SMALL BUSINESS LOAN GUIDE

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A guide to help small business owners navigate the loan application process

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This guide is not to be considered legal advice. The information contained herein is strictly the opinion of the author and not necessarily that of Pan American Bank.

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WHY THIS GUIDE?

THE BUTCHER, THE BAKER, THE CANDLESTICK MAKER

As we head into 2014 we are beginning to see signs of a modestly improving economy. With an improving economy comes a wave of entrepreneurs and small business owners looking to capitalize by growing their existing business or starting a new business. For many of these entrepreneurs and small business owners the path to success requires a detour through a lender to fund their growth. And most of these entrepreneurs and small business owners hate every moment of the process.

Entrepreneurs and small business owners tend to be very good at what they do. Whether their business involves cutting meat, baking bread, or making candlesticks, these individuals manage to make a living "doing their thing." Unfortunately, when it comes to applying for a loan, the owners of these businesses usually do not know the intensive the process that is required to approve a loan.

This guide was written to provide a roadmap and set expectations for small business owners seeking a small business loan. Whether the loan will fund a start-up or expand an existing business, the process requires a thorough look into the business or proposed business and requires the submission of sufficient documentation to allow the lender to develop a strong opinion of the risk that underlies a loan to the business.

This guide will allow small business owners to understand the process that lenders undertake when reviewing a loan application. While each lender has its own eligibility criteria there are aspects of every small business loan application process that remain consistent. This guide will provide small business owners with sufficient information to competently navigate the small business loan process – whether they are butchers, bakers, or candlestick makers.

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EQUITY INVESTMENT

Small business owners must have a “reasonable” amount invested in their business to receive favorable consideration for a loan. This ensures that, when combined with borrowed funds, the business can operate soundly.

During the underwriting process lenders examine the business' debt-to-equity ratio to understand how much money the lender is being asked to lend relative to how much the principals have invested. The smaller the ratio, the stronger the company, and the more likely a lender will approve the loan.

Each industry has its own benchmarks for low, moderate, and high debt-to-equity ratios. Within each industry there also may exist segmentation based on factors such as revenue size, location, years in operation, franchise/non-franchise, etc. Industry advocacy organizations often maintain metrics, including debt-to-equity ratios. Small business owners should be aware of their debt-to-equity ratio relative to their industry prior to applying for credit in order to fully understand the impact that the borrowing will have on the business.

Sample Debt-to-Equity Ratios – Restaurant Industry				
	03QTR13	02QTR13	01QTR13	04QTR12
Debt-to-Equity Ratio	0.76	0.75	0.75	0.75
SOURCE: CSIMarket.com http://csimarket.com/Industry/industry_Financial_Strength_Ratios.php?ind=914				

Principals can invest assets that contribute to the operations of the business and/or invest cash which can be used to acquire such assets. The value of invested assets is substantiated either by invoices or appraisals.

Strong equity with a moderate to minimal debt level can produce a debt-to-equity ratio well below industry average. Under these circumstances the principals have provided the business with an improved ability to sustain itself during tough times. In contrast, a small business that has minimal or non-existent equity has a higher risk of default – particularly during difficult periods.

A STORY OF TWO INVESTORS

Joe and Steve were lifelong comic book enthusiasts. One day the two decided to open a comic book shop. Joe invested his comic book collection that was appraised at a wholesale value of $500,000. Steve, choosing to be a 50% partner, invested $500,000 cash in the business. Joe’s wholesale value contribution went directly to inventory and Steve’s cash injection went to other purposes, including leasing a storefront, paying for tenant improvements, and paying for marketing expenses. Joe and Steve also received a $100,000 loan for working capital purposes. With debt of $100,000 and equity of $1,000,000, the business had a debt-to-equity ratio of 0.10. Whether this ratio is low, moderate, or high depends on the ratios of other comic book stores.

Strong equity investment demonstrates to the lender that the principals are very committed to their business. Sufficient equity is particularly important for new or expanding businesses as there is a period of time after start-up or expansion in which the business is not yet profitable and will require the ongoing financial support of the principals.

Weak equity investment increases risk. However, low equity in relation to existing and projected debt can be overcome with a strong showing in all the other credit factors. Non-existent equity can make obtaining a loan almost impossible, as the principals have not shown a commitment to the small business.

Determining whether a company's level of debt is appropriate in relation to its equity requires analysis of the industry, the company's expected earnings, and the viability and variability of these earnings. The stronger the support for the projected profits, the lower the risk, and the greater the likelihood that a loan will be approved. Applications with high debt, low equity, and unsupported projections are prime candidates for loan denial.

CASH FLOW PROJECTIONS

A significant percentage of small businesses struggle and/or fail due to their inability to adequately manage their cash flows. A business cannot operate very long when cash outflow exceeds cash inflow. Every small business must monitor its cash flows to prevent a serious business disruption.

Many businesses' cash flow issues stem from an absence of cash flow projections that adequately address day-to-day activities. Businesses that do not take the time to thoughtfully estimate their cash flows over the coming period (day, week, month, quarter, etc.) place themselves at serious risk.

For example, a poor or nonexistent cash flow projection can create significant problems if the business has not addressed how it will manage its cash in between the time that it must pay vendors, employees, and others, and the time that it collects from its customers. A business' cash management is extremely important to ensure that the business has the liquidity to adequately support day-to-day operations. Strong cash flow management can mean the difference between being in and out of business.

When applying for a loan the small business must be able to demonstrate that it can meet all of its liabilities as they come due. Lenders require that borrowers have the ability to repay their obligations and proposed obligations through cash generated from operations. The lender will evaluate the cash flow from the business, the timing of payments, and the probability of successful repayment of the loan before making a credit decision.

Principals must ensure that adequate time and effort has been invested to prepare a reliable cash flow projection. This is especially important when the projections are for a new business or an expanding business with anticipated revenues and expenses exceeding past performance by a significant amount.

In addition to demonstrating the ability to meet future obligations through a cash flow projection the principals and the business must also demonstrate their willingness to make payments by keeping a credit history that shows timely payment of outstanding debt. Payment history on existing debt is considered an indicator of future payment performance. As such, small business owners must pay all of their bills and other debts on time to demonstrate that the small business and its owners can be relied upon to repay a loan. Lenders will also want to know whether the business has any contingent sources of repayment in case cash falls short of projections.

SAMPLE CASH FLOW PROJECTION			
	Jan	Feb	Mar
Starting Cash	$0.00	$68,200.00	$56,400.00
Equity Investment	$100,000.00	$0.00	$0.00
Loans/Transfers	$0.00	$0.00	$0.00
Cash Collections	$0.00	$15,000.00	$25,000.00
Total Cash In	$100,000.00	$83,200.00	$81,400.00
CASH OUT			
Start Up Expense	$5,000.00	$0.00	$0.00
Lease	$1,000.00	$1,000.00	$1,000.00
Salaries	$10,000.00	$10,000.00	$10,000.00
Utilities	$500.00	$500.00	$500.00
Office Supplies	$2,500.00	$2,500.00	$2,500.00
Postage	$300.00	$300.00	$300.00
Taxes	$300.00	$300.00	$300.00
Professional Svcs	$200.00	$200.00	$200.00
Repairs/Maintenance	$0.00	$0.00	$0.00
Marketing/Advertising	$10,000	$10,000	$10,000
Travel	$2,000	$2,000	$2,000
Total Cash Out	$31,800.00	$26,800.00	$26,800.00
Ending Cash	$68,200.00	$56,400.00	$54,600.00

WORKING CAPITAL

Working capital is defined as the difference between current assets and current liabilities. Current assets are the most liquid assets on a business' balance sheet. They are cash or can be converted quickly to cash. Current liabilities are any obligations due within one year. Working capital measures what remains once current liabilities are subtracted from current assets. Working capital can be a positive or negative amount. Working capital is available to pay the business' current debts, and represents a cushion or margin of protection.

Positive working capital is essential for a small business to meet its continuous operational needs. The availability of working capital influences the business' ability to meet its trade and short-term debt obligations, as well as to remain financially viable. If the small business' current assets do not exceed its current liabilities, the business runs the risk of being unable to pay short term creditors in a timely manner.

SAMPLE WORKING CAPITAL	
Cash	$200,000
Accounts Receivable	$600,000
Inventory	$100,000
Total Current Assets	$900,000
Accounts Payable	$300,000
Other Current Liabilities	$100,000
Total Current Liabilities	$400,00
Working Capital	$500,000

Businesses that are seasonal or cyclical often require more working capital to stay afloat during the slow period. Although a small business may make during the year more than enough to pay all of its obligations, it must ensure that it has enough working capital throughout the year to meet its short term obligations. For example, a company may make the majority of its sales over the holidays, resulting in large payoffs at the end of the year. However, the company must have enough working capital during the entire year to buy inventory and cover payroll when revenues and cash flows are lower.

COLLATERAL

Collateral is a form of security that can be used to assure the lender that the small business has a secondary source of loan repayment if the primary source (cash flow from operations) fails. Assets such as equipment, buildings, accounts receivable, and inventory are considered possible sources of repayment if they can be sold by the lender to settle the outstanding debt. Collateral can consist of assets that are usable in the business as well as personal assets that remain outside of the business.

Small businesses applying for a loan should assume that all assets financed with borrowed funds will be used as collateral for the loan. Depending on how much equity was contributed by the principals toward the acquisition of these assets, the lender may require other assets as collateral.

> **AN ABUNDANCE OF COLLATERAL**
>
> In January 2005 Mary obtained a $100,000 small business loan to purchase equipment. In order protect itself from a loss the lender used the equipment as collateral by placing a lien against the equipment. In the event that Mary's business failed to produce the income projected and failed to make payments on the loan, the lender would sell the equipment but likely recover only a portion of the loan balance from the sale of the equipment, leaving the lender exposed. To provide further protection against a loss the lender supplemented the security on the loan by placing a lien against Mary's home. With the home as collateral the lender can more easily prevent a loss if the cash generated from the sale of the equipment does not cover the balance owed on the loan.

Regulated lenders are required to obtain a third-party valuation when real estate is being used as collateral. The lender may also require professional appraisals of business and personal assets, plus any necessary survey and/or environmental report.

Owner-occupied residences generally become collateral when:

- The lender requires the residence as collateral;
- The equity in the residence is substantial and other credit factors / sources of collateral are weak;
- Collateral is necessary to assure that the principals remain committed to the success of the business; or,
- The business is operated out of the principal's residence or other buildings located on the same parcel of land.

To the extent that worthwhile assets are available, adequate collateral is required as security on all loans. However, if the loan is an SBA loan the SBA will generally not decline the application if inadequacy of collateral is the only unfavorable factor. In addition to collateral, lenders generally require personal guarantees from the principals.

BUSINESS ADMINISTRATION

Business administration is the process of managing the day-to-day affairs of the business. This includes how the principals pay the bills, collect on the debt owed, deliver the products and services, and manage the inventory.

A small business' demonstrated ability to manage its day-to-day affairs is a prime consideration when making a loan decision. There are also some areas in which the small business needs to appear strong in order to make a favorable impression.

- **Character:** The impression made by the principals is very important. The lender makes an assessment as to whether or not the principals are sufficiently trustworthy to repay the loan. Character is determined by a number of factors, including but not limited to, prior loan history and reputation in the industry.
- **Managerial Capacity:** The principals' educational background and experience in business as well as past achievements in their industry determines managerial capacity. The quality of the principals' references and the background and experience of company employees are also important.

Historical and projected financial statements can be used to create metrics that provide insight into how the business has been managed in the past and how it will operate in the future. No single metric tells the entire story, but the use of several metrics in conjunction with one another can give an overall picture of management's performance.

Some key metrics that lenders review include:

- Debt-to-equity;
- Working capital;
- The rate at which income is received after it is earned;
- The rate at which debt is paid after becoming due; and,
- The rate at which the product or service moves from the business to the customer.

Industry advocacy organizations often maintain metrics. Each industry is unique and ratios may vary from industry to industry, as well as, based on a small business' characteristics (e.g., revenues, years in business, franchise/non-franchise, etc.). Small business owners should be aware of their key metrics relative to their industry prior to applying for credit in order to fully understand the impact that the borrowing will have on the business and to understand the information being considered by a lender.

Sample Debt-to-Equity Ratios				
	03QTR13	02QTR13	01QTR13	04QTR12
Restaurant Industry Debt-to-Equity Ratio	0.76	0.75	0.75	0.75
Hotel/Leisure Industry Debt-to-Equity Ratio	0.90	0.89	0.88	0.87
SOURCE: CSIMarket.com http://csimarket.com/Industry/industry_Financial_Strength_Ratios.php?ind=914				

HOW MUCH TO BORROW?

Before applying for a loan the principals should thoroughly assess the business' current financial situation. The Small Business Administration encourages small business owners to answer the following questions to better understand the business' financing needs:

- Does the business need more capital or can it manage with the existing cash flow? A business that is having trouble paying its obligations on time may need an infusion of working capital to relieve periods of weak cash flow.
- What is the nature of the small business' need?
- Does the business need money to start or expand its business or as a cushion against risk?
- How urgent is the need for more capital? It's better to anticipate the business' capital needs rather than seeking capital under pressure. It is harder to gain approval for a loan when the small business is in trouble.
- How great are the business' risks? All businesses carry risk, and the degree of risk will affect both the cost of the loan and available financing alternatives.
- In what stage of development is the business? Needs are generally more critical during transitional stages - start-up and expansion being two of the most urgent and costly.
- How will the capital be used? The lender will need to know the specific intent for the money.
- What is the state of the business' industry? Is the industry depressed, stable, or quickly-growing?
- Is the business seasonal or cyclical? Seasonal cycles require funding that is generally short term, and consists of smaller loans with a shorter maturity. Loans for cyclical industries, such as construction, are designed to support a business through depressed periods - these industries are sometimes known as 'feast and famine' businesses as the cash flow is often erratic and unpredictable.
- How strong is the business' management team? Effective management is an important element of business. The lender will look for a strong managerial presence.
- Is the need for financing consistent with the business plan? Small business owners must make the completion of a business plan a priority. All lenders will want to see a solid, well thought out business plan for the start-up and growth of a small business.

These questions assist the lender in determining how to best structure the financing so that it meets the needs of the small business. For example, financing can be long-term if used to purchase a building, or short term if used to finance seasonal working capital. The better the information, the better the loan structure.

DOCUMENTATION CHECKLIST

While loan program requirements may differ, the documentation that is requested remains consistent from lender to lender. The following are items that will generally be required as part of any small business loan application:

- Personal Background: Either as part of the loan application or as a separate document, this information will be requested, including previous addresses, names used, criminal record, educational background, etc;
- Resume: Some lenders require evidence of management or business experience, particularly for loans that are intended to be used to start a new business;
- Business Plan: Lenders generally require the submission of a thoughtful business plan. The business plan should include a complete set of projected financial statements, including profit and loss, cash flow, and a balance sheet;
- Personal Credit Report: The lender will obtain a personal credit report for each principal as part of the application process. Each principal should obtain a credit report from all three major consumer credit rating agencies prior to submitting a loan application. Inaccuracies and blemishes on a credit report can delay or negatively impact the loan application. Advance notice of any credit issues can assist the principals in addressing these items before beginning the application process;
- Business Credit Report: The lender will usually obtain a business credit report. It is important for the principals to review in advance the business' credit report in order to identify and remedy any issues;
- Income Tax Returns: Most lenders require applicants to submit personal and business income tax returns for the previous 3 years;
- Financial Statements: Lenders usually require principals to submit signed personal financial statements. Some lenders require financial statements from all principals – regardless of ownership percentage. Other lenders may require financial statements only from principals holding at least a certain ownership percentage (e.g., 20%). The principals may also be required to provide projected financial statements, either as part of, or separate from, the business plan. It is a good idea to have these prepared and ready in case a lender requests the information;
- Bank Statements: Lenders generally require one year of personal and business bank statements to be submitted as part of a loan package;
- Collateral: Collateral requirements vary greatly. Some loan programs do not require collateral. Loans involving higher risk require substantial collateral. While strong business plans and financial statements can help a business avoid providing collateral, most lenders will require some form of

collateral to protect against risks. Principals should prepare a collateral document that describes the cost/value of personal and business property that can be used to secure a loan; and,

- Legal Documents: The lender may require the principals to submit one or more legal documents. The following documents are typically requested:
    - Business licenses and registrations required to conduct business;
    - Articles of Incorporation;
    - Copies of contracts with any third parties;
    - Franchise agreements; and,
    - Commercial leases.

Small business owners – particularly those of start-ups – are advised to seek legal counsel relative to formation documents and filings, leases, purchase/franchise agreements, employment contracts, and other documents that benefit from having a legal review.

In addition to legal counsel, small business owners should also seek assistance from local organizations such as the Small Business Development Center (www.sba.gov/tools/local-assistance/sbdc) or SCORE (www.score.org). Both organizations provide support to small businesses, including the provision of fee-free consulting services.

SMALL BUSINESS RESOURCES

The following organizations support small business owners. They offer helpful online guidance as well as numerous other resources to assist small business owners:

Small Business Administration – www.SBA.gov

SCORE – www.SCORE.org

Small Business Development Center - www.sba.gov/tools/local-assistance/sbdc

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