CALIFORNIA SBDC

Los Angeles Regional Network

# What to Know and What to Do Before Applying for a Loan for Your Business

### Going after a loan? These are the six essential areas a lending institution will consider

## Your Personal Character

The very first thing a loan officer looks for when reviewing a business proposal is some indication of how trustworthy you are. If your background demonstrates a lack of integrity, your request will not be considered, even if it the best business idea there is. They want to know a lot about you personally; who you are, how long you've been in business (if at all), and your history of meeting your financial obligations. Your credit history will be checked to see how you've handled previous debts. Why? Because if you are a small business, in the eyes of the lending party you ARE the business, and how you've handling things in the past is a good indicator of how you'll handle them in the future.

**What To Do:**

Know your credit report. Get a copy well before your loan request is made, and if it is less than perfect (which most are) fix or resolve any mistakes in the report. If you have a low score because of a bad payment history or too much debt (I have been told by some in the banking industry that credit card balances should not exceed anywhere from 5-15% of your gross income), clean it up before applying. It takes time to do this, so begin this task well in advance.

Make sure you have some good personal references. It does make a difference if somebody they may know and respect will vouch for you.

If you have some gaps in your work history or issues in your background be prepared to explain, in detail, the reason(s) for these "black marks". Honesty is the best policy! Be truthful, but you don't necessarily have to be blunt or negative.

## Your Ability to Actually Run the Business

An old saying goes "just because you can bake bread does not mean you can run a bakery". The lending institution needs to be sure that you or the person making the business decisions knows what they are doing. Bad management is the primary reason why most new businesses don't make it more than 3 years, and your lender is not in business to lose money on bad investments.

Many times the knowledge, skills and abilities (KSA's) you have may be something you can apply to the new company, but are not necessarily something you learned in your new company's area of business. For example, you may have worked as a manager in a very successful retail clothing store, but you want to open a dry goods store. You basically understand what it's going to take to work in a retail environment, but will have somewhat of a learning curve when it comes to the dry goods business. The skills you can bring with you are called transferrable skills and are important, so let the lending institution know you have them.

**What To Do:**

Look at your resume and see how much of your background is transferrable to your new business. If you do not have adequate experience, it may be a good thing to go to work for someone who does essentially what you hope to do yourself and learn the ropes.

The lending institution will want to see a brief bio/resume on you and anyone in a key position in your new company, to see that those in decision making roles know what they are doing. Have a brief bio/resume prepared for all those persons involved with you.

If you do not have the necessary KSA's to run this new business, you may want to seriously consider hiring someone with more experience to run it for you – at least for the interim – until you are capable. This will probably make a big difference in the chances of you have of getting the funds.

## Can You Pay Me Back?

The biggest question in the lending institution's mind, if in their estimation you seem to be a credible, trustworthy, knowledgeable candidate, is if you can pay back the money they would be lending you. Lenders are conservative by nature, and the information you are providing them in your business proposal HAS to be objective, accurate, believable and concise. The conclusions they have to reach after reading the proposal should be that it is a solid idea based on credible information. While there are no guarantees, their exposure to risk seems to be palatable.

Keep in mind that the person you are talking to about the loan did not go into their field because they wanted to sell, but in essence what you are asking them to do is sell your idea to the loan committee. They have to feel comfortable with the idea and with you as well. If they present your request to the committee and it is based on bad or inadequate information, not only will you not meet you obligation to repay but you quite possibly have damaged the loan officer's reputation and maybe even his/her job.

**What To Do:**
Be prepared to demonstrate several things in your plan; how you can make your loan payments, at what point are you estimating you will show a positive cash flow and eventually profit (they are not the same thing!), and how big a profit you expect to see, when, and will it be sustainable.

Create a minimum of a 2 year projected cash flow – which if the truth be known – is the foundation for generating your business proposal. This cash flow projection is part of your overall "pro forma" and is the second thing a lending officer will review, after your Executive Summary. Most, if not all, lending institutions require this and some need 3 years' projections, all based on monthly income and expenses.

Every figure you put in the cash flow has to have some sort of "reasonable assumption" backing up the reason you chose to use that number to represent the income or outgo of money. The litmus test is that if you use a figure, you should be able to generate some sort of documentation as to why the figure you used is accurate. And example would be the power bill – did you just guess or actually call the power company to find out the true costs?

Key point – Be sure your numbers show "seasonality" of both sales and expenses. I know of very few companies that have the same costs or income every month for everything. Also, do not round your number off to the nearest $50. Make them accurate to the dollar if possible, and be able to "prove" your number is accurate. Think about it – when is the last time you got a phone bill for exactly $100 every month? Do you think a loan officer doesn't notice things like that? Just that simple change can make a huge difference in your chances of success.

Key Point – If you are a new business it may be best to begin the forecasting process by determining your breakeven point on the cash flow, then go on to show if this number is realistic and sustainable. What you are trying to generate is a feel for how much business you HAVE to do to cover your costs, then figure out how much more than that you expect to do. Keep it realistic. It's better to be pleasantly surprised than mildly disappointed when projecting sales figure, and most business owners tend to be pretty optimistic when it comes to sales. Also, determining your breakeven will give you a firm grasp as to how the business is doing at any given point. (ie., I have to sell 40 units a week to cover my costs for the month).

## Your Business Environment

What your business is going to offer and where it is going to offer it is a big part of the decision making process of a lending institution. Questions like "who will be our competitors?" and "where are they located?" may be a couple of the questions you need to be prepared to answer. Bigger questions like the overall state of the general economy may play a role, as well as "why will your product/service be better than what's already out there?" might be raised.

What To Do:
When thinking about your business, consider a couple of things;
If there are no direct competitors in your immediate geographic area, is it because 1) there is not enough demand to support the business in the region, 2) what you plan to offer can be gotten easily and more cheaply online, or 3) nobody thought of it?

If you are planning an online business you have to keep in mind that your marketplace is international; what may seem to be good for you in your geographic area may not be what is wanted or needed elsewhere. Do you homework on determining what else is available online that meets the needs you hope to fulfill.

Is your business idea one that is highly dependent on seasonal activity or drastically affected by the overall economy? Areas such as tourist-based industries, gift items, sports related, and other non-essentials can be harder to get a loan for than other businesses that deal with more basic products and services.

Your competition is not limited to just those who do what you do. If your product or service is one that would be purchased with disposable income (money spent for non-essential items), your competition could be virtually anything that someone could spend their money on to have fun, feel better about themselves, get something they really don't need but would like to have, etc. For example, if you have $50 in your pocket and you were going to spend it on something that was not essential, what would or could you spend it on? A nice meal? A trip to the mall? Get your nails done? Download some music? Buy a subscription to a magazine? All these things could be considered indirect competition for your business.

One other thing to consider; is your direct completion going to be other small businesses or Wal-Mart? It does make a difference….. Research your competition objectively.

## Collateral and Loan Guarantees

While lending institutions are looking primarily at your business's ability to repay what you owe them, they do want to have some sort of assurance that if the business goes belly up there is a way for them to recoup the potential loss from the bad loan. What they would like to see is something that is easily converted into cash, and is equal in value (or more) that what you're requesting.

And even if you do get a loan, it will not be approved for 100% of what you need; historically you will have to generate anywhere from 10 to 30% of the capital from elsewhere, and not loans from other creditors. The only real loan that makes sense to use is a second mortgage on a house, but unless you have a lot of equity in the house it will lessen the chances of getting the loan you're applying for – especially if you are planning on using the house as collateral for the loan you're asking for from them.

Some things that are not considered to be too good for collateral are:
Rolling stock – cars, trucks, etc.
Inventory – don't expect much in the form of value here. Maybe 25% of what it cost you.
Restaurant equipment
In some cases, undeveloped land

It is not an unusual practice to require that all principle owners of the business cosign and/or provide some sort of personal guarantee for the loan; meaning they are responsible for repayment if your business fails. This really accomplishes two goals – it assures the bank of recourse if the business is not successful, and it demonstrates that there is a commitment from the participants in the business venture to make it work.

What To Do:
Before applying for a loan, make sure everyone involved is aware of the need for their potential guarantee on the loan repayment. They will probably have to go through the credit check by the lender as well.
If you're planning on using something that can be appraised for its value (like a house), have a recent appraisal available for review by the loan officer.
Be able to document your costs thus far in the business to show you have invested the necessary amount out of your pocket to cover the equity you need to have to secure the loan.
There's nothing wrong in asking the loan officer what they would consider viable for use as collateral.

## Conditions and/or Terms of the Loan

Significant issues that may affect our application for a loan include:

How much money do you want to borrow?
What are you going to use it for?
How long do you want to take to pay it back?

When a lending institution gets a request for a loan, what the loan is going to be used for is crucial to their decision making process. It is in your best interest to spell out where the money is going to be used, and how the loan is going to increase your income over and above the cost of the loan repayment.

If you are starting a business, be prepared to include at least 90 days of operating expense in the loan request; you are not going to be running at full capacity right off the bat – your business will ramp up - and you will need some money to keep the doors open during that time. Odds are the operating capital you request will not be gone in 90 days; as you increase sales you will require less and less of that money and it will be your cushion for much longer.
Some business types will historically need more than 90 day working capital, so ask what is the typical amount of working capital included for your type of company when applying for a loan.

Where the money is going is also crucial. If you are going to use the majority of the money for debt consolidation or to increase your salary, you are dramatically limiting your chance of being funded. Lending institutions are much more open to loaning money for purchasing equipment or something that is tangible, retains its value, and they can repossess if necessary.

The length of a loan has role in the overall decision. The difference in the monthly payments between a 5 year and 10 year loan can be significant to the cash flow, and can make or break a company's success. It would be in your best interest to run your cash flow projections using information provided by your loan officer giving you the typical loan length and interest rate.

What To Do:
Make sure your terms of the loan are reflected in your payment for the loan in the cash flow projections.

If you are planning on starting a business, do not put in the salary you'd eventually like to make. Determine your "survival level" salary needs and use that number. If you are making a profit at those levels, those profits could be your salary increase. A lending institution is not going to look at a loan where a significant portion of the money they're loaning is going into your pocket.