OSC1

Business Financing 101- What It Takes to Borrow Money

The Ohio State University
South Centers
SBDC

Slide 1

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What will the lender be looking for from me and my business?

Financing is …

- A means to accomplish short and long-term goals for the business.
- A strategic tool to aid in taking a calculated risk to obtain a future reward.
- For most, a necessary part of doing business today.

Financing includes …

- Credit lines, term loans and leases obtained from a traditional lender.
- Overdraft protection on checking accounts.
- Credit cards.
- Trade accounts with suppliers.
- Non-traditional sources, such as private individuals.

A Good Banker/Lender is…

- A trusted advisor who is willing to LISTEN to your dreams and goals, and is not just out to sell a product.
- Has your best interests at heart for the long-term, even when the answer is something you may not want to hear.

Banker / Lender…

- Can customize solutions to fit your needs (within prudent lending standards).

- Willing to help clients understand what they need to do to “get to the next level.”

A Good Customer …

- Is honest with their banker and keeps him/her informed, especially when facing financial challenges.
- Provides complete and accurate information as needed on a timely basis.

Customer…

- Recognizes the importance of maintaining good credit history and pays bills on time.
- Understands that the relationship must be mutually beneficial for both parties.
- Realizes their banker is not their enemy!

The C's of Credit

Basic Components of Credit Analysis

- Capital
- Conditions
- Character
- Collateral
- Capacity

Capital

- Applicant’s equity or net worth.
- Owner’s personal investment in company.
- How much risk are you taking.
- Can provide a “Plan B” repayment source.
- Type of business – differences in needs.

Conditions

- Local economic climate.
- Other industries could affect your business.
- What is the purpose of the loan.
- Political influences/ history.
- Competition.

Character

- Check on your company’s financial status.
- Personal credit history/creatures of habit.
- Experience.
- Responsible company leadership.
- Timeliness in fulfilling obligations.

Collateral

- “Plan C” Repayment Source.
- Anything of use for security of repayment.
- Personal Guarantees.
- Hard Assets, AR , Inventory, Goodwill.
- Loan to Value Ratios.

Collateral Discounts or LTV's

- Are based upon perishability and/or liquidation value under duress.
- Allow "cushion" for potential fluctuations in value.
- Prior liens are subtracted after discounting to find net available value.

Collateral Discounts…

- Typical discounted values for businesses -
  - Inventory—40-50% (type, obsolescence?).
  - Equipment—50-75% (age, condition, market?).
  - Real Estate—75%.
  - Some inventory and equipment may have little or no value because of limited resale market.

Capacity

- Repayment ability.
- Ability to get repaid.
- <u>Cash Flow !</u>
- Innovation, education, knowledge, experience.
- Consideration of other liabilities.

Common Sense

How to figure Debt Service Coverage …

Part 1—Calculating funds available to service debt

Net Income from Sch. C or Form 1120/1065

+ Depreciation.
+ Interest.
- Family Living Allowance if not in labor expense.
- Allowance for income taxes (actual or 30%).
- Allowance for normal capital expenditures.

= $$$$ AVAILABLE TO SERVICE DEBT.

How to figure Debt Service Coverage …

Part 2 - Calculating DSCR

Divide $$$$ AVAILABLE TO SERVICE DEBT (from Part 1) by Total Principal and Interest payments for 1 year, including any new proposed debt.

Resulting number needs to be greater than 1.0, preferably 1.25x or higher.

Ratio <1.0 means insufficient cash is available to pay debt obligations.

Other things to know about Debt Service Coverage …

- Also looked at on a "Global" basis - including personal debt and other significant businesses owned by client.

- Typically only 50% of outside (non-business) income is considered as "available" to cover non-business debt (if earner is on the loan).

DSCR….

- Usually calculated as a 3-year historical average.
- Major changes in operations—may use projections.

Your Credit Report From a Lender's Perspective

- Hard inquiries.
- Available balances on open accounts.
- Payment history.
- "Maxed Out" credit lines.
- Debt to income.

Consumer Credit vs. Commercial Credit

- Consumer
  - Credit history.
  - Employment history/ earnings potential.
  - Stability (residency, personal reserves etc).

Consumer Credit vs. Commercial Credit

- Commercial Credit
  - Commercial number years in business.
  - Type of business (retail, service, manufacturing etc).
  - Legal structure.
  - Location.
  - Seasonal vs. non-seasonal.
  - Area market, industry in general.
  - Management strength.

Preparing a Loan Package

- Being Prepared:

  - Portrays positive image.
  - Greatly <u>increases</u> chances of securing capital.
  - Improves response time.

Things that make your lender happy …

- A down payment!
  - 20-25% is standard for most projects.
  - More may be required for riskier ventures, such as restaurants and recreational enterprises (35%).
  - At minimum, 10% actual cash is required as part of the typical 20-35% down payment for SBA loans—usually cannot be borrowed money.

- Additional down payment required may be made up with equity in other assets; long-term loans will require real estate equity.
- Seller financing does not count towards the SBA’s 10% cash down requirement.
- Be prepared to put up your house!
- Collateral discounting previously discussed applies!
- Credit worthiness and relationship with borrower may impact requirement.

- Good credit scores (>720).
- Debt Service Coverage Ratio >1.25x.
- Profit on the tax return!
- Working Capital Ratio >1.25x.
    - Current Assets divided by Current Liabilities including current portion of long term debt.
- Abundant collateral.

- Equity (Assets – Liabilities) > Liabilities.
- Adequate insurance to mitigate risks—property, life, health, disability, business continuation?
- Estate and succession plans clearly thought out and in writing.
- Business agreements with partners in writing.

Questions to Ask Yourself

- What is the specific purpose?
- What amount do I need--not how much can I borrow?
- What collateral is available?
- How much cash can I put in the deal?
- Terms: What rate? How long? What is the estimated payment?
- Can I repay the loan?

Other tidbits …

- Lenders can only base lending decisions information you report to the IRS.
- Clients must balance the desire to pay minimal taxes against the need to obtain current and future financing, including a cushion for growth.

- For a spouse's outside income to be considered in debt service calculations, spouse must usually be a co-borrower or guarantor.
- Poor personal credit history of the spouse can hamper the business's ability to get credit or increase rates.

- If you have to be late on something, don’t let it be a payment to the bank or something that’s reported to the credit bureau.
- Bankruptcy is at least a 7-year problem.
- Late payment of taxes, particularly payroll taxes, is a MAJOR problem.

Do Your Homework

- All lenders are not the same
- Research various lenders, ask questions.
- Establish a relationship with your lender
- Different loan programs
  - Ohio Grow Now Program
  - SBA Small Business Administration
  - Gap Financers

Loan Package Check List

___ Business Plan

___ Market Research (where applicable)

___ Resume of Owner(s) and Key Management

___ Sources (bank loan, owner's cash equity, etc.) / Uses (building, inventory, working capital, equipment, etc.) of Funds include Annual Debt Payment of any Loans

___ Copy of Partnership Agreement, Articles of Incorporation, Articles of Organization

Loan Package Check List

(continued)

- ___ Copies of Licenses, Permits, Trademarks, etc.
- ___ List of collateral)with serial numbers where applicable), age, cost, current market value
- ___ Personal Financial Statements for Anyone with 20% or more Interest in the Business
- ___ Personal Federal Tax Returns for the Previous Three (3) Years for Anyone with 20% or more Interest in the Business

Loan Package Check List

(continued)

- ___ Name, Address, Telephone Number of Business Attorney, Accountant, Insurance Agent, Business Consultant
- ___ Twelve (12) to Twenty-Four (24) Month Cash Flow Projection with Line Item Description
- ___ Three (3) years of Projected Annual Profit and Loss Statements
- ___ A Beginning Balance Sheet for Start-Ups or a Projected One (1) Year Balance Sheet for an Existing Business
- ___ Written Quotes on any equipment Purchases / Leases and / or Construction Costs

Loan Package Check List

(continued)

- ____ Copies of any Real Estate/ Other—Purchase/ Lease Agreements
- ____ Legal Description of Real Estate that is a part of the Business or to be used as Collateral
- ____ Recent Property Appraisals or Business Valuations
- ____ EPA Related Documents
- ____ Letters of Intent from Prospective Customers

Existing Businesses Should include the following

- ___ Profit & Loss Statements and Balance Sheets for up to the Previous Three (3) Years
- ___ Interim (within the past 90 days) Profit & Loss Statement and Balance Sheet
- ___ Company's Tax Returns for up to the Previous Three (3) Years
- ___ Aging of Accounts Payable/ Receivable
- ___ Contracts with Customers
- ___ List of Customers and Percent of Business each account for
- ___ Favorable Letters from Commercial Customers

Questions?