

# So You Want to Borrow Money to Start a Business?

Many small business owners cannot understand why a lending institution would refuse to lend them money. Others have no trouble getting money, but they are often surprised to find strings attached to their loan approvals. Such owner-managers often fail to realize that lenders, including banks, have to operate by certain principles just like other types of businesses do, but theirs involve the protection of the money.

There are certain fundamentals of borrowing that you should be conversant with and they include the following:

- Credit Worthiness
- Different Types of Loans
- Amount of Money you Need
- Collateral Provided
- Loan Restrictions, Covenants and Limitations
- The Application Process
- Lending Standards Used for Evaluation

## INTRODUCTION

Inexperience with procedures of borrowing will often create resentment and bitterness, particularly in the case of rejection, so education with the process will help resolve that issue before it is created. The major determining factor of lending decisions is the ability of the borrower to repay the loan. It is also very necessary for the lender to have confidence in that the business owner has a specific idea of the amount of money needed and what it is needed for. Banks often times put limits on business activities in regards to the loan approval to improve the prospect of getting repaid. Most of these restrictions for the borrower's good as well as the bank's protection.

Sound business borrowing is an available avenue for you to utilize to promote and accelerate your company's success. Hopefully the information provided will give you some insight if you have little

or no experience with borrowing and might help you even reevaluate your borrowing operations.

## Is Your Firm Credit Worthy?

Unless you are a business owner that has plenty of capital, the ability to obtain money when you need it could be even more important to the overall operation of your business than a good location or the right equipment, reliable sources of supplies and materials, or even an adequate labor force.

The lender, particularly a bank loan officer, must reach a level of comfort as to your answers or responses to the following five questions:

1. In that the character of the borrower comes first, what sort of person are you? Your ability to manage your business is secondary.
2. What will you do with the money you have requested to borrow? The answer to this question will determine the type of loan and its structure. Money used for the purchase of seasonal inventory requires quicker repayment than does money used to buy fixed assets.
3. How and when do you plan to pay it back? The lender's judgment of your business ability and the type of loan will be a deciding factor in the answer to the question.
4. Is the cushion in the loan large enough? In other words, does the amount requested make suitable allowance for unexpected developments? The banker will look at this question on the basis of your financial statement which sets forth the condition of your business and on the collateral pledged.
5. What is the outlook for business in general and for your business specifically?

## Adequate Financial Data is a “Must.”

The banker wants to make loans to businesses which are solvent, profitable, and growing. The two basic financial statements used to determine those conditions are the balance sheet and the profit-and-loss statement. The statement of condition is a major yardstick for solvency and the latter is a yardstick for profits. A continuous series of these two statements over a period of time is the principle device for measuring financial stability and growth potential. Often times tax returns will be ask for as well to serve as confirmation for the statements presented.

The following information is of interest to the banker:

- **General Information:** Are the books and records up-to-date and in good condition. What is the condition of accounts payable? Of notes payable?
- **What are the salaries of the owner-manager and other company officers? Are all taxes being paid currently? What is the order backlog? What is the number of employees? What is the insurance coverage?**
- **Accounts Receivable:** Are there any indications that some of the accounts receivable have already been pledged to another creditor? What is the accounts receivable turnover? Is the accounts receivable total weakened because many customers are far behind in their payments? (This will be revealed by an aging of the accounts.) Has a large enough reserve been set up to cover doubtful accounts? How much do the largest accounts owe and what percentage of your total accounts does this amount represent?
- **Inventories:** Is merchandise in good shape or will it have to be marked down? How much raw material is on hand? How much work is in process? How much of inventory is finished goods?

When is the last time an inventory was taken? Is there any obsolete inventory? Has an excessive amount of inventory been consigned to customers? Is inventory turnover in line with the turnover for other businesses in the same industry? Or is money being tied up too long in inventory?

- **Fixed Assets:** What is the type, age, and condition of the equipment? What are the depreciation policies? What are the details of mortgages or conditional sales contracts? What are the future acquisition plans?

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## What Kind of Money?

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When you begin to try to borrow money for your firm, it is important to know the kind of money you need from a bank or other lending institution. There are three basic types of money: short term, term money, and equity capital.

Keep in mind that the purpose for which the funds are to be used is an important factor in determining the kind of money needed. But even so, deciding what kind of money to use is not always easy. It is sometimes complicated by the fact that you may be using some of the various kinds of money at the same time and for identical purposes.

A very important distinction between the types of money is the source of repayment. Generally, short-term loans are repaid from the liquidation of current assets which they have financed. Long-term loans are usually repaid from earnings.

### SHORT-TERM BANK LOANS

Short-term bank loans are used for purposes such as financing accounts receivable for 30 to 60 days or slightly longer. Or you can use them for purposes that take longer to pay off – such as building a seasonal inventory over a period of 5 to 6 months.

The purpose of the loan is tied very closely to the repayment program established: for example, accounts receivable loans, when the outstanding accounts have been paid by the borrower's customers, and inventory loans, when inventory loan has been converted into saleable merchandise.

Loans can be granted either on a secured or unsecured basis. Unsecured loans are the most frequently used form of bank credit for short-term purposes. The bank does not rely on collateral but rather your credit reputation.

The secured loan involves a pledge of some or all of your assets. The bank requires security as protection for its depositors against the risks that are involved even in business situations where the chances of success are good.

## TERM BORROWING

Term loans provide money you plan to pay back over a fairly long period of time in an incremental fashion. They may be termed as: intermediate – loans longer than 1 year but less than 5 years or long-term – loans for more than 5 years.

However, for the purpose of matching the kind of money to the needs of your company, think of term borrowing as a kind of money which you probably will pay back in periodic installments from earnings.

## EQUITY CAPITAL

Some people confuse term borrowing and equity (investment) capital. There is a big difference. Equity money does not have to be repaid as it is money you get by selling a part interest in your business.

People come into your company who are willing to risk their money in it and provide new cash for potential income or investment growth.

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## How Much Money?

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The amount of funds you need to borrow depends on the purpose for which you need them. Computing the amount of money required for business

construction, conversion, or expansion – term loans or equity capital – is relatively easy. Equipment manufacturers, architects, and builders will readily supply you with cost estimates. On the other hand, the amount of working capital you need depends on the type of business you are in. Rule-of-thumb ratios may be helpful as a starting point, however, a detailed projection of sources and uses of funds over some future period of time – usually 12 months – is a better and more useful approach. The characteristics of a particular situation can be taken into account in this method by developing a projection through the combination of a predicted budget and a cash forecast.

Budgets are based on recent operating experience plus your best judgment of performance during the coming period. Cash forecasts use your estimates of cash receipts and disbursements during the budget period. In combination, the budget and cash forecast together represent your plan for meeting your working capital requirements.

To plan for your working capital requirements, it is important to know the “cash flow” which your business will generate. You must analyze all elements of cash receipts and disbursements at the time they occur. These elements are listed in a profit-and-loss statement which has been adapted to show cash flow. They should be projected for each month of operation.

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## What Kind of Collateral?

**The kind and amount of security will depend on the bank and on the borrower’s situation.**

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Occasionally, your signature may be the only collateral necessary when making a loan. At other times the bank requires additional comfort that the money will be repaid. The kind and amount of security will depend on the bank and on the borrower’s situation.

If the loan required cannot be justified by the borrower’s financial statements alone, a pledge of security may be used to assist in bridging the gap.

The types of security are: endorsers, co-maker, and guarantors; assignment of leases; trust receipts and floor planning; chattel mortgages; real estate; accounts receivable; savings accounts; life insurance policies; and stocks and bonds. In a substantial number of states where the Uniform Commercial Code has been enacted, paperwork for recording loan transactions such as these are greatly simplified.

### **ENDORSERS, CO-MAKERS AND GUARANTORS**

Borrowers often get other people to sign a note in order to bolster their own credit. These endorsers are contingently liable for the note they sign. If the borrower fails to pay up, the bank expects the endorser to make the note good. Occasionally, the endorser may be asked to pledge assets or securities as well.

A co-maker is one who creates an obligation jointly with the borrower. In such cases, the bank can collect directly from either the maker or the co-maker.

A guarantor is one who guarantees the payment of a note by signing a guaranty commitment. Both private and government lenders often require guarantees from officers of corporations in order to assure continuity of effective management. Sometimes, a manufacturer will act as a guarantor for customers.

### **ASSIGNMENT OF LEASES**

The assigned lease serves as security similarly to the guarantee. It is used, for example, in some franchise situation. The bank would lend the money on a building and take a mortgage. Then the lease, which the dealer and the parent franchise company work out, is assigned so that the bank automatically receive the rent payments. In this manner, the bank is guaranteed repayment of the loan.

### **WAREHOUSE RECEIPTS**

Banks also take commodities as security by lending money on a warehouse receipt. Such a receipt is usually delivered directly to the bank and shows that the merchandise used as security either has been placed in a public warehouse or has been left on the

premises under the control of one of your employees who is bonded (as in field warehousing). Such loans are generally made on staple or standard merchandise which can be readily marketed. The typical warehouse receipt loan is for a percentage of the estimated value of the goods used as security.

### **TRUST RECEIPTS AND FLOOR PLANNING**

Merchandise, such as appliances, boats, automobiles and so forth, have to be displayed to be sold. The only way many small marketers can afford such displays is by borrowing money. Such loans are often secured by a note and a trust receipt.

This trust receipt is the legal paper for floor planning. It is used for serial-numbered merchandise. When you sign one, you acknowledge receipt of the merchandise, agree to keep the merchandise in trust for the bank, and promise to pay the bank as you sell the goods.

### **CHATTEL MORTGAGES**

If you buy equipment such as a cash register or a delivery truck, you may want to get a chattel mortgage loan. You give the bank a lien on the equipment you are buying. The bank also evaluates the present and future value of the equipment being used to secure a loan. How rapidly will it depreciate? Does the borrower have necessary fire, theft, property damage, and public liability insurance on the equipment? The banker has to be sure that the borrower protects their equipment throughout the term of the note.

### **REAL ESTATE**

Real estate is another form of collateral for long-term loans. When taking a real estate mortgage, the bank finds out the location of the real estate, its physical condition, its foreclosure value (i.e., the value that could be expected to be gained from the property if sold), and the amount of insurance carried on the property. These items are verified through the use of a qualified, educated and licensed real estate appraiser. Appraisals take different forms and due to the complexity of the real estate and its use, the size of the mortgage requested, and other factors, appraiser designations may be important.

## ACCOUNTS RECEIVABLE

Many banks lend money on accounts receivable. You are in effect, if you pledge your receivables, counting on your customers to repay your note. The bank may take accounts receivable on a notification or non-notification plan. The notification plan requires the purchaser of the goods to be informed by the bank that his or her account has been assigned to it and he or she is asked to pay the bank. The non-notification plan requires the customers to continue to pay you sums due on their accounts and you pay the bank.

## SAVINGS ACCOUNTS

Occasionally, you might get a loan by assigning to the bank a savings account. In such cases, the bank gets an assignment from you and keeps your savings account. If you assign an account in another bank as collateral, the lending bank asks the other bank to mark its records to show that the account is held as collateral.

## LIFE INSURANCE

Another kind of collateral is life insurance. Banks will lend up to the cash value of a life insurance policy. You have to assign the policy to the bank.

If the policy is on the life of an executive of a small corporation, corporate resolutions must be made authorizing the assignment. Most insurance companies allow you to sign the policy back to the original beneficiary when the assignment to the bank ends.

Some people like to use life insurance as collateral rather than borrow directly from insurance companies. One reason is that a bank loan is often more convenient to obtain and usually may be obtained at comparable interest rates.

## STOCKS AND BONDS

If you use stocks and bonds as collateral, they must be marketable. As a protection against market declines and possible expenses of liquidation, banks usually lend between 60 and 75 percent of the market

value of high grade stock. On Federal Government or municipal bonds, they may be willing to lend up to 90% of their market values.

The bank may ask the borrower for additional security or payment whenever the market value of the stocks or bonds drops below the bank's required margin.

## Loan Restrictions and Limitations

### WHAT ARE THE LENDER'S RULES?

Lending institutions are not just interested in the loan repayments. They are also interested in borrowers with healthy profit-making businesses. Therefore, whether or not collateral is required for a loan, they set loan limitations and restrictions to protect themselves against unnecessary risks and at the same time against poor management practices by their borrowers. Often some owner/managers consider loan limitations a burden. Others feel that such limitations will offer them an opportunity for improving their management techniques.

Especially in making long-term loans, the borrower as well as the lender should be thinking of:

1. The net earning power of the borrowing company,
2. The capability of its management,
3. The long range prospects of the company, and
4. The long range prospects of the industry of which the company is a part.

Such factors often mean that limitations increase as the duration of the loan increases.

### WHAT KIND OF LIMITATIONS?

The kinds of limitations which an owner-manager finds set upon the company depends, to a great extent, on the company. If the company is a good risk, only minimum limitations need be set. A poor risk, of course, is different. Its limitations should be greater than those of a stronger company.

The limitations which you usually run into when you borrow money are:

1. Repayment terms.
2. Pledging or the use of security.
3. Periodic reporting.

A loan agreement is a tailor-made contract covering all the terms and conditions of the loan. With it the lender does two things:

1. Protects their position as a creditor (keeps that position in as protected a state as it was on the date the loan was made) and
2. Assures repayment according to the terms.

The lender reasons that the borrower's business should generate enough funds to repay the loan while taking care of other needs. The lender considers that cash inflow should be great enough to do this without hurting the working capital of the borrower.

### Covenants – Negative and Positive

The actual restrictions in a loan agreement come under a section known as covenants. Negative covenants are things that the borrower **may not do** without prior approval from the lender. Some examples are: further additions to the borrower's total debt, non-pledge to others of the borrower's assets, issuance of dividends in excess of the terms of the loan agreement, and increases in salaries to the principals.

On the other hand, positive covenants spell out things which the borrower **must do**. Some examples are: maintenance of a minimum net working capital, carrying of adequate insurance, repaying the loan according to the terms of the agreement, supplying the lender with financial statements and reports, and obtaining and maintaining certain key ratios to measure the financial performance of the firm.

Loan agreements may be amended from time to time and exceptions made however. Certain provisions may be waived from one year to the next with the consent of the lender.

### You Can Negotiate

Next time you go to borrow money, try to determine the lending terms before you sign. It is a good practice no matter how badly you may need the money. Ask to see the papers in advance of the loan closing. Legitimate lenders are glad to cooperate.

Chances are that the lender may "give" some on the terms. Keep in mind also that while you are mulling over the terms you may want to get the advice of your associates and outside advisors. Remember, however, that once the terms have been agreed upon and the loan is made (or authorized as in the case of the SBA), you are bound by them.

### The Loan Application

A loan application on which you list certain information about your business is required by banks and other private lending institutions, as well as the Small Business Administration (SBA).

For the purposes of an SBA loan, SBA Form 4 is used. This form is generally more detailed than some bank forms. References to assets and/or collateral offered may often times list net values. They should be interpreted to be what you paid for the assets less any depreciation or hence the book value of the asset.

Often times financial data of the business is supplemented by Federal income tax returns as additional confirmation.

The lender will always want to know the types of insurance the company carries as to how much coverage is available, who is protected, and are those insurance policies pledged to other lenders.

SBA, and banks where the principal will serve as a guarantor, will also want to know about the personal financial condition of the applicant. Among the types of information are: personal cash position; source of income including salary and personal investments; stocks, bonds, real estate and other property owned in the applicant's own name; personal debts including installment credit payments, life insurance premiums, and so forth.

## Evaluating the Application

Once the necessary information is supplied completely, the next step in the borrowing process is the evaluation of the application. Whether it be a bank or the SBA, the officer considers the same kinds of things when determining whether to grant or refuse the loan. As an example:

1. The borrower's debt paying record to suppliers, banks, home mortgage holders, and other creditors.
2. The ratio of the borrower's debt to net worth.
3. The past earnings of the company.
4. The value and condition of the collateral which the borrower offers for security.
5. Often times the borrower's management ability, character, along with the future prospects of the borrower's business is reviewed.

While the above are not all the factors, it does give you a good idea of how the lender will be viewing your application for funds. They will always be looking for a primary source of repayment which is typically in a business loan the conversion process of the product or service. Secondly, a source for repayment will be looked for in case the first source of repayment falters. The third source of repayment typically is liquidation of the collateral and the lender will also view that based on projected value.