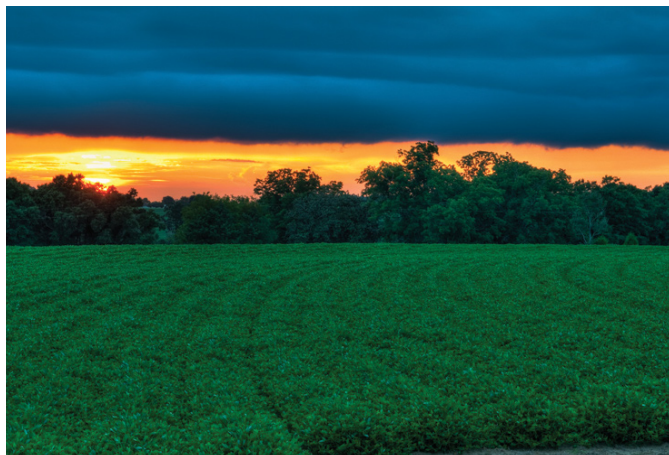

UNDERSTANDING COMMERCIAL LENDING

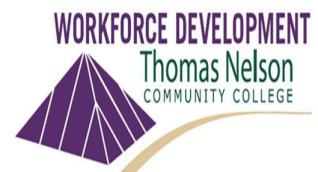
THE QUESTION & ANSWER GUIDE



HAMPTON ROADS
CHAMBER



U.S. Small Business
Administration



SMALL BUSINESS DEVELOPMENT CENTER OF HAMPTON ROADS, INC.
"Where business comes to talk business."

HAMPTON ROADS CHAMBER OF COMMERCE • 500 EAST MAIN STREET, SUITE 700, NORFOLK, VA 23510
PHONE: 757-664-2592 • WWW.HRSBDC.ORG



Dear Prospective or Existing Small Business Owner,

The Commonwealth of Virginia traces its roots back to Jamestown when, in 1607 a group of intrepid entrepreneurs with backing from the Virginia Company in London, founded the first English-speaking settlement in the new world. Today, there are over 665,000 small businesses in operation throughout the state.

The Small Business Development Center of Hampton Roads wants to ensure that you get all the assistance you need to prosper and succeed in today's competitive marketplace. Whether you are thinking about starting a business venture, getting started or already in business or ready to expand, we are here to help you every step of the way. The Center provides counseling and training services to small business owners throughout the eighteen cities and counties of southeastern Virginia and the Eastern Shore.

Established in 1990, the Center is part of a state-wide network of 29 offices and a national network of over 1,000 offices including a research center at the University of Texas at San Antonio. If we cannot find the answer locally, our staff can drill down through multiple levels of information resources to find an answer to your question.

The booklet is just one of the many tools available to our clients. The information provided here, coupled with the counseling and training services offered by the Center, will help you properly establish your business, grow it, or develop strategies to correct any shortcomings.

The Small Business Development Center of Hampton Roads offers unique and innovative services specifically tailored to meet your needs. We invite you to take advantage of our services and allow us to work with you to help you realize your goals.

Jim Carroll
Executive Director
Small Business Development Center of Hampton Roads, Inc.
Vice President, Small Business
Hampton Roads Chamber of Commerce
Email: jcarroll@hrchamber.com

A Partner in Your Success

Choosing a lender and developing a relationship is a very important goal.

Besides money, lenders can provide something almost as valuable; advice and support. By giving you insights into opportunities within your industry, lenders allow you to take advantage of those opportunities. They will help you choose which of their products and services are best for your situation.

Keep in mind that lenders want you to be successful because they want a portfolio of strong, profitable businesses.

By using this guidebook to better understand the basics of commercial lending, you'll feel more confident making important decisions about your business.

Contents

What are the first steps in contacting a lender?	5
What are the basic questions a lender will ask me?	5
How can I prepare for a meeting with a lender?	5
What should I expect from my lender?	6
What are the small business owner's responsibilities to a lender?	6
What is a business plan? What should I include in it? . . .	7
How can I create a business plan that will generate financing?	7
What kind of loan do I need?	8
What are different types of loans used for?	8
Should I check my personal credit? What can I do if I have had personal credit problems?	9
Why does my personal credit history enter into a lender's decision?	9
Does my legal status impact how much money my business can borrow?	10
Should I incorporate my business?	10
Will my suppliers be looked at?	11
Do you have any hints for dealing with suppliers and contractors?	11
What is the Small Business Administration?	12
How does the "SBA Guarantee" work?	12
What are some common financial problems businesses face?	13
How can I avoid running out of money?	13
What steps should I take if my business develops financial problems?	14
How can my business get refinanced or secure another loan?	14
What is a line of credit?	15
How does a line of credit (LOC) secured with inventory and accounts receivable work?	15
Should I buy or lease my location?	16
How do I decide whether to lease or buy a piece of equipment?	16
Will my lender look at the lease for my location?	17
Should I get my own appraisals?	17
What questions should I ask when buying a business? . . .	18
I would like to buy a business. The present owner says he takes half the income "under the table." Can I get this financed?	18
What should be in a purchase-and-sale agreement?	19
I am buying a franchise. What should I do before signing a purchase-and-sale agreement?	19
What collateral do I have to offer?	20
Are there guidelines for using real estate as collateral? . . .	20
What questions will a lender ask when I request a commercial real estate loan?	21
What is the difference between accrual and cash accounting methods?	21
How much of my money has to be invested in the business to qualify for a loan?	22
Do I need to show how the loan money will be used? . . .	22
What financial statements does my lender want?	23
How should I handle my projections? Should I provide "best case" or "worst case?"	23
What can I do to make sure my cash flow statement is good?	24
Since my accountant handles my financial statements, do I have to understand them?	25
Should I prepare notes to explain items in my financial statements?	25
How long will my loan decision take?	26
What should I do if my loan is rejected?	26
Glossary of important lending terms	27



What are the first steps in contacting a lender?

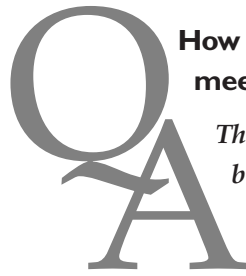
What are the basic questions a lender will ask me?

First Steps

- Call the commercial lending department (or a bank's branch) to find out the business loan rules.
- Ask if the lender is looking for loans of your size and type.
- Ask for a loan application.
- Prepare all the requested documents and include a business plan.
- Make an appointment.
- Rehearse your presentation.

Basic Questions

- How much do you want? How will the loan be used? See page 22.
- How long will it take to repay the loan? See page 8.
- What collateral do you have to offer? See page 20.
- How much are the owners investing in the business? See page 22.



How can I prepare for a meeting with a lender?

These guidelines seem basic but they are important

- Dress properly and be on time.
- Bring your business plan, a completed loan application, and any other materials you need.
- The entire presentation should take no longer than 30 minutes. Give an overview or outline at the beginning. Know how you are going to end the presentation.
- Invite your lender to your business location and show special equipment or services. If you are expanding or remodeling, explain your plans.
- Answer all negative questions with positive answers. Back up your answers.
- Find out when you can expect an answer. Request decisions or negotiations made on the telephone be put into writing.
- Follow up the meeting with a thank you letter and a phone call.

Q What should I expect from my lender?

A When lenders approve your loan requests, they have faith in your business and your ability to make a profit and repay their loans. Value is added when a lender is on your company “team.” Your lender can also help you determine which of their financial products best meets your business’ needs.

A lender can be a good “big picture” advisor; he or she will give you insights into your industry’s growth opportunities and how you can take advantage of them.

Lenders *want* you to be successful. As your business prospers, so does their business.

Q What are the small business owner’s responsibilities to a lender?

A Keep in mind that your lender is using depositors’ money to make your loan. And that lending institutions are in business to make money, just like you are. Therefore, treat lenders no differently than you would any other business person. And - *most importantly of all* - make sure your loan is repaid on time.

If you are seeking to establish a financial arrangement with your lender, you will most likely be asked to submit documents including

- *professionally prepared tax returns for three years*
- *financial statements*
- *list and value of collateral*
- *accounts receivable aging (list invoices by how old they are)*
- *accounts payable aging (as required by your lender)*

If there is a delay, provide a date when the lender can expect to receive them. Changes to your loan, such as timing of payment, must be approved

It is wise to meet with your lender a few times during this year to share your successes and concerns. Make an appointment, or invite the lender to your business for a first-hand look.



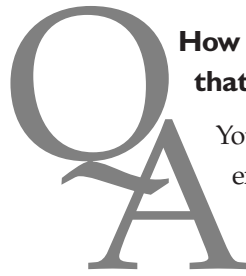
What is a business plan? What should I include in it?

This document summarizes your firm, including your goals and earning objectives. It shows how a loan will be used and repaid. Financial statements (projections for a start-up business) are also included. Business plans are also developed when an existing firm plans a major change in operations.

A business plan is a crucial part of a loan request. It also tells your sales personnel, suppliers, and others about your operations and goals. A good business plan helps you allocate resources properly, handle unforeseen complications, and make the right decisions.

A business plan includes:

- *An Executive Summary (description of owners)*
- *Your management & employees*
- *Your marketing plan*
- *A competitive analysis*
- *Your business location*
- *Your operations*
- *Your Loan Request (see page 22)*
- *Financial Statements (Balance Sheet, Income Statement, Personal Financial, and Cash Flow)*
- *Appendix which explains the details (for example, resumes, inventory evaluation, marketing plans)*



How can I create a business plan that will generate financing?

You don't have to be a financial expert to create a good business plan. Use common sense.

Write your business plan as though you were the person being asked for the money.

The owner(s) should create the business plan. A professional consultant or accountant can help, but the plan should be based on your input. Know what the plan says and how all the numbers are derived.

Don't make lenders search through pages to find out how much you are requesting. A cover letter should state how much money is being requested, how much equity is in the business, how the loan will be repaid, and what is offered for collateral (see page 20).

Include three things toward the front of the business plan:

- *the legal name of the borrower/business*
- *the legal name of all owners*
- *the names of your "professional team" (lawyer, consultant, CPA, insurance agency)*

What kind of loan do I need?

It depends on the purpose of the loan and how long are you asking for repayment.

Short Term (less than a year):

Maybe a Line of Credit (LOC) or a “bullet note.” Like a credit card, they have a predetermined loan limit. On lines of credit, the money is used when needed and then repaid. LOCs can be used for working capital.

Term Loans:

Loan payments are made in installments, usually every month. Smaller-term loans are for buying a business, long-term working capital, inventory, expenses, machinery, equipment, furniture, and leasehold improvements. Determine the total amount you need by obtaining quotes and estimates.

Longer-term loans are used to buy or refinance commercial real estate, make major improvements or additions to real estate, or purchase major equipment.

These loan needs are determined with buy-sell agreements, appraisals and quotes.

What are different types of loans used for?

Working capital

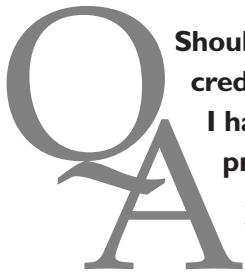
The loan is used for the business’ expenses (proven by a cash flow analysis showing the amount needed). It is often covered by a revolving line of credit (see page 15). Working capital that will be used over many years may require a longer term loan.

Inventory

Buying the inventory may require an intermediate - or long-term loan (see page 9). A line of credit (see page 15) can also cover some inventory needs. You will need to prove your inventory needs and expenses by projecting your income/sales, expenses and profits.

Equipment, Machinery, Furniture and Fixtures


Loans which help buy these items are proven with quotes. These items can often be rented or leased (see page 16) which helps because no down payment is required. Your older assets may have some value; they can often be refinanced or sold (and leased back from the buyer).



Should I check my personal credit? What can I do if I have had personal credit problems?

Review your personal credit report once a year. Your credit information impacts many decisions, from the loan size to the interest rate. A credit report includes credit cards, any mortgages, and your loan payment history. There are three different credit reporting agencies (Equifax, TransUnion, and Experian) who provide your information to lenders so it's a good idea to review all of the information available.

Your FICO credit score comes from the Fair Isaac Company who condenses all of your credit information into one number or score. Credit scores typically range from 500 to 800 and low scores affect your ability to obtain a loan or the desired interest rate. The formula used to calculate your FICO score is based on 1) your payment history, 2) the amount you owe, 3) your credit history, 4) the number of new accounts, and 5) the type of accounts (mortgages, credit cards, installment loans). How can you maintain and improve your credit score? Pay your bills on time and manage credit wisely. If you have credit problems, explain them to the lender.



Why does my personal credit history enter into a lender's decision?

Since you run the business, lenders assume there is a direct relationship between your personal credit history and the business' credit history. Credit-conscious lenders prefer applicants who have good credit.

The more secure a lender feels about you, the better the chance for your loan approval.

Pay attention to the Seven C's:

- ① **Credit.**
*Must be good.
Problems must be explained.*
- ② **Capacity.**
The business must be able to support its debts and expenses, and be profitable.
- ③ **Capital.**
Money you or investors are putting in or equity you already have in the business.
- ④ **Collateral.**
The value of assets that secure the loan.
- ⑤ **Character.**
Of the borrower and guarantors.
- ⑥ **Conditions.**
The economy, industry trends, or anything that will affect your business.
- ⑦ **Commitment.**
Your ability and your willingness to succeed which involves guaranteeing the debt personally even if the company can't pay it.

Q Does my legal status impact how much money my business can borrow?

A Yes. The business must be able to leverage its equity to repay the loan. Lenders consider a

business' legal description because it often provides alternate sources for repayment of the loan.

A *sole proprietorship* is owned by one person. Raising money depends on collateral and cash flow. If the business gets into financial trouble, the individual does too. There is little liability protection, so you risk losing not just the business but personal assets too. Some risks can be covered with insurance.

In a *partnership*, several people can supply money to repay a loan. Additional money can be raised by adding partners. The personal assets of general partners are still at risk if the loan goes into default.

A hybrid between a partnership and a corporation is the *limited liability company*. It has the limited liability of a corporation but is taxed as a partnership or corporation (depending on the structure).

See page 10 for *corporations*, another legal status.

Q Should I incorporate my business?

A A *corporation* is the most common form of business. It is legally treated as a separate entity so the owners' liability is limited.

It is easy to sell a corporation and to transfer ownership. Additional owners provide more sources to invest in the business.

The "C" corporation is taxed at the corporate rate for profits while the Subchapter S corporation is taxed at the business owners' individual tax rate (based on percentage of ownership). There are some restrictions for an "S" corporation including the maximum number of stockholders.

Lenders require personal guarantees (from those who own 20% or more of the business). Lenders will also review the organizational documents to insure their legality.

Q Will my suppliers be looked at?

Yes. Suppliers are critical to a business, especially a new one.

A If there is a limited number of suppliers, they may have too much power. If they raise prices, you cannot, in turn, raise yours, so losses occur. It is best to have as many suppliers as possible to be able to select those that suit your needs.

Suppliers can be helpful in many ways. They may offer extended terms which is like getting a loan. Suppliers usually are more lenient and have flexible repayment terms. They also offer specialized advice and managerial help with their products and services. A source of quick money for a distressed business may be selling inventory back to the supplier.

A list of suppliers should be generated and kept current including the terms of each. Lenders will check the suppliers' financial condition, their ability to supply you with products, and check on your payment history.

Q Do you have any hints for dealing with suppliers and contractors?

If you are the supplier and your clients are contractors:

A Look over the terms they offer to their customers to ensure they are not lax. Are standard contracts used? Is their bidding process automated and formal, or is it haphazard? Know their payment history, which will predict how fast will they pay you.

If you are the contractor and are sub-contracting work to other companies:

Are they competent? What are their terms? Are they financially sound? If you choose sub-contractors who do not produce on time, or produce an inferior product or service, you can lose customers or suffer cost overruns and losses.

If you are the contractor for a client:

Review the plans to determine whether they can afford your services. Their ability to pay for a service contract can be determined by reviewing commitment letters from lenders. Ask for their credit report and check their references.

Q What is the Small Business Administration?

A The Small Business Administration (SBA) is not involved with direct loans unless there is a natural disaster. Its emphasis is on guaranteeing loans to qualified borrowers, up to 75%.

The SBA also sponsors about 900 nationwide Small Business Development Centers (SBDCs), Business Information Centers (BICs) and the Senior Corps of Retired Executives (SCORE). These organizations advise small business owners. Look in the phone books for listings.

Call the SBA Answer Desk at 800-8-ASK-SBA to find out more about their programs and services. SBA information can also be found on their Website www.sba.gov

Q How does the “SBA Guarantee” work?

A When a lender secures the SBA guarantee, its risk is smaller. Instead of risking 100% of its money, the risk is reduced to

25% since the SBA guarantees up to a maximum of 75% in most programs. Once a lender has approved your loan request, it is submitted to the SBA for its approval and guarantee.


Example

A \$100,000 loan is approved with a 75% SBA guarantee. The maximum loss by the lender (on the loan) is 25% or \$25,000.

If this business defaults on its loan, 75% of the outstanding amount (what is left on the loan) is paid to the lender by the SBA. If \$65,000 is left on the loan:

\$65,000	Loan balance	
	x 75%	SBA guarantee
		\$52,000 is returned to the lender

Note: You are still responsible for the loan balance even if the SBA returns money to the lender. Your payment is proportionately applied to the SBA.



What are some common financial problems businesses face?

Little or no record keeping.

You must keep meticulous records for yourself, the IRS, and your lender. You should be able to read and understand your business' financial statements.

Failure to seek outside help.

Some excellent resources available are:

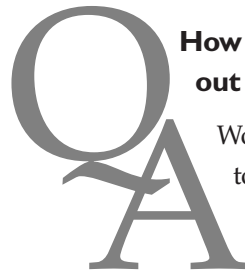
- *Small Business Administration (SBA)*
- *Service Corps of Retired Executives (SCORE)*
- *Small Business Development Centers (SBDC)*
- *Your state's economic development departments*

Poor financial management.

A business needs good financial management, from within the company or an outside advisor. It's your money, so be very self-disciplined.

Reluctance to invest in the business.

Why should the lender stand behind you if you won't invest your own money?



How can I avoid running out of money?

Working capital (money for day-to-day activities) is your business' lifeline. Don't purchase unimportant items or try to run your business with inadequate working capital. Have money available or have access to it.

Consider these points to determine how much money is needed for cash flow:

- *Hard assets list budget. Estimate equipment requirements (furniture, machinery, remodeling), where it will be obtained, when it is needed, and how the costs will be paid.*
- *Gross profit. Determine your gross profit by figuring the cost-of-goods sold for each revenue source (each product or service).*
- *A list of fixed and variable expenses on a monthly basis. This may require the help of an accountant or business advisor.*
- *Interest expenses on the loans you are applying for. The loan's principal amount (due each month) comes out of your profits.*
- *A cash flow projection. Actual cash expenses are subtracted from cash (cash sales, collection of receivables, etc.) received every month which shows how much money you need on a monthly basis (see page 24).*

Q What steps should I take if my business develops financial problems?

A Immediately consult with your accountant or a financial advisor to determine what's causing the problem. Once the source is found, the solution may involve raising money or securing a loan to correct the problem. Don't wait; try to correct the problem before your business gets into deeper trouble. Develop financial projections that will satisfy your needs.

You may have a tendency to limit communication with your lender, believing bad news will damage your relationship. Lenders are astute business people so they understand business cycles. The lender's positive concern is preferable to their negative reaction to withheld information. Keep the lender up to date with your business.

Q How can my business get refinanced or secure another loan?

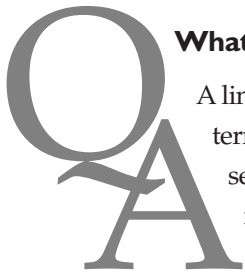
A Lenders become cautious when additional money is requested within a year of closing on your last loan. They need to ensure you can repay the existing loan *and* a new one.

If you need to borrow more money, make sure:

- *your source of repayment is established and profitable*
- *enough working capital is available or being requested*
- *there are no missed loan payments and your credit is problem-free*
- *collateral is available to back up the new loan*

Revise your business plan to prove repayment of the new loan along with:

- *current personal tax returns*
- *current business tax returns and financial statements*
- *interim business financial statements that are not more than 60 days old*
- *contracts (helps to show income), letters of intent to do business*
- *a list of accounts receivable (shows how old invoices are) and accounts payable (shows what is owed and how old it is)*



What is a line of credit?

A line of credit (LOC) is a short-term loan (one year) which is set-up before the money is needed. LOCs give you the ability to get money, repay it, and redraw the funds again. LOCs are commonly used for seasonal businesses or to carry accounts receivable and/or inventory.

A regular LOC can be secured or unsecured. If secured, the collateral is usually your inventory and accounts receivable. The LOC has to be paid down to \$0 each year, for 30 days (to ensure it is for short-term working capital). A *Revolving LOC* is a longer-term loan and is based on a formula (percentage of advance against accounts receivable, and/or inventory) and doesn't have to be paid down to \$0 like the regular LOC. It follows the percentage of accounts receivable and/or inventory. It's usually renewed every year.

Don't confuse an LOC with a letter of credit (L/C). A letter of credit guarantees payments to a third party by the lender, on your behalf. If a business owner defaults on a payment, the bank will pay it. This is used often by importing/exporting businesses.



How does a line of credit (LOC) secured with inventory and accounts receivable work?

Inventory

Lenders will usually finance 50% of the inventory's cost (raw materials and finished goods, not work-in-progress). For example, seasonal businesses that rely on tourists usually finance their inventory. Their busy season begins in the Summer and slows in the Fall. However, these owners buy inventory in February so they must borrow the money. The businesses begin paying back the loan in the Summer until it is totally repaid in the Fall.

Accounts Receivable

Lenders will usually advance 75% of the qualified accounts receivable (those not past due or considered uncollectible). An example is a business that works with government agencies (who typically pay invoices in 30-60 days). Most small businesses can't wait 60 days (or more) for invoices to be paid so they borrow money to cover that interim period.

Q Should I buy or lease my location?

If buying, ask yourself:

- *Can I increase sales and make more profit than I do now?*
- *Do I have enough money for the down payment?*

- *Can I afford the monthly payments?*
- *What type of financing is available?*

If leasing, ask yourself:

- *What is the cost per square foot and other costs (such as maintenance)?*
- *Can I afford the monthly payment on the lease?*
- *What are the terms and conditions?*
- *Can I transfer or terminate the lease if I need to end it early?*
- *Can I lease with the option to buy? If so, can some of my lease payment be applied toward my down payment?*

Q How do I decide whether to lease or buy a piece of equipment?

Lease rates are usually higher but the monthly payment is shown as an expense and

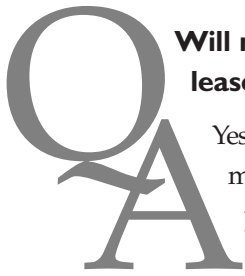
there is an option to purchase the asset at the end of the lease (at a pre-determined percentage of its fair market value).

Leases don't require a down payment but most require the first and last monthly payments plus a damage deposit.

Operating leases do not appear on your balance sheet. The equipment lease does not appear as an asset nor does the total lease amount appear as a liability. Only one month's payment will appear on the balance sheet. However, the entire lease should be explained to the lender in a footnote.

Capital leases have a \$1 purchase option, must be shown as an asset and a liability on your balance sheet, and are depreciated.

Make your decision after carefully weighing all considerations and costs, then get the equipment operating quickly so it can begin paying for itself.

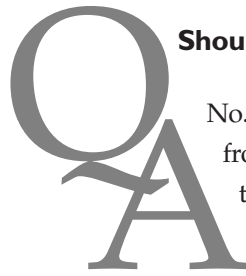


Will my lender look at the lease for my location?

Yes. Lenders scrutinize leases so make sure you review it first with your attorney and accountant.

Your lender will look at:

- *Length of Lease. The lender will want the term of the lease to be the same as the term of the loan, or extendible to the loan maturity date.*
- *Monthly payment and escalation clause. This should match the projected cash flow analysis. Try not to tie the escalation clause to sales or profits, but to the consumer price index.*
- *Responsibilities. Who pays taxes, insurance, maintenance and other expenses? What is your total monthly payment? How is the base rent established? You are usually quoted a rent “per square foot” which is the amount paid on a yearly basis for one square foot. Multiply this figure by the number of feet you are leasing. Then divide by 12 to get the monthly payment.*
- *How much of the security deposit must you put down? How will you get it back if you have to break the lease or if the lease expires?*
- *Is it transferable? If you terminate the lease, what will be the cost?*



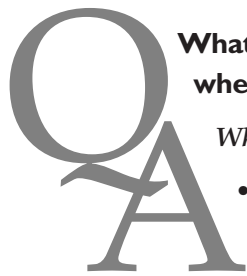
Should I get my own appraisals?

No. Banks select the appraiser from their approved list and you, the borrower, pay for the appraisal. Banks want commercial real estate and

collateral appraisals that are less than six months old. If older, the appraisal must be updated.

If you want an indication of value before making an offer, commercial real estate appraisers can give you a summary appraisal for a small percentage of the full commercial appraisal fee.

Be sure the real estate has no environmental problems. If this is an issue, the lender may require an environmental study (which you also pay for). If problems are found, an in-depth study may be ordered to determine solutions.



What questions should I ask when buying a business?

Who started the business?

- *Why is the business for sale?*
- *What is the price? How was the price determined?*

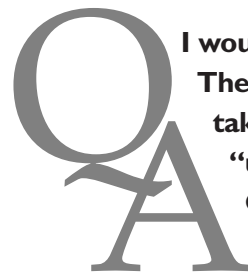
- *What am I buying? Building, inventory, equipment?*
- *What is the amount of goodwill (see page 19)? Will the seller finance this?*
- *Are there any patents or trademarks?*
- *Who are the competitors?*
- *What's the climate of the business' industry?*
- *What are the sales and trends?*

Before buying a business, have:

- *audited financial statements (signed by the seller)*
- *federal income tax returns (signed by the seller)*
- *a purchase-and-sales agreement (see page 19)*
- *pictures of the operation/location*
- *appraisals on all assets*
- *input from customers and suppliers*

Take the time to:

- *check the business debt*
- *evaluate the price and age of inventory*
- *check the quality and the age of accounts receivable if you're buying these*
- *determine the age, condition and cost of fixing or replacing machinery*



I would like to buy a business. The present owner says he takes half the income "under the table." Can I get this financed?

Never believe that half the income is unreported on financial statements. Maybe some is, but it usually means the seller is artificially inflating the income to get the selling price up.

The difference between the value of the assets and the fair market value is called *goodwill*. Since lenders usually don't finance goodwill, you will need to decide how much (over the value of the assets) are you willing to pay. You should ask the seller to take back a loan for some or all of the goodwill.

The amount available for a loan depends on how much cash flow (profit after tax and adding back depreciation) is available to service the debt (make payments), how much collateral you have to cover the loan, and your investment in the company.

Q What should be in a purchase-and-sale agreement?

A A purchase-and-sales agreement shows you agree to purchase a business and the current owner agrees to sell it to you. It establishes the price, terms and financing contingencies.

It should state:

- *an agreed-upon price*
- *a list of what is being bought (machinery, equipment, furniture, fixtures, etc.)*
- *actions required by the seller (such as repairs)*
- *actions required by the buyer (such as seeking financing of a certain amount)*
- *a time limit during which the agreement is binding to both parties*

The selling price determines how the business could be financed and what programs the lender has available. A “good faith” deposit is usually required which should be refunded if you can’t gain financing. Purchase-and-sale agreements are available in office supply stores, via software programs, and on the Internet. Before you sign the agreement, it’s smart to have your attorney prepare and/or review the agreement to ensure you’re legally protected.

Q I am buying a franchise. What should I do before signing a purchase-and-sale agreement?

A Retain the services of an attorney who will review the franchise agreement and the purchase-and-sale agreement with the franchise’s area manager.

Why is this important? Take, for example, the story of the entrepreneur who needed \$60,000 for a franchised ice cream store. He was shown an outdated franchise agreement, and told there would be a new agreement once the financing was approved. The entrepreneur went full speed ahead, writing a business plan and requesting a \$60,000 SBA loan.

Meanwhile, the franchise company was sold to a large food franchiser whose inspectors decided that the store needed \$40,000 in upgrading!

The entrepreneur did get back his \$5000 deposit, but was responsible for \$2600 in appraisals and legal fees. Although he sued the broker and seller to recover these costs, he was still responsible for legal fees. All this could have been avoided if he’d spoken directly to the area manager first and insisted on a current franchise agreement.

Q What collateral do I have to offer?

A Collateral is your assets which may be liquidated by the lender if you don't repay your loan.

It is the secondary method of a loan payment; the first source is cash flow (profits).

Collateral assets may be business or personal. Business assets may include receivables, inventory, equipment or real estate. Savings, stocks, or real estate may be considered personal assets.

You should be aware that lenders discount the value of your collateral, and the discounted amount must be at least equal to the loan request. Each lender's formula for discounting collateral will vary. Take, for example, a \$10,000 piece of equipment. Lender A may discount it by 30%, so it "counts" as \$7,000. Lender B may discount it by 50%, counting it as \$5,000. Be sure you understand your lender's method of discounting.

Q Are there guidelines for using real estate as collateral?

A Lenders like real estate because it doesn't go anywhere, has a fairly stable value and they can perfect their lien (a mort-

gage). Lenders may recover all or a large percentage of their loan if the real estate goes to foreclosure.

Ask the lender these questions:

- *What type of real estate do you accept as collateral?*
- *What percentage of the value are you willing to lend?*
- *Must it be a first mortgage?
Will you take a second mortgage?*
- *Are there any particular characteristics which would disqualify the real estate from financing (wells, septic systems, design, usage)?*
- *Are there any environmental concerns?*

Q What questions will a lender ask when I request a commercial real estate loan?

A Will the loan be paid from the business occupying the mortgaged property? If so, a review of the company's financial statements will determine its ability to pay a mortgage. If it is going to be leased to other occupants, lenders will review the leases and the credit of the occupants to ensure their ability to pay you.

What is the collateral value of the building? Lenders will usually lend up to 70% of the value. The other 30% is paid for in cash, although part of this can often be financed by the seller. To determine the real estate's value, lenders may use the appraiser's figure or the sale price (whichever is lower). Lenders will consider the improvements to be made in the appraised value and phase the loan in as improvements occur. What is the loan-to-value ratio the lender will accept? What are the rates, terms, and conditions?

Q What is the difference between accrual and cash accounting methods?

A There are two ways to handle your accounting - *accrual* or *cash*.

The *cash method* means you record a sale when you collect money, and record an expense when you pay for it.

Lenders usually require the accrual method which means:

- Sales are made and immediately recorded but payments are collected in future months.
- Your customers pay later, which creates "accounts receivable."
- Purchases made and expenses incurred are received and recorded, but paid for later, creating "accounts payable," sometimes called "accruals payable."
- Net income does not always mean cash, as money is tied up in accounts receivable and inventory.

Note: In both accounting methods, assets (such as equipment) are depreciated over their lifetime, as required by the Internal Revenue Service.

Q How much of my money has to be invested in the business to qualify for a loan?

A 20-50% of your money must usually be invested but it depends on many factors, such as collateral offered, the purpose of the loan, and your repayment ability.

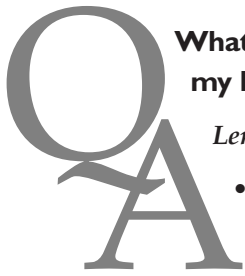
For fixed business assets (machinery, equipment, furniture, and fixtures), business owners typically put 25% down toward the purchase price.

Ask your lender about municipal, state or SBA programs that require lesser amounts of your own money to be invested (5%-10%). Some municipalities and state programs will subordinate loans to the SBA lender (which takes the place of a portion of your down payment).

Q Do I need to show how the loan money will be used?

A You must show the lender how you will use the money. Give amounts and totals for each category, like this:

LOAN REQUEST	
Amount Requested	140,000
Owner's Investment	30,000
Other Investors	<u>20,000</u>
Total	190,000
USE OF FUNDS	
Working Capital (via cash flow)	25,000
Equipment and Machinery (via estimates)	110,000
Furniture & Fixtures (via estimates)	25,000
Office Equipment (via estimates)	<u>30,000</u>
Total	190,000
REPAYMENT	
Term: \$140,00 for five years Rate: Prime + 2 ¼%	
Principal and Interest: \$3026.52 monthly payment (based on 8 ½% + 2 ¼% for a total of 10 ¾%)	
Repayment source: Cash Flow	
Collateral offered:	
• New Equipment & Machinery	100,000
• Old Furniture & Fixtures	25,000
• New Office Equipment & Computer	30,000
• Equity in Real Estate	<u>70,000</u>
Total	225,000



What financial statements does my lender want?

Lenders want to review:

- **Balance Sheet** This is a snapshot of your business. A moment frozen in time.


The numbers change every day. Companies should show the balance sheet before and after financing.

- **Operating Statement** (also called Income Statement, Profit and Loss Statement, Income/Expense Statement) This is your business' report card. Expenses are subtracted from income, which gives you the business' net profit or loss over a period of time.

If you are starting a company, also include:

- **Projected Cash Flow Statement.** This is your cash register-- it shows money that comes into the business and money that comes out. See page 24 for details.
- **Personal Financial Statement.** Shows personal assets and liabilities for each owner of the business.

Existing businesses should include three years' worth of statements and interim statements, not more than 60 days old. Start-up companies should use projected statements.



How should I handle my projections? Should I provide "best case" or "worst case?"

Provide a believable projection, which can be proven.

Include the following projections:

- **Profit and loss statement** monthly for the first year, quarterly for the second year and annually for the third year
- **Cash flow statement** monthly for the first year, quarterly for the second year and annually for the third year
- **Balance sheet** by month for one year
- **Breakdown of sales** by product, by month for one year
- **Cost of goods sold** by product, monthly for one year
- **Employee list** and salaries per month for one year
- **Breakeven analysis.** When a company has neither a profit nor a loss. One dollar more and the company has a profit; one dollar less and the company shows a loss. Lenders want to see when the business becomes profitable.
- **A list of assumptions** used to explain and support your projections

Q What can I do to make sure my cash flow statement is good?

A The Cash Flow Statement is your cash “register.” On a monthly basis, it shows the money that comes into the business and what goes out. This allows you to determine if there’s a cash surplus or deficit. Remember that profits do not guarantee a positive cash flow. Cash must be available to pay for bills and day-to-day activities. The cash flow statement will also show an important figure, the cash breakeven point at which cash income equals the cash outflow.

The cash flow statement must show your company has cash to pay debts on time. You need to estimate monthly income and expenses based on the direct and variable costs of your product or service.

Other Things You Should Know About Cash Flow Statements:

- *The Cash Flow Statement differs from the Operating Statement because it records when cash is received and paid.*
- *Show income and expenses on a monthly basis for the first year, quarterly for the second year, and annually for the third year.*

- *Begin with revenue/income at the top, followed by expenses and repayment of the loan (not vice versa).*
- *Round off numbers. Do not use cents.*
- *Show realistic assumptions. If you project sales to increase by 80% every year, the lender may be skeptical. Prove assumptions and attach them to this statement.*
- *Cover the downside. Identify any weaknesses and be prepared to finance them.*
- *Cash usually jumps up from year one to year two because set-up or start-up costs are high in the first year.*
- *Negative or “pull down” balances are common in the first year. Deficiencies must be covered by providing more cash (loans or owners investments), or reducing expenses (which is often not possible).*
- *Increased sales normally cause a drain on the working capital. When sales are good, you need to buy more material and labor. Until you start getting paid by your customers, there may be a deficit. Show how you’ll overcome this.*

Q Since my accountant handles my financial statements, do I have to understand them?

A Input from your advisor (accountant or your business' financial manager) is valuable but don't be totally dependent on him or her. Educate yourself.

How can you know if you're getting quality service if you don't understand it? You should have a basic understanding of your company's finances. You obviously want to know how your business is profiting. Ask your accountant to sit down with you, and make it your business to learn how to read your financial statements and reports.

Q Should I prepare notes to explain items in my financial statements?

A Yes. Put these notes in writing because the lender you meet with may need to share this information with others. Refer to specific items in your statements. Keep your comments brief.

Q How long will my loan decision take?

A It varies, but the decision will be delayed if a business plan and its projections leave questions unanswered. Ask your business advisor to review your business plan before you present it to a lender.

For example, a lender reviews your loan request and finds missing information. A list of missing items has to be developed and sent to you, usually in writing. The information comes back to the lender, over a period of time which is called the “paper snowstorm.” The whole process is time-consuming for you and the lender.

If a loan officer receives a complete business plan, he or she will usually act on it immediately. If every point is covered, this indicates that the business owner knows what the company is doing and where it’s going.

Also, commercial loan officers can get overwhelmed with many loan requests. They may need to take care of other responsibilities or make decisions on other loan proposals before your loan request can be reviewed.

Q What should I do if my loan is rejected?

A *Ask the lender these questions:*

- *Why was I rejected? Get the reasons in writing.*
- *Does this mean I’m turned down permanently? Or can I resubmit the loan request when I correct the problems?*
- *Should I go to another lending institution?*
- *Should I seek alternative financing? What are the alternatives? Might they include state and municipal loans, venture capital, and banks that offer SBA-guaranteed loans?*
- *Do you have any other suggestions?*

As a small business owner, you need to understand the lender’s restraints. Some lenders try to vary their portfolio of small businesses so your business may not be a good addition. Some may have minimum or maximum loans they can make. Other lenders are not allowed to invest in certain industries.

Glossary

Ability to Pay

Ability to pay loans from the business' income.

Accounts Payable (A/P)

Expenses incurred and purchases made, but not paid for.

Accounts Receivable (A/R)

Sales made but not collected.

Accounts Receivable Financing

Short-term financing obtained by pledging receivables to the lender (as collateral for a loan). This enables a business owner to draw against an established line of credit, dictated by a formula (a percentage of accounts receivable).

Accrual Basis

An accounting method. See page 21.

Adequate Notice

The length of time required to notify your lender of business action such as cancellation of a lease or prepayment of a loan. Adequate notice is predetermined in writing.

Advance

Money withdrawn from a pre-approved line of credit.

Amortization Schedule

A chart or table that breaks a monthly loan payment into two categories; principal and interest. It also reports the balance due.

Annual Percentage Rate

The cost of credit as a yearly rate.

Articles of Incorporation

Legal document filed by a prospective corporation's owners in a designated state that explains the purpose of the corporation, its directors, and the distributed shares of stock. When approved by the state, the corporation then becomes a legal entity.

Assets

What the company owns. Current assets can be converted into cash in one year. Non-Current Assets take one year or more to turn into cash.

Asset-based Lending

Financing secured by pledging assets (inventory, receivables, or collateral other than real estate).

Available Credit

The unused portion of a line of credit.

Breakeven Point

When a company has neither a profit nor a loss. It's considered to be at the breakeven point. One dollar more and the company has a profit; one dollar less and the company shows a loss.

Business Credit

Loans made to businesses in the form of a term loan or a line of credit.

Business Plan

An overview put together by new companies and existing companies that are trying to obtain a loan. It includes all aspects of a business and financial statements. See page 7.

Call

If the loan covenants (rules) are broken or if the maturity is reached, "calling" a loan means it must be paid in full.

Cap

A cap limits a loan's interest rate from rising beyond a certain rate. A 10% loan with a 2% cap will only rise to 12%.

Capacity

Borrower's ability to repay a debt.

Capital or Net Worth

Assets less liabilities. The amount of money invested in the business plus the retained earnings. A business can have a negative balance.

Cash Basis

A type of accounting system that recognizes cash when it is received and expenses when they are paid. See page 21.

Cash Collateral

Bank deposits and similar assets that can be converted to cash quickly.

Cash Flow

Money available from a business' operations to satisfy cash needs. The primary source for monthly payments on a loan. See page 24.

Collateral

Assets pledged to support a loan. The money received from liquidating the assets is the secondary source of a loan repayment .

Collateral Value

Value of pledged asset(s) as determined by an appraisal or other methods of valuation. Lenders often discount collateral by a certain percentage. See page 20.

Commercial Mortgage

A loan for a business' real estate. Rates and terms are negotiated and the finance charge is usually related to the prime rate.

Commitment

When a lender agrees to lend a specific amount, with rates, terms, conditions and covenants... in writing.

Community Development Bank

Locally-operated commercial bank which lends money to the local community.

Concentration

When a lender's loan portfolio is heavy in a particular industry or type of business.

Corporation

A form of business registered with the state as a legal entity. See page 10.

Cosigner

A person who signs and guarantees a loan for someone else.

Contingent Liabilities

Money you agreed to repay by signing notes, or by being a co-maker or guarantor of loans. Lenders want to know how much money you are liable for if the loan results in legal actions or contested taxes.

Cost of Goods Sold

Cost to make a product, including materials, labor, and related overhead.

Covenant

Loan agreement rules for the borrower as dictated by the lender.

Credit

Lender's agreement to provide funds or apply money to an account owned by the customer.

Credit Line

Certain amount of money available to a borrower for a predetermined period of time

Credit Rating

An individual's worthiness for credit as determined by a credit reporting agency. In addition to the information these agencies provide, lenders use tax returns and other financial statements to determine your credit worthiness.

Credit Scoring

A predetermined process of scoring which is used to approve or reject loan applications.

Current Assets

Assets that can be converted into cash in one year.

Non-Current Assets take one year or more.

Current Liabilities

Liabilities due within one year.

Delinquency

Failure to make a loan payment when it's due.

Depreciation

Except for land, assets wear out. The value goes down and can be deducted from your business as an expense. Present values of assets are shown as original cost less depreciation. Market value, or the price you could sell it for, could differ from this figure.

Draw Down

Activating a line of credit. For example, when you "draw down" a line of credit, you activate it.

Equity

Difference between the total assets of a business and the total liabilities.

Factoring

Short-term financing from the sale of accounts receivable to a third party.

Financial Statement

Reports showing the financial condition of a business on a particular date or for a period of time (such as one year). Lenders review the Balance Sheets and Income Statements. See page 23.

Fixed Assets

Assets like furniture, fixtures, equipment, machinery, and real estate.

General Partner

When a business is a partnership, every owner who holds a share (a percentage) of the company shares in the profits and losses. General partners are responsible for total liabilities.

Gross Profit

Gross sales less cost of goods sold. This is your mark-up. Also called gross margin.

Gross Sales

Revenue or income from sales before returns and allowances.

Guaranty (or Guarantee)

Agreement by a third party to pay debt if the borrower does not.

Guarantor

A guarantor has the same responsibilities as a co-signer. If the loan goes into default and is not paid by the signer(s) of the loan, the guarantor is responsible.

Goodwill

The difference between the value of the hard assets and the business' selling price. Also called "blue sky."

Income Statement

Financial statement showing a business' profit and loss over a period of time (usually a month or a year). See page 23.

Interest

Money paid (cost of credit) for the use of money.

Interest rate

The interest expressed as a percentage rate.

Inventory

Assets held for eventual resale. May be in the form of raw materials, work in progress, or finished goods.

Lease

Contract giving a business owner the right to use an asset for a specified period of time. The asset owner is called the lessor and the owner using the property is called the lessee. Can be used for a building, equipment or machinery.

Leasehold Improvements

Improving your leased business location, at your own expense.

Letter of Credit (L/C)

Payments to a third party by the lender, on the owner's behalf.

Lien

A claim against a business' assets to secure payment of a debt.

Limited Partnership

Partner that invests in a business and receives a share of the profits (or losses). A partner's liability is limited by the amount of his or her investment. A limited partner does not have any management authority in the operation of the business; the role is purely that of an investor.

Limited Liability Company/LLC

A form of business that is a hybrid between a corporation and a partnership. See page 10.

Liabilities

How much the company owes. Current liabilities are those due within one year. Long-term liabilities are due after one year.

Line of Credit (LOC)

A short-term loan. See page 15.

Liquid Asset

Asset that can be turned into cash quickly

Liquidity

A company's ability to pay its expenses. The ability to turn an asset into cash (such as selling a piece of machinery).

Loan Agreement

The document or contract of the parties that reflects the commitment.

Loan Committee

Team that evaluates, approves or denies loan applications. Whether a loan officer or a loan committee decides on a loan request may vary by type of loan and lender.

Loan Package Documentation

Documents for the commercial loan contract including financial statements, a business plan, and a credit report. It includes legal documents that show the debt, notes, mortgages/leases, and loan agreements.

Loan Grading

System of classification that evaluates risk by assigning a number according to risk. Loan grading is used by lenders, and helps lenders to evaluate loan applications and manage loans.

Long-Term Liabilities

Expenses, loans, and payables due after one year

Marketing

Activities used to sell a product or service to the purchaser.

Market Value

The price an asset, product or service will bring in a current, competitive market.

Merchant Agreement

Written agreement between a credit card processing bank and merchants (who allow clients to use credit cards). The bank turns the credit card sales into deposits for the merchant and charges a processing fee.

Net Profit

Money left after all expenses have been paid. Used to pay loans and to grow the company.

Net Sales

Revenue or income from sales after returns and allowances are deducted.

Net Worth

Assets less liabilities.

Non-Current Assets

Assets that take one year or more to turn into cash.

Notary Public

Person authorized by the state to administer oaths and witness documents. A notary's seal and signature authenticates a document.

Outstanding Checks

Checks that have been sent for payment but are still in the process of being collected by the bank.

Overdraft

When the amount of a check exceeds the available balance. Overdraft protection allows business owners to write checks for more than the account balance without the checks being returned. This service must be approved by the bank.

Owners' Investment

The money owners have invested in a business.

Prime Rate

The rate of interest per annum announced by the lender from time to time. Most business owners are charged the printed rate plus a percentage (if the prime rate is 6%, the borrower is charged "prime + 2" or 8%).

Pro Forma

Forecasting future income, expenses, or cash flow with projections.

Retained Earnings

Net profits accumulated through the company's life and reported in the net worth or equity section of the balance sheet. Note: Can be negative if losses occur.

Rate of interest

Fixed: Interest rate remains the same for the length of the loan.

Variable: Interest rate depends upon an index and increases or decreases (for example, the prime rate or the Treasury Bill index).

Ratios

Ratios are your business' "scores" that come from your Income Statement and Balance Sheet, not the Cash Flow Statement.

Refinancing

Replacing existing loans with new loans that have different terms. Often called "refi."

Rescheduling

Extending the length of time required to pay the loan which adjusts the monthly payment.

Release

Releasing collateral when a loan has been paid off or substituted by other collateral.

Secured Loan

Loan secured by collateral (which will be liquidated if the borrower defaults on the loan).

Small Business Administration

See page 12.

Subchapter S corporation

A legal form of business that is incorporated but taxed at the business owners' individual rate of return. See page 11.

Tangible Asset

Real property such as buildings and machinery. Trademarks, goodwill, or accounts receivable are not considered tangible assets.

Term

A loan's maturity, stated in months or years.

Term Loan

Loan, given in one lump sum, is provided at the closing. Repayment is monthly.

Trend Analysis

A process by which lenders examine business statements and financial ratios to determine if the financial strength is improving or weakening.

Working Capital

Difference between current assets and current liabilities. An indication of liquidity and the ability to meet current obligations.