A MICHIGAN CFO ASSOCIATES WHITE PAPER

Getting the Credit (and Respect) You Deserve From Your Bank

The Small-Business Owners Guide to
Finding and Securing Bank Financing

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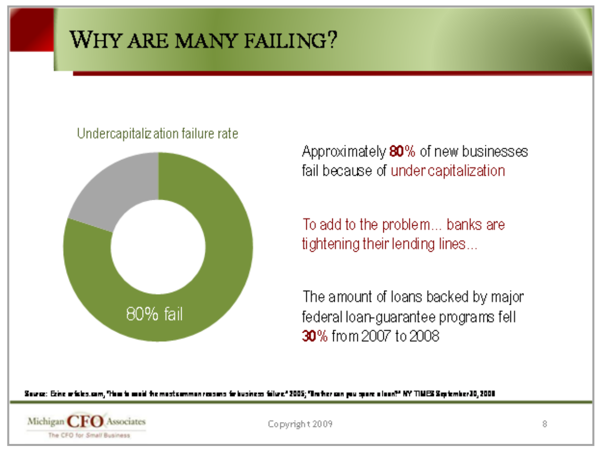
Introduction

Most businesses need some form of credit to operate. Whether its working capital to buy materials or pay employees, or term debt to make capital investments in the business, access to capital is one of the keys to long-term success. In fact, undercapitalization can cause up to 80% of small businesses to fail (see chart below).



For many businesses this means requesting a loan or line of credit from a bank. Unfortunately the process can be intimidating, complicated, seemingly illogical, frustrating and sometimes adversarial. But it doesn't have to be. Like many things in life, experience and knowledge of the process and success factors often come through failing the first time or two. Unfortunately, in some cases failure to obtain the needed capital could ultimately mean failure of the business.

This guide was created to outline the process we follow when seeking funding for our clients in order to present information in the best possible light and maximize the chances of success (i.e., getting the bank to say YES).

Why Loans Get Rejected

There are many reasons a loan request might get rejected, but here are a few of the more common ones:

- Insufficient Collateral
- Recent, poor financial performance or a history of poor performance
- Insufficient capital/equity from the owner (not enough “skin in the game”)
- Owner does not convey a sense of being trustworthy (this is more common than you might think)
- Poor financial records and/or unqualified financial personnel/disciplines
- Unrealistic expectations or being overly optimistic (on the part of the business owner)
- Changing risk profiles from the bank (by industry, company or loan size, geography, etc.)

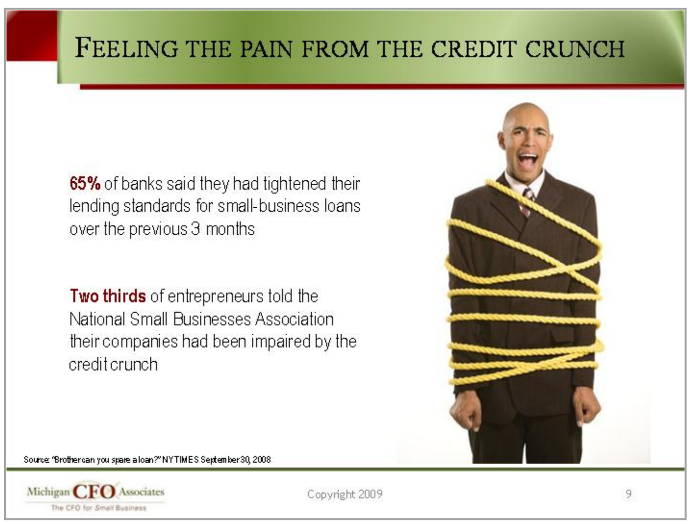
These (and other) reasons for failure can generally be grouped into a few different categories:

i. The business is not creditworthy (or not creditworthy yet);
ii. The business is creditworthy, but cannot support the amount requested;
iii. The business is creditworthy, but is doing a poor job of presenting its request in the best possible light;
iv. The bank is not making loans for reasons unrelated to the creditworthiness of the business

Generally, there are solutions to each of these categories. For instance, if the business is not creditworthy, an aggressive plan is created to improve profitability and cash flow, so that the company may be creditworthy in 6 – 12 months. Alternative funding sources can be explored in the meantime.

If the business is not communicating its creditworthiness effectively, a more experienced financial professional should be used to review the plan and presentation strategy and create an effective loan package and process.

If the bank or banks in question are not making loans, then other banks or sources can be approached. The value of experience and good contacts in the financial community can dramatically reduce the time and frustration with this situation. Knowing whom to ask is almost as important as knowing how to ask and what to ask for.



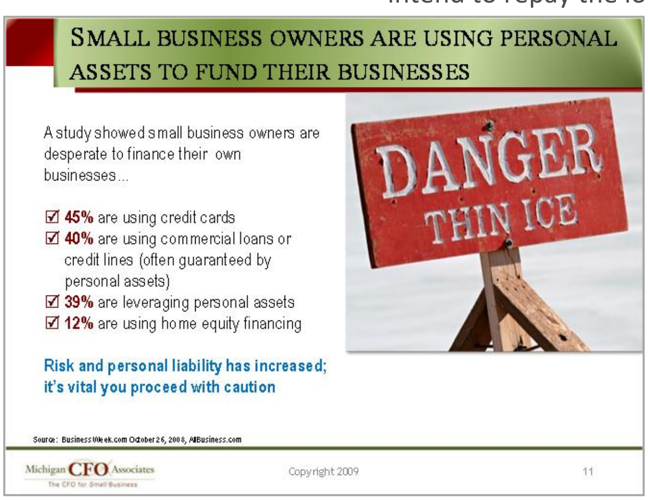
Preparation is Key

Unless your loan request is a "slam dunk" for approval, requesting a loan without knowing what you want, why you want it, how you're going to repay it, why it's a good risk for the banker, and <u>providing the documents to prove your case</u> – your chances of success are greatly reduced.

Some specific strategies for making sure you're prepared:

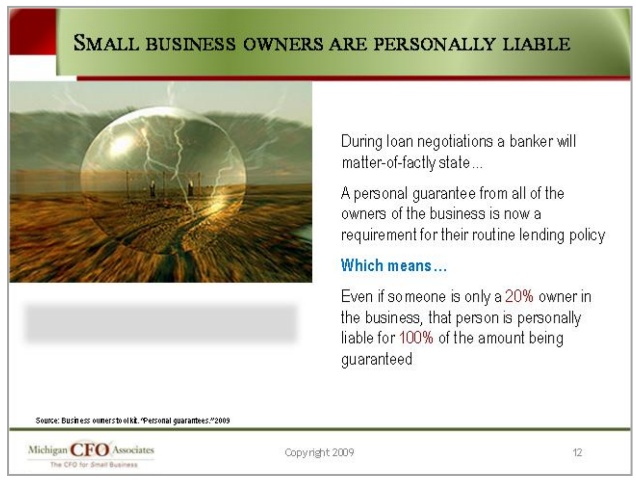
- Don't make your request too soon – get all your loan package documents together (See page 6) and **anticipate the questions** that are going to be asked.
- You must have a story – banks don't lend money just because you need it or want it. What is the reason for this loan? What is happening in your business, industry, geography, etc. that is relevant to your company's success? How does the loan fit into these circumstances?
- Keep in mind the yin/yang relationship of the two different functions within the bank. The "Relationship Manager" (i.e., business development arm of the bank) is seeking to bring in new business. His or her focus is on generating businesses and is more friendly, accommodating, and positive. However, to get the loan approved, generally it has to go through a **Credit Department** or **Loan Committee** which is more objective and is evaluating hard financial data first and soft subjective data second. You must have a loan package with solid data to maximize your chances of success.
- What do they want to know? What are they looking at? In general, they're looking at **The Five C's of Credit**, which are:

1. **Capacity** to repay is the most critical of the five factors; it is the primary source of repayment - cash. The prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan. Payment history on existing credit relationships - personal or commercial- is considered an indicator of future payment performance. Potential lenders also will want to know about other possible sources of repayment.



2. **Capital** is the money you personally have invested in the business and is an indication of how much you have at risk should the business fail. Interested lenders and investors will expect you to have contributed from your own assets and to have undertaken personal financial risk to establish the business before asking them to commit any funding.

3. **Collateral** or guarantees are additional forms of security you can provide the lender. Giving a lender collateral means that you pledge an asset you own, such as your home, to the lender with the agreement that it will be the repayment source in case you can't repay the loan. A guarantee, on the other hand, is just that - someone else signs a guarantee document promising to repay the loan if you can't. Some lenders may require such a guarantee in addition to collateral as security for a loan.
4. **Conditions** describe the intended purpose of the loan. Will the money be used for working capital, additional equipment or inventory? The lender will also consider local economic conditions and the overall climate, both within your industry and in other industries that could affect your business.
5. **Character** is the general impression you make on the prospective lender or investor. The lender will form a subjective opinion as to whether or not you are sufficiently trustworthy to repay the loan or generate a return on funds invested in your company. Your educational background and experience in business and in your industry will be considered. The quality of you references and the background and experience levels of your employees will also be reviewed.



Source: www.mbda.gov

How Much Should You Ask For?

How much you request and how much you need may be two different numbers. And frankly, the only way to answer these questions is to create financial projections that look out over the next 12 – 24 months and see what the data shows. Financial projections should include **all 3 Financial Statements** (Income Statement, Balance Sheet and Cash Flow Statement) and ideally a **Collateral projection**, especially if you're seeking a revolving line of credit. The Collateral projection is used to calculate bank lending formulas which will show how large a loan your business can support.

If you're saying to yourself *"That sounds complicated"*, well you're right, it is complicated. There are tools that you or a capable finance person can use to simplify this process (see the resources section at the end of the report). But it's important to understand that **these calculations are going to get done one way or another** – by you and your people, or by the bank. There are, however, several advantages to doing them yourself (internally):

- You know how much to ask for, because you've calculated what the business will support, and you can tailor your request based on this data

- You're starting the process using YOUR assumptions, (why let them decide on the assumptions) which can be discussed/negotiated with the bank if necessary. If you allow the bank to do the calculations, you may never see them, and therefore not know how or why they've reached a decision. Do the calculations yourself, and you at least *begin* the process with control
- It shows that you're serious about the process specifically, but also business in general. The majority of businesses do not go to this level of effort to procure a loan. That makes you unique and significantly increases your credibility as a serious business owner, as well as a better credit risk.
- There is a chance that the bank won't even question your data because you're doing the work for them and if it's thorough – depending on the bank and circumstances – it may just get rubber stamped and approved
- Finally – and perhaps most importantly – this is information you as the business owner need to know anyway – regardless of the bank's involvement

Your loan request should be based on demonstrable, believable data (i.e., the "loan package" covered below), not your gut feel, or any other subjective measure. Of course, all projections are based on assumptions, so documenting your assumptions is key. But your request must be based on data under a given set of assumptions, not guesswork.

Getting the Loan Package Together

In most cases, you'll be approaching more than one bank or funding source for credit simultaneously. So we want to get all the documents together that they're likely to ask for (preferably in a .pdf electronic format), and then send them the specific documents they've requested from our "menu" of available documents. That menu of documents typically includes the following:

- Last 3 years corporate tax returns
- Last 3 years personal tax returns from owner(s)
- Last 3 years CPA prepared financial statements
- Current year interim financial statements
- Financial projections (as discussed above), and relevant support schedules (e.g., backlog, new business opportunities, etc.)
- Current A/R & A/P Agings
- Current Inventory listing (if applicable)
- Most recent equipment appraisal (if applicable and available)
- Most recent building appraisal and environmental studies (if real estate is owned)
- Personal Financial Statement from owner(s)

Another document that they may or may not ask for – but you'll want to provide – is an **Executive Summary** of what's happening in the business. This may be a combination of financial & non-financial items (prospects, products, pricing, initiatives, etc) that give the bank a quick sense of what's happening in your business and what you're excited about (more on this later).

It's important to know a few things about the process of getting credit. And it helps to put yourself in the shoes of the banker, and think about what he or she is experiencing on a daily basis, so we can tailor the loan package and request to stand out from all the others.

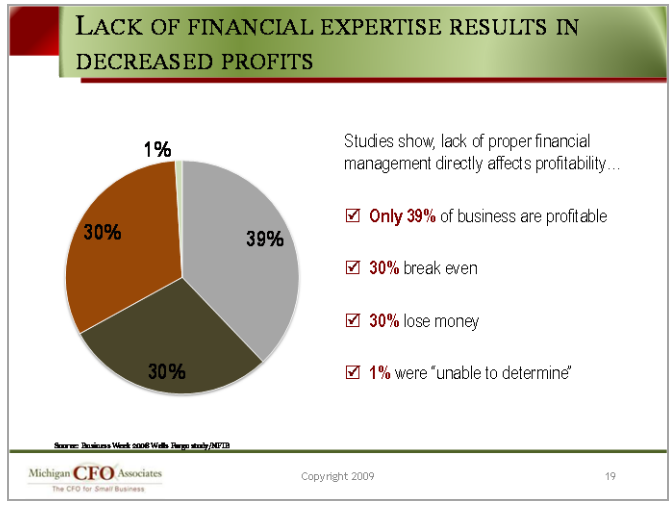
- Most businesses are not prepared to provide the documents listed above, and simply having them all ready to go in a presentable format (i.e., not sloppy) makes you stand out from the get-go. Don't supply the bank with a pile of unorganized, sloppy crap and expect them to sort it out. It reflects poorly on you.
- Bankers rarely get documented projections and almost never get the types of projections we discussed above (cash flow & collateral projections). These documents are critical to your success in getting what you want. Let me say it again: detailed, realistic, well constructed projections that demonstrate how the bank gets paid back are critical – especially if you're asking for an increase to an existing line of credit. There's an old saying: ***In God we trust, all others bring data.*** Let your data do the heavy lifting in this process
- Create the menu of reports once, distribute them to multiple qualified banks to get the best possible proposal

- With the exception of the Executive Summary and the Projection Package, DO NOT provide financial documents that were not asked for unless they clearly, unequivocally help your proposal. You must present your data & story in the best possible light – don't shoot yourself in the foot by providing data or documents that are unflattering or raise questions that otherwise wouldn't have come up. Note: This does not mean mis-lead the bank; it means give them what they ask for and limit all other documents to those that are helpful and do not create additional probing.

All Projections Go Up

A quick word about projections. Bankers review loan packages all the time, and while I don't know the statistics, I'm going to guess that 95+ percent of projections they look at show a rosy, upward trend in sales and profits. According to research we did, only 39% of businesses are profitable. . . and that was based on data from 2008 (it's likely worse).

So bankers see these rosy pictures painted by various business owners day after day after day. Then, while reviewing the projections, the owner will then matter-of-factly state ***"And these numbers are conservative"*** implying that the actual results should exceed the already rosy projections. If you listen closely, you can almost hear the banker say *"SURE THEY ARE".*



Do your best to avoid the normal, predictable routine that inexperienced business owners follow. Here are some keys to keep in mind:

- Base your projections on objective data and document your assumptions;
- Don't say ***"These numbers are conservative".*** Demonstrate to the banker that your numbers are conservative (if they are) by showing them the underlying assumptions and data that make them conservative. Otherwise don't say it.
- If at all possible, use an independent financial professional to provide ***actual and perceived objectivity*** to your numbers. Owners are notoriously overly optimistic and (from the bank's perspective) potentially manipulative. Using a professional that has experience in securing credit – such as your CPA, internal Controller, or an Outsourced CFO – will add significant credibility to your data and presentation.

Make it Easy for Them

Bankers are busy people, and they don't make any money evaluating loan proposals. While they may want additional business, you can't rely on them to double check your data, reformat reports, calculate things in the most favorable fashion for you, or make sure you've presented your information well.

When putting your loan package together, you want to make it easy for them; if at all possible do all the work for them so it's just a matter of reviewing YOUR calculations instead of creating their own based on what you've given them.

A few tips:

- Have the requested documents in an order that follows a logical flow
- Include an Executive Summary that clearly states WHAT you are asking for and WHY

you are asking for it – as well as any conditions you'd like present or not present (loan formulas, personal guarantees, sweep accounts, etc.)

- Keep in mind that the data will be reviewed by a variety of people within the bank, so it's better to include key points in writing, as opposed to hoping that the person or people you talk to relay the information to the Credit department, Loan Committee, etc. Don't rely on them to "sell you" or remember key points – write them down.
- Anticipate the questions they might have and if necessary, formulate answers in your Executive Summary.

Presenting Your Request

Ideally, you want to deliver the loan package to the bankers in person, and preferably at your location. If possible, have as many of (if not all) the key decision makers from the bank present. That way you can give everyone the presentation and data first-hand and answer any questions they may have.

I've made the mistake in the past of simply forwarding documents to a banker I've never met face to face, or to a banker who hasn't visited my client's plant or location. This is a mistake, and you should avoid it if at all possible. While the decision is mainly based on objective data, do not underestimate the value of subjective components. Having them on site, seeing your operation, seeing your people, and beginning to build the relationship is very important. Obviously you want every detail of your operation to be impressive on that particular day.

Your physical location, along with the presentation should be a carefully scripted process that leads the bank down a greased chute towards "YES". You and/or your financial person should be 100% prepared to walk the bank through your documents, explain the complicated areas, touch on the key items, pages, ratios, etc. that lead the bank to the only plausible conclusion: Make the Loan.

Simply put, this requires preparation.

Finally, as the business owner you should provide a passionate presentation. Don't be afraid to show the bank your passion for what you believe in. Passion and enthusiasm are contagious and just may be the difference in an otherwise dry presentation.

After the Loan Closes

Maintaining a good banking relationship is critically important; you never know when you're going to need their help. It pays to invest in this relationship and stay in contact with your banker, even after the loan closes. Some tips for a good banking relationship:

- **No surprises**. Nothing is going to de-rail your relationship faster than a large, negative surprise. Surprises may come in a few different forms, but here are two common ones:

  1) **Accounting surprises** (large physical inventory adjustment, A/R write-offs, corrections for sloppy or incompetent accounting); and

  2) **Situational surprises** (loss of a key customer, a project going way over budget, shrinking margins, etc.)

- **Make their life easy & make them look good**. Bankers have bosses and policies that they are accountable to. It doesn't take much effort to make them look good, and it is extremely short sighted to ignore these simple steps and make them look bad. Examples:
  - **Deliver on time**. Deliver your financial statements and other required reports by the due date or sooner. Don't make them call you every month looking for the same stupid report. If financials are due 45 days after quarter end, deliver them on time.
  - **Communicate**. If there is a problem or delay, communicate. Be proactive. Don't wait for them to call you.
  - **Bad news**. If there is a large negative surprise, figure out your strategy for communicating it, then do it. Remember, large negative surprises make you AND your banker look foolish to the bank higher-ups.

The easiest way to avoid surprises is to **work with competent, experienced financial people that follow a process.** Bookkeepers are fine, but they are not a substitute for a financial professional. And frankly, relying on a bookkeeper to advise you of problems in your multi-million dollar business is asking for trouble. And you should expect it. They're a bookkeeper for a reason. Use competent people for planning, analysis and strategy. Leave the bookkeeper to payables and receivables.

> ***"Relying on a bookkeeper to advise you of problems in your multi-million dollar business is asking for trouble. And you should expect it."***

Summary & Resources

Getting "The Credit You Deserve" is a process. By taking the time to prepare your plan, supporting documents, and presentation, you greatly increase your chances for success.

Resources:

- **XL Projection PRO.** This is the spreadsheet model we use in preparing loan packages for clients. It produces all of the reports detailed above and can be used with almost any type or size of business. It is available for standalone purchase. For more information please visit www.XLprojectionPRO.com
- *The #1 Financial Mistake Made by Small-Business Owners*. Free Whitepaper available at www.michiganCFO.com/freereport.
- **Executive Briefing: WARNING: SLOW Growth Ahead**. This webinar is based on six months of research commissioned to identify the causes of stagnation in small-businesses and how to identify the warning signs – as well as what to do to avoid them. The webinar is delivered regularly; visit www.michiganCFO.com/webinars to view the schedule.
- **CFO "GAP Analysis".** This is an assessment of financial strengths and weaknesses from a CFO's perspective. We conduct only two per month; if interested contact us at the number below. (There is a nominal charge).

Visit www.michiganCFO.com for additional resources including webinars, articles, newsletters and media appearances.

**To learn more about how a Virtual CFO can benefit your organization,
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