluating their borrowing relationships.

The truth is America has many profitable and well-capitalized banks and a large network of excellent bankers. I fully understand that bankers, like dentists, are individuals that most people would rather not have to visit very often. But the fact is that we all use and sometimes need money.

Consider it an imperative for you and your business to think through what you need in a banker and make sure you're working with the kind of institution and person that understands your requirements.

At the very least you should find out how the bank and your banker view your type of business, from a banker's perspective. One of the interesting aspects of making loans is that we are all placed in the role of evaluating the riskiness of different business ventures. However, what constitutes risk is very much affected by the perspective of the person doing the evaluation. Those types of businesses that bankers think we understand, and with whom we have had success, will be viewed as having less risk than those that we do not understand or with whom we have/had trouble.

As an example, one of my favorite bankers is exactly the type of person that you would want to work with on most types of loans. He is honest, consistent, trustworthy, smart, and willing to meet you anytime that is convenient for you. If you are looking for a restaurant loan, however, he would be the wrong person to see. Why? Because he might have been burned early in his career by a large loss on a restaurant.

So, when Joe Businessman comes to see a loan officer about a restaurant loan, he might as well have said he wanted to talk about the government, spiders, or taxes.

As you go about the business of looking for a banker, you need to know what kind of loans individual bankers like or dislike. This is not difficult to do - just open the conversation by asking the prospective banker to tell you about the best and worst type of lending experiences he or she has ever had. Chances are he or she will not give you names, but will tell you all you need to know about his or her successes and failures. If you find that they had terrible experiences with your type of business, it might be best if you ask him or her to introduce you to someone else in the bank who has a difference experience.

On the other hand, if you find a banker that has had great success in lending to your industry, or making your type of loan, then you have found someone who may well be excited about your proposal. They may also have the expertise gained from a successful venture in your industry that can be invaluable to your future planning.

At the very least you should find out how the bank and your banker view your type of business, from a banker's perspective. One of the interesting aspects

Among other key qualifications for you to consider are the following:

Is your loan officer willing to be creative and take a reasonable risk? By that, I don't mean does the banker make unsecured, five-year loans to pay this year's taxes. That's not creative, that's stupid. But loan officers are under pressure to make a high volume of loans with a low level of risk. Individual loan officers react to these pressures in one of four ways.

- Some will make a high volume of high-risk loans. You don't want one of them as your banker, because he won't be around long, and when he or she is fired, your loan will look bad by association.

- Some will make a low volume of low-risk loans. You don't want that kind of loan officer either, because he or she will probably be promoted off the loan floor and into the credit department.

- Some will make no loans at all. If you run across someone like that, he or she is an FDIC employee and your bank has failed.

- Finally, some may succeed at making a high volume of low-risk loans. You want one of them. The officer will get your loan approved with creative structuring and will make sure the bank feels well secured. You can go to the FDIC's website (FDIC.gov) and see what percentage of problem loans are held by every bank in America. If you are talking to a banker from a bank with a high percentage of problem loans, ask what happened … and ask if they were involved in the problem loan situation. If your loan officer is currently handling a large volume of problem loans, he may not be willing to be creative on your proposal and may be more averse to risk than he would be normally.

Is your loan officer someone you can consistently count on? As Mark Twain said, "There are bankers who will loan you an umbrella when the sun is shining and then want it back when the rains come." There are solid, consistent, trustworthy bankers, and there are bankers who don't even have a compassionate glass eye. Ask around to see how different bankers treat people who have run into trouble. Either ask friends in your industry, or ask your accountant, attorney and insurance agent who they have heard is a reliable banker and who is not.

In terms of reliability, you'll also want to know your banker's job history. Even if you think a loan officer would be wonderful to work with, one who is merely touching down at this job en route to greener pastures will probably not be there when you need help years down the road. Ask your prospective loan officer about his work history. Frankly, he is applying for a job. Choose a banker who stays at good banks for a number of years, rather than anyone who changes jobs every two or three years. It's better to have a reliable workhorse than a racehorse who is here today and gone tomorrow

Does your loan officer have the authority to approve your loan or the influence to get it approved? Usually, loan officers have specific lending authority or loan limits. Within those limits, they can approve a loan right away. If a request exceeds that individual loan officer's authority, the loan officer will have to go to a more senior officer or to the loan committee to gain approval. It's important that your loan officer either has the authority to decide or the influence to get affirmative decisions from higher up.

It would be nice if everybody could deal with a senior officer, but that's not always possible, especially when you are a new business. You can, however, be equally well served by a respected rising star.

You must ask yourself if your loan officer is competent enough to explain your loan to others. Your loan officer is your in-house advocate at the bank. Even if your loan is approved on the spot, it still will have to be reviewed by the credit department and, if it's a large enough loan, by the loan committee. Their ratios and formulas may seem like another language compared with your loan proposal, and it's up to your loan officer to serve as an interpreter and advocate, providing what they need to analyze your request. You will not be able to make a presentation to a loan committee. You need a loan officer who will represent you well.

Loan officers need to be able to explain who you are, how you are organized corporately, how you fit into your market, what you are using the money for, why the terms and conditions are a good deal for the bank, how you are going to pay the loan back, what your financial condition is, their industry analysis, and when they can expect to receive progress reports on your operations.

I've seen presentations that left senior management with the impression that the loan was a low risk and a highly profitable bank asset. I've also seen loan officers appear before the loan committee like a hog on ice: they didn't know much about the borrower's financial condition, they described the purpose of the loan as working capital, which means absolutely nothing, and they weren't sure how the loan would be repaid. Needless to say, such a presentation leaves senior management cold.

There are obviously many other qualifications to consider in choosing the right banker/advocate within the bank…like finding someone with whom you can get along. The bottom line is that you can choose who you bank with rather than just accepting whoever happens to be at the bank when you call. Make your choice a wise one…it will play a critical role in the ongoing financial growth of your company.

Not all loan proposals are approved. If your loan is declined, you need to ask the loan officer why. Then go back and consider the issues raised by your lender and see if you can restructure your proposal to address their issues. It may be that going back with a second proposal that addresses the issue raised will prove for a more positive response. On the other hand, it could be that if you take your restructured proposal to another bank, you will receive a more positive response.

If a loan officer at one branch of a bank turns you down, your proposal has probably been input into the bank's internal system. It is more likely that a lender from another bank will give a different interpretation of your proposal than another loan officer from a different branch of the same bank. If one bank has turned you down, I recommend that you go elsewhere.

If your banker has approved your loan under terms and conditions that are acceptable to you, I recommend that you accept and proceed to close. If you do not like all the terms and conditions, you can always negotiate. Another alternative is to seek another proposal from another bank.

It is important to establish a positive working relationship with a good bank wherever you start. It is not a good idea to repeatedly "shop" your deal to other banks. It gives the impression of not providing a stable customer/lender relationship. You are not fostering loyalty. It is better to stay at the bank with the person you started with rather than changing banks for a slightly better rate during good times. You will need to rely on the positive relationship you have established when hard times come, as they inevitably will. A friend has told me that:

"Bankers are slow learners.
Once you've got one trained to
understand your deal,
you should stay with him
in a mutually beneficial working
relationship."

Chapter Two

THE THREE C's OF LENDING AND BORROWING

CHARACTER

CAPACITY TO SERVICE DEBT

COLLATERAL

There are three key items a banker is trying to understand in your loan proposal. They are Character, Capacity to Service Debt, and Collateral to secure the loan.

When you are preparing to go to the bank to borrow money, these are three important words in "banker-eez" you need to understand. They are the three words that all bankers will use to evaluate you as a borrower and determine whether or not to make you the loan.

CHARACTER: This does not mean are you a real character (this might be damaging to your case). The first word in evaluation means, "Does this person intend to pay me back and does he or she have the ability to do so." The ways that a banker will check out your character include:

- ✔ Getting a credit report/history on you from the Credit Bureau to see how you have paid other people.
- ✔ Calling other bankers you have borrowed money from to see how you handled your obligations.
- ✔ Asking you about your current job and previous jobs to see if you are a person who is likely to stay on a job long enough to be able to repay the loan.
- ✔ Asking you about your education and training to see if you have a broad enough background that you would be able to get another job if something happened to your current one.
- ✔ If you are managing a business, they will probably also ask about members of your management team, i.e. their education and experience

Things that you can do to facilitate this phase of their evaluation include:

- ✔ Preparing a resume and/or business management history of your current and previous work experience, education and training.
- ✔ Preparing a list of former creditors, and
- ✔ Being able to discuss your plans for the future; at least as far enough ahead as it will take you to repay the loan.
- ✔ If you are a business manager, prepare resumes of members of your management team.

CAPACITY TO SERVICE DEBT: Once a banker has determined that you intend to pay him or her back, he or she will try to determine whether you are able to repay the amount you are requesting. To do this they will total all of your personal and business income, and all of your debt service requirements and see if you can afford any more loan payments. The basic ratios used are as follows:

For Individuals or Consumers

- ❍ **Home payment or rent should be within 23-33 percent of net monthly income, and**
- ❍ **Total home payment or rent plus other debt payments should be within 30-40 percent of personal monthly income.**

As an example of the way this works could be if one spouse earns $2,000 per month and another earns $1,000 per month, then your total monthly income is $3,000. Your home payment or rent should not exceed 33 percent of $3,000, or the payment should be $1,000 or less of your total fixed payments (house payments or rent, plus other debt) should not exceed 40 percent of $3,000 or a total of $1,200. The reason for this maximum is that you also have to pay for groceries, utilities, taxes, etc. out of the rest of your income.

Now, in this example, if you have a house payment of $600 and a car payment of $300, then you would still be qualified to have an additional payment of $300. However, some people forget to include payments on credit cards when they are figuring their capacity to service debt requiring another $100 per month in payments, your capacity of additional debt is reduced to $200.

If you come to the bank already knowing how much total income you have, how much debt you owe, and what your ratio of debt to income is, then you will improve your chances of getting your loan.

But, how much will this borrow? It depends on what you are spending the money for and how you secure the loan (collateral is coming up in a minute). Bankers normally set up repayment of loans based on what you are doing with the money. For example:

(1) If you are paying this year's taxes, you ought to repay the loan in 12 months; because you will owe more taxes next year.
(2) If you are buying a car, you can probably get from two to five years to repay the debt.
(3) If you are buying a home, you can take up to 30 years to repay the debt.

For Businesses

For a business, the issue of capacity to service debt is a little more complicated. Generally, on loans that will be paid out over a long period of time (1 or more years) banks expect your net cash income (net income after taxes, plus interest and depreciation), to exceed the required monthly payment by at least 1.2 times. A higher positive cash flow is better. The amount of time you can take to repay loans is similar to consumer loans. For example:

(1) This year's taxes should be repaid within 12 months.
(2) Equipment should be repaid within the useful life of the equipment.
(3) Commercial real estate loans are usually repaid in 15 to 20 years (sometimes as long as 25 to 30 years).

And all these repayment programs are affected by the third "C" word:

COLLATERAL: Bankers never make loans purely on the basis of collateral (or they shouldn't). Evaluating your character and capacity to repay are much more important.

On the other hand, most of the time banks want you to pledge something of tangible value to secure your loan. This pledge is called offering collateral. The idea is that if you mean to repay the debt, but are unable to do so, then you will be able to sell the collateral for enough money to repay the lien.

I have always thought of collateral as "Plan B." In this sense, it is important (to the banker) that the collateral be of greater value than the amount of the loan. As long as this is true, then the borrower always has the ability to remain in control of his debts, because he can always sell assets pledged to loans and pay off the debt. If the assets are not worth as much as the debt, then the borrower's debt can become out of control if his income drops. In that case, selling the asset pledged as collateral still does not pay off the loan.

That is why, when you are buying a car, a house, or some other asset, a banker will want you to make a down payment. This will allow you to start out with the asset being worth more than the debt.

On some occasions, you are able to borrow money “unsecured” (without pledging collateral). However, this is usually limited to either one month’s income or 10 percent of tangible net worth (the difference between what you own and what you owe), whichever is less.

You will improve your chances of getting a loan if you are able to offer as collateral for the loan something that is worth more than you want to borrow. You also need to be prepared to prove your collateral’s value (i.e.: an appraisal on your home).

Now, these aren’t the only words important to bankers; but they certainly are the basics.

"The fact is that most bankers know three other “C” words pretty well. They are CONSERVATIVE in making loans, because they are loaning their depositors’ money. They understand from experience, the most CHARITABLE thing they can do, as a banker, is to help you keep your debts within your ability to repay them. They have found too often in the past that financial CHAOS leads to a “B” word that bankers prefer not to mention

Chapter Three

WHAT TO BRING TO THE BANK

When you go to the Bank to borrow money, you need to bring the right kind and amount of information with you. This will expedite the approval of your loan and let you get about the business of using the money to make money.

Information to bring to the bank falls in the three categories of "bankereze" described in Chapter 2: character information, cash flow information, and collateral information.

Checklist: What to Bring to the Bank

I. Character Information

1. A copy of your business plan or description of the business.
2. A resume of management's experience in this type of business.
3. A resume of management's education and experience in business management.
4. A listing of current and prior creditors.

II. Cash Flow Information

1. Last three year's financial statements on the business.
2. A projection of next year's income, expenses, and balance sheet.
3. Last three year's tax returns on the business.
4. Current financial statements on the business owners.

III. Collateral Information

1. An aged listing of accounts receivable.
2. A description of the kinds and turnover of inventory.
3. A listing of equipment, including cost and value.
4. A listing of real estate and buildings, with cost and values.
5. A listing and explanation of values of tangible assets.

Character Information:

- ✔ A resume of management's education and experience in business. Include more than merely names of company's names of references that will vouch for your ability.
- ✔ A resume of management's education and experience in business management. Again, not merely your degrees and universities, but numbers of courses in topics like leadership, accounting, marketing, personnel management, economics, planning, product design and business law. Be sure to include a description of experiences that you and other managers have had in management or supervisory positions in other businesses.
- ✔ A list of banks, businesses or people you have borrowed money from in the past, including current telephone numbers. The bank probably will be calling them to see how you repaid the debts.

Cash Flow Information:

The bank will want to know whether or not you can repay the loan you are requesting. They will want to look back three years - if possible - and forward at least one year - preferably three - to analyze the trends in the cash flow in your business to service debt, which generally consists of net profits, plus non-cash expenditures. They will compare this to the cash requirements of all your current debt and your proposed loan. They are hoping to find that you are generating a lot more cash than is required to repay your loans.

I suggest that you bring the following kinds of cash flow information with you:

- ✔ Your last three years' financial statements on your business. These should include at least a balance sheet, a profit/loss statement, and a sources and uses of funds settlement.
- ✔ A projection of the next year's income and expenses and changes in the balance sheet on a month-to-month basis. This will help the banker understand how their loan proceeds will be used and how the changes in the business will impact your ability to repay the loan.
- ✔ Your last three year's tax returns on your business. This will help the bank understand any items in your financial statement that tend to reduce profits in order to provide "tax planning."
- ✔ A current financial statement on everyone who owns more than 10 percent of the business. The bank will be trying to determine whether the owners' cash flow is respectively helpful or harmful to the business.

Collateral Information:

Almost all loans made to small businesses and professional people are secured by some kind of collateral. The kind of collateral you pledge usually depends on the reason you need the money and the size of the loan. For example, if you are buying a new building and you can pay 20 to 25 percent of the cost from your own cash, then you will probably only pledge a first mortgage on the building.

On the other hand, if you are refinancing all the debt in your company and getting some new cash for expansion, you will probably pledge all the assets of the company. The bank will need to know what the assets are in your company and what they are worth in today's market.

I suggest that you bring the following kinds of collateral information:

- ✔ An aged listing of accounts receivable. The bank will probably subtract all accounts over 90 days past due, discount all accounts over 60 days past due, and question you about all over 30 days past due. They will also want to know more about any large accounts - over 5 percent of your total sales - like, what kind of financial information do you have on these accounts and how well they paid you in the past.

- ✔ A listing of all the significant pieces of equipment you own or plan to acquire with the loan, their original cost, their current depreciated value on your books, your estimate of their current market value and if there is a large discrepancy between the book value and market value. Also, include some third party the banker can talk with to verify the value.

- ✔ A listing of all real estate and buildings owned, their original purchase price, any major expenditures you have made to increase their value, the current depreciated value at which they are carried on your books and your estimate of market value. If you have had a recent appraisal or you are aware of a recent comparable sale, bring that information too. If you are purchasing a new facility, bring a copy of the contract - or if you are leasing, bring a copy of the lease.

- ✔ A listing of any items that you consider of intangible value- contract rights, patents, good will - and a clear substantiation of why that is valuable. Frankly, this is always the most difficult part for bankers to understand. Any third party assistance that you can provide would be helpful.

Information on Guarantors or Additional Financial Backers

If there are weaknesses in your proposal, think in advance about a backer or a guarantor of your loan. This should be someone with the financial strength and business experience to shore up your weaknesses. If you believe you need a guarantor (or have been told so), then go ahead and bring his financial statement and last 2 or 3 tax returns, and resume of business experience.

Summary and Conclusion

The idea is neither to come in with a wheelbarrow full of data nor to wander in with a one-page summary. You need to provide the banker you are talking to with enough information that he or she can make a responsible credit decision and then explain that decision to a loan committee, a loan review department, and possibly to bank examiners.

It is difficult to make these kinds of decisions and explanations based on conversations that are not supported by relevant data. So, if you'll follow the checklist above, you'll do us both a favor…and together we'll make this economy grow again.

Chapter Four

USING A GOVERNMENT GUARANTEE LOAN PROGRAM

The US Government has two major loan guarantee programs to assist small businesses in gaining favorable financing:

The Small Business Administration (SBA) and

US Department of Agriculture Business and Industry Loan Program (USDA B & I).

Both programs can be useful to small businesses in getting longer than normal repayment terms with lower than normal equity requirements. At the same time, they reduce the perceived risk to the banks of small business lending. We believe these are excellent programs and all small businesses should consider using them in the right circumstances.

The most frequently used program is the SBA's 7A Loan Guaranty Program. The SBA offers a variety of programs that fall under the broad limitation of $5 million maximum loan or loans with a maximum $3.75 million in loan guarantees which fit the needs of most small businesses. To be defined as a small business, the company must have a $15 million or less net worth and earned less than an average of $5 million taxable income for the last 2 years.

- Buying or expanding the land and building that house a small business. Generally, these loans can be for up to 25 years and require lower down payments than conventional financing.
- Buying equipment for a small business. Generally, these loan terms can up to 10 years (or the useful life of the equipment), and require a lower down payment than conventional financing.
- Working capital for a small business. Generally, these loans can be for up to 110 years and may finance growth in inventory and accounts receivable.
- Refinancing existing debt under more favorable terms up to 10 years.
- The acquisition of a small business or professional practice by new owners up to 10 years.

While it is true that SBA and/or USDA sometimes require more paperwork and time to process than conventional financing, (but not always), the benefits to the small business owner can be significant.

Consider this scenario:

A small business has been leasing a building for the first 2 or 3 years of operation and now wants to buy the building it has been leasing or a different building. Let's say the building costs $500,000. Comparison of conventional versus SBA financing (rates are for illustration purposes and will vary based on a variety of credit factors).

	Conventional Financing	SBA Financing
Purchase Price of Building	$500,000	$500,000
Normal down payment	$100,000 (20%)	$50,000 (10%...can be less)
Net Amount Borrowed	$400,000	$450,000
Term of Loan	15 years	25 years
Interest rate	Prime + 1 with a floor of 5.5%	Prime + 1-1/2 with no floor
	Initial Rate 5.5%	4.75%
Monthly Payments	**$3,285.25**	**$2,583.40**
Other features	Usually a 5-year balloon note	Full 25-year payout note
Fees to close the loan	1% Loan Origination	2.25% SBA guarantee fee
	$4,000	(+2.25% of the $450,000 loan)
		However, in the State of Oklahoma (and other states), there is a tax credit for the SBA fee. The fee amount may be added onto the loan amount and paid out over 25 years.

** These are given for illustrative purposes; rates and fees will vary based on the credit characteristics of the borrower and the size and term of the loan. SBA guarantee fees range from 2.0 to 3.5% of the loan amount.*

Benefits of an SBA guarantee:

- Lower down payment with larger loan amount
- Longer term payout
- Lower initial rates
- Lower monthly payments
- State Tax credit for SBA fee, with ability to add thee fee into the loan and pay it out over 25 years.
- Bottom line - less cash required by the small business, both to close the deal and service the debt.

But, is there a stigma for using a government guaranteed loan? We think the answer is definitely No.

Consider some large companies today who started or expanded with SBA loans in the past:

Apple Computer, Nike Shoes,

CRAY Research (the makers of the super computer),

Columbia Sportswear, Godfather's Pizza,

Simple Simon's Pizza, Ditch Witch, Eskimo Joe's,

and thousands of dentists, optometrists, veterinarians, doctors, attorneys, CPA's, funeral home operators, pharmacies, and other professionals. With the SBA having guaranteed over $200 billion in loans over the last decade, it's very likely one or more of your competitors have already taken advantage of these programs.

We believe using SBA or USDA loans for a small businesses to make the best deal on financing their land, building, equipment, or working capital, is comparable to homeowners using the government sponsored secondary market organizations like Fannie Mae and Freddie Mac to get the best deal on financing their homes. The government is simply facilitating access to the capital markets for small businesses (and homeowners) that they cannot directly access themselves.

The fact is that 60 to 80% of all new jobs in America are created by small businesses and over 50% of all American workers work for small businesses. So using an SBA or USDA guaranty to get the best terms for your business loan makes sense for your business, your bank, your community, and your country.

USDA B & I

In this chapter, we have primarily talked about the SBA 7A Program. That is because it is applicable to all small businesses everywhere. However, if you own a small business in a non-metropolitan area, the USDA B & I loan program can be more flexible than the SBA. It's purpose is to help create jobs in rural America. So, ask your banker if your company may qualify.

Chapter Five

HOW MUCH EQUITY IS ENOUGH

Almost every time an individual or company goes to a bank to borrow money, one of the issues they face is the need to either make a down payment on the item they are purchasing or demonstrate that they have enough equity in their financial situation to support the desired loan.

The difficulty here is defining what equity is and how much is enough for what you want to do.

What is Equity?

Generally, equity is your cash investment in your business or personal item being purchased. For example, if you buy a $100,000 house, make a $20,000 down payment and take out an $80,000 loan, your equity is the $20,000.

Over a period of years your equity in your home will normally grow as you reduce the balance of your loan and the value of the home remains relatively constant or increases as a result of inflation.

In a business, the "real" equity is a little more difficult to determine. This is because most businesses use a variety of accounting methods to determine the present value of fixed assets - which are usually depreciated. Some businesses periodically appraise the value of their total assets and list them on their financial statement at their recently appraised value.

The best approach - from a banker's point of view - is to conservatively value your assets, writing off uncollectible accounts receivable and slow inventory, and depreciating your equipment or other fixed assets to present liquidation value, then compare them with a complete statement of your liabilities. The difference is your equity in the company.

Sometimes business people try to explain to bankers that their "real" equity is equal to some multiple of sales or some other intangible factors. While this may be true, if you are selling your business today in a favorable market, it will probably not be considered equity from the standpoint of qualifying you for a loan.

That's because bankers want you to have "equity" in your business or personal assets sufficient to absorb any possible losses that may occur, in the foreseeable future. It is our experience that if losses do occur, then whatever intangible value may have existed in your business in the good times will probably disappear.

The net result will be that the difference between the value of the actual assets that you own - that can be sold - and the debts that you owe will in fact be the real equity in your business. If your equity is zero or less, you will be broke, and we will lose money. This is also true in evaluating your personal assets and liabilities.

How Much Equity is Enough?

That entirely depends on the risk involved in either the long-term value of the asset you are purchasing, the type of business you are pursuing, and whether or not you are using a Government Guaranteed Loan Program.

In the case of a person buying a home, normally the values are considered to be very stable and you can buy a home with only five percent equity.

However, the higher the cost of the home, the smaller the resale market is likely to be, the less stable the value is likely to be, and the higher the requirement for your investment of equity is likely to be. For very expensive homes, normally at least 20 percent or more equity is required.

In business deals, the equity requirement is even more variable.

To the extent that your business or the assets you are buying are "risky", you will be required to have more equity. Conversely, to the extent that your business or the types of assets you are buying are very solid, stable values, you can borrow money with less equity. If you use a Government Guaranteed Loan Program (like SBA or USDA), the equity requirement will normally be substantially lower than conventional financing.

Isn't Collateral the Same Thing as Equity?

No, they are related but not the same thing. In fact, bankers normally require collateral to support their loans. Sometimes they take a lien on all the assets of the company. Sometimes they even take liens on assets not in the company but perhaps owned personally (like a second mortgage on the owner's home).

If you are borrowing as much or more than you have invested in the business and/or you need to take more than 12 months to repay the loan, you will normally have to pledge collateral in order to get the money.

The Bottom Line

Essentially, bankers are in the business of borrowing money from their depositors, re-loaning that money to their borrowers, and making a profit by earning more interest than the cost of the risk involved in making the loan.

To the extent that they are successful in making a high volume of low-risk loans, they will be profitable banks. Therefore, they will require you to have a significant amount of equity - or cash investment - in the projects you are undertaking in order to reduce their risks.

> *"The lowest risk loans, or investments are normally charged the lowest interest. Anything you can do to help your banker understand why your business or investment is less risky will increase your chances of getting the loan that you desire"*

Chapter Six

SOURCES OF EQUITY FOR YOUR BUSINESS

When borrowers come to a bank for a loan, they basically are in search of capital for their businesses. In the case of a loan, the money is called debt capital.

Frequently, their bankers will tell them they need to raise more "equity" capital in order to qualify for more debt. But where do you go to acquire equity capital? There are several possible avenues:

Personal Resources

The most obvious personal resource is your life savings or cash value of life insurance. But beyond cash, there may be other options.

If you own your home, you might refinance the first mortgage to take your equity out in cash and inject the money into your business.

There might be other assets on your balance sheet, like an inherited tract of land in Kansas or your former home that is now a rental, which can be sold to generate more cash.

Basically, anything you own that is not a necessity can be sold to generate cash.

Family and Friends

Most of us think we are too proud to ask family and friends for help. On the other hand, if we believe that our business will be a successful investment, it is likely that our family and friends will respond to a soft (or direct) solicitation for investment in this opportunity. If nothing else, they believe in you and want to see you succeed. As a word of caution, please do not ask them to invest more than they can afford to lose.

Employees

Sometimes the people who most believe in your plans are right under your nose, and you forget to ask them - your employees. You never know what resources they might have and might be willing to invest to make the business grow, unless you ask.

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Suppliers and Customers

Your suppliers have a vested interest in your success; they want to sell you future products and services. It is possible that they will extend you more generous terms or even make a direct investment in your business, in order to insure you as a valued customer.

Speaking of customers, your own customers obviously already value your products and services or they wouldn't buy them. They could possibly prepay for products or services, or make progressive payments to improve your cash flow. They also might consider a direct investment in order to insure a steady supply of whatever you offer.

Lease Rather Than Buy

Another area of your own financial statement to search, or that of your business, is the assets you own that you might lease instead.

I have frequently found start-up or rapid-growth businesses are inclined to tie up too much of their cash in fixed assets, like equipment or buildings.

During the early stage of your business where you are building inventory and accounts receivables, you should always shepherd your cash cautiously. Lease, rather than buy, fixed assets.

For that matter, if you are retrenching and need to raise cash, you might also consider selling fixed assets to liquidate debt and leasing to improve your cash flow.

Government Programs

Most states and the federal government offer excellent programs to assist in raising capital.

These range from the Small Business Administration and its many programs to the US Department of Agriculture (USDA) and their Business and Industrial Loan Programs for non-urban areas. The SBA has programs where you receive advice from retired business SBA executives (Service Corps of Retired Executives), and they make guaranteed loans through many banks, and direct investment through Small Business Investment Companies (SBICs).

The successes of these programs nationwide include Nike Shoes, Apple Computer, Digital Switch and Cray Research. All of these flagship companies have in their early stages utilized SBA assistance.

To access these programs you can either call the SBA or USDA directly, or contact your local bank to see if they participate in their programs.

Local, Semi-Private or Private Funds

For the really earnest seeker of funds, there are many local programs, like a local Tulsa Economic Development Corporation.

Semi-private programs, like a Rural Electric Cooperative Loan or Investment Program, and private funds, like the various venture capital groups in Tulsa, also can be pursued for funding.

The bottom line to local groups is jobs. The bottom line to private groups is profits. In all cases, the creation of jobs and profits motivate other people to want to help you raise capital.

Another alternative is Angel Investors or Venture Capitalists. However, these investors are primarily interested in companies who have already passed the startup phase and are now seeking funding for growth or expansion. They are usually second stage investors, to whom you will need to sell a percentage of your company for funding. You will be able to retain more control after you have proven your business model will work.

Education, Research and Information

There are many State and Federal programs that can provide services for your company.

The VoTech will train your employees (and save you money and/or increase productivity).

The VoTech Bid Assistance Centers do market research. Several university research programs can assist you in making your business more efficient.

For personal education, many universities offer degree programs in Entrepreneurship that are very helpful to understanding how to start and grow a business.

Credit Cards

Let me say up front that credit card funding for new businesses is not a good idea, unless it is the only option, and you are determined to go forward without conventional funding. The good part about credit cards is that they are usually unsecured and require very little financial information. The bad part is that they charge an exceptionally high interest rate (usually 18%-30%) compared to conventional financing (currently 5%-7%). They also have a shorter term payout plan than conventional financing, and do not apply thoughtful structure to repayment terms. If you already have a lot of credit card debt, pay it off as soon as possible. In my opinion, credit cards should only be useful for monthly expenses, and then paid off monthly. If you have already used credit cards to finance your business and you have become successful, you may want to consider refinancing your credit card debt with an SBA guaranty at a much lower rate of interest.

Chapter Seven

FINDING FINANCING FOR VARIOUS STAGES OF BUSINESS GROWTH

Most businesses in America go through three distinct stages of growth with different needs for financing.

In these various stages, you will find that bankers, and other providers of financing, receive you with different degrees of warmth or interest. Knowing where you are and what is considered reasonable may help obtain satisfactory financing.

STAGE ONE **Start Up Companies** – Start up companies often have primary capital needs for basic items like product development and covering initial overhead. Frankly, you will probably find your banker to be less than enthusiastic on start ups. Normally, your best sources of capital for start ups are:

- **Yourself:** Your own savings, cash value of life insurance, assets that can be converted to cash, or borrowed against the value of your home or other significant assets to invest in the business. I have sometimes found that an entrepreneur can refinance his home and use the money to start his company. If the venture doesn't work, he can get a job elsewhere and still keep his home.
- **Relatives and friends:** They believe in you and may be willing to help back your project. In all of these cases, always make sure everyone understands the risk that they are not investing more than they can afford to lose, and put whatever you have agreed to verbally in writing. Use an attorney.
- **Trade creditors:** Often your suppliers will provide you financing terms in order to secure your business.
- **Major customers:** If your product or service is important enough to them, they may prepay a portion of the costs or even make a direct investment in the company.
- **Government programs:** Federal, state, and local governments all have programs to encourage business growth and job creation. To find out about these options, contact your State Department of Commerce, local Chamber of Commerce, or the SBA.

- ❍ **Commercial banks:** Remember, banks do not normally provide equity financing. You will be expected to pledge some asset as collateral that could be sold for enough to pay off the loan if the venture doesn't work. Banks usually want to see that you have developed your product and market on your own funds before they provide significant lines of credit. If you decide to go to a commercial bank with a start up idea, you need to be thinking about either providing collateral outside of the business (like a real estate mortgage) or provide a strong guarantor for the loan (see Chapter 3) or both.
- ❍ **Venture Capitalists:** It is also possible to approach venture capital markets as a startup company. However, the more time you can build your company without seeking help from venture capitalists, the less of your company you will have to give up when and if you do seek their funds.

STAGE TWO **Rapid Growth Companies** – Rapid Growth Companies - Once you've got the company started, you hope that business takes off quickly. If it does, then your borrowing needs are often "some money now and more money later" to carry growing amounts of accounts receivable and inventory. It is at this stage of growth, that you normally start receiving significant amounts of financing from banks. The way this should work is as follows:

Accounts Receivable Financing

- ❍ Your company must continuously show profits and you must retain a significant portion of those profits in the form of net worth in order to get your creditors to continuously increase your lines of credit.
- ❍ You need to anticipate the average length of time it takes you to collect accounts receivable and then project different levels of accounts receivable at various levels of sales. Say, for example, you normally take 30 days from billing to collect your receivables. At $1 million in annual sales, you will normally have about $85,000 in accounts receivable outstanding. If your sales rise to $1.5 million, then your accounts receivable will probably rise to about $125,000. You can expect that most banks will loan you up to 75 percent of the value of your accounts receivable, sometimes 80%. So, at a $1 million annual sales level with monthly accounts receivable of $85,000, you might receive a $63,000 line of credit; and at a $1.5 million annual sales level with $125,000 in accounts receivable, you might have your line increased to $93,750; in some cases up to $100,000.

Another variable in this equation is the length of time it takes you to collect your accounts receivables. If you average 45 days rather than 30 days from billing to collecting your receivables as in the example above, you will need a line of credit that is 50 percent higher. You should know that your banker will compare your average days of accounts receivable outstanding to your industry average and be reluctant to increase your line (or even make you the loan) if your accounts receivable collections are slow relative to your industry.

When proposing your accounts receivable line to your banker, it is important to be able to project the impact on your balance sheet of various levels of sales. For example, if you believe it is possible to rise from $1 million to $2 million in annual sales, as stated above, you need to be projecting your need for a $125,000 line of credit and to demonstrate how you will support the other $38,000 in accounts receivable from retained earnings or other sources of capital.

Inventory Financing

- You also need to anticipate your average inventory turnover, and project your various needs for inventory at different levels of sales. You should be able to take these projections to your suppliers and get adequate levels of trade credit to support these increased inventory needs.
- If it is necessary to borrow money from your bank to support inventory growth, you must know that bankers are more reluctant to finance inventory than they are accounts receivable. The axiom is that if you can't sell the inventory, they will not be able to sell it. As a result, normally bankers will limit advances on inventory to approximately 50 percent of cost, and they will monitor both the inventory turnover level and sales to make sure they are not financing stale inventory.

Facilities & Equipment Financing

- While accounts receivable and inventory are the normal financing needs of rapid growth companies, it is also possible that you will want to acquire equipment or facilities to enable you to grow faster. My advice to rapid growth companies is always to lease equipment and facilities, if you can. The reasons for this are twofold: (1) You must protect your cash to finance accounts receivable and inventory. You do not want to tie up your cash in fixed assets if you can keep from it. (2) When you are growing rapidly, it is very difficult to determine how much space or what kind of equipment you will need when you stabilize at some more normal pace of growth. Therefore, you are inclined to either project too much growth (or buy too much equipment or facility), too little growth (and buy the wrong size), or the wrong kind of growth (and buy things you don't need). In all these cases, when you figure out your mistake, the fixed assets have dropped in value. When you sell them, you've squandered cash. However, when you do need to finance equipment, anticipate that you will need to pay 25% down and repaying the loan within the useful life of the equipment. When you are financing facilities (real estate), anticipate paying 20 to 25% down and repaying the loan over 15 to 25 years.

STAGE THREE **Stable Companies:** Stable Companies - This is when you have gone through the stage of rapid growth (frequently with a limited product or service line) and now you need to acquire fixed assets to make your company more efficient, discontinue service to accounts that don't pay (they'll go to the new start ups or rapid growth guys), dump inventory that isn't moving well, and diversify your product line to build stability into your company.

This is the appropriate time to go to your bank with plans to stabilize and begin reducing your accounts receivable and/or inventory line (as you are carrying more of these assets with retained earnings) and begin to increase your borrowing for new equipment or new facilities.

It is also the time to see if purchasing and financing facilities and equipment (under terms previously described) is better than leasing. By now, you should have a good idea of what you really need and purchasing the right equipment and facilities may make your company more efficient and enable you to build equity in fixed assets as you pay down your loans.

Chapter Eight

IS A LOAN THE ANSWER TO YOUR PROBLEMS

Business people, who perceive a need in their company for additional financial resources, need to take a hard look at their total financial picture, and determine what the causes of that financial need are and whether or not a loan provides the solution.

The chart on the following page should help you analyze which combination of three different types of answers might best resolve your company's financial needs:

1. Money (perhaps a loan) will resolve the financial needs of your company.
2. Reorganization of various activities is necessary to resolve the needs of your company.
3. Discontinuing a particular line of service or product is necessary to resolve the needs of your company.

Naturally, most people begin to analyze their situation expecting that they have a problem with a Type No. 1 answer - money. This is similar to the patient who goes to the doctor and expects that the answer to his problem is some medicine yielding a quick recovery.

Unfortunately, sometimes the correct answer to the problem is not more money. Like the patient who walks into the doctor's office 100 pounds overweight and wants a pill to fix his problem, the real answer is not medicine; it is a different diet, more exercise and a reorganized life. When a business shows signs of slow inventory turnover and accounts receivable collection, or management lacking depth and ability to control the company, the answer to the problem is not more borrowed money (Type No. 1). The answer is improved inventory control, accounts receivable collection, and/or additional management expertise (Type No. 2).

There is a third type of problem that the business person never likes to find - the failed venture (Type No. 3). Like the patient who comes to the doctor wanting to know how to continue an activity that his body can no longer support, the answer is neither more medicine nor reorganizing. It is admitting that sometimes we have outgrown certain activities (Type No. 3). A business person never wants to find that a venture has failed because he has invested a lot of time, money, and creative energy trying to make it successful. Sometimes the correct answer is to close down all or part of the present venture and go on to a better life doing something else.

Business Health Check Up

If you are trying to provide your company a Business Health Check-Up, you can probably turn to your banker to help you develop a series of questions similar to those you might expect from a physician giving you a physical exam. The attached chart is like a “home checklist” of typical questions to ask in evaluating your business and yourself.

If you complete this self-analysis and find most of your answers in Column 1, chances are your financial health is very good and your bank will work with you to arrange for a loan to help you build your company.

If most of your answers are in Column 2, you had better be prepared to discuss how you are going to reorganize your company’s operations when going to your banker for more money. The fact is that usually it will require more money to accomplish the reorganization. But understanding that the solutions to your problem require both reorganization and money will show that you’re in control of the situation.

If most of your answers are in Column 3, it is unlikely your banker will loan you more money. You can expect that he will suggest you liquidate various portions of your business in order to raise cash or reduce debt.

Most companies will find some of their answers in more than one column. In my recent trip to the doctor, I needed medicine for my sinuses, an improved diet and exercise for my body, and to discontinue activities only appropriate for a teenager. Hopefully, your company’s fiscal health is better than my physical health. In both cases, we need to face the situation the way it really is and exercise leadership to make it better.

BUSINESS HEALTH CHART

	Type I Money is the answer	Type II Reorganize is the answer	Type III Liquidate is the answer
1. CREDIT RECORD			
Other Banks	Good	Slow	Collections/Liens Lawsuits
Suppliers	Good	Slow	Lawsuit
2. ASSET QUALITY			
RE & Building	Easily marketable Needs remodel	Limited Poor condition	Poor Location Good condition
Equipment	Easily marketable Good condition	Some obsolescence Needs repair	Obsolete Poor condition
Inventory	Fresh, high turnover Good control	Modest turnover Weak control	Poor turnover No control
Acct. Receivables	Good billing & Collecting Low Past dues	Slow billing & collecting. Big past due	Poor billing & Collecting High past due
3. CASH FLOW			
Profit & Dep. Loss Inc. in Assets Less Debt Service	Strong debt servicing coverage after asset growth	Barely able to service debt after asset growth	Insufficient to debt service or increase assets
4. COMPANY MANAGEMENT			
CEO	Experienced, well Educated, in control	Too old, too new Not in control	Incapable Out of control
Second Tier	Provide depth in Ability, experience, Age mix	Inexperienced Lacking depth	No Backup
Overall	Balanced, clear Succession, depth	Imbalanced No successor	No depth
5. INDUSTRY CONDITION			
Growth/Trends	Strong	Flat	Declining
Competitors	Strong	Flat	Declining
Profitability	Up	Flat	Declining
Local Conditions	Good	Flat	Saturated

BUSINESS HEALTH CHART *Continued*

	Type I Money is the answer	Type II Reorganize is the answer	Type III Liquidate is the answer
6. COMPANY POSITION			
Reputation	Highly respected	Unknown, neutral	Not good, no support
Market Share	Strong & stable	Declining	Declining
	Small & growing	Small & stable	
Investor/Follower	Leading Market With products	Slow to change	Not reacting
Financial Comparison	1st/2nd quarter	3rd quarter	4th quarter
7. BUSINESS PLAN			
	Has one & uses it Can follow performance	Has one but does not follow very closely	Doesn’t have one