# WHAT A BUSINESS BANKER LOOKS FOR IN A LOAN PROPOSAL

BY SCOTT TOURTELLOTTE AUGUST 1, 2014

Being in banking for twenty-five (25) years and having handled most all aspects for our clients, such as cash management, international transactions, merchant services, etc, what we hear the most angst, confusion and misunderstanding about is obtaining credit. This should not be the case if you have open communication with a good business banker. So, what does my lender need and why is he/she asking for it? (This discussion pertains to a typical commercial & industrial type business and not investment real estate or development)

## BUSINESS PLAN:

Creating a business plan is a very good exercise, not only for your banker's needs, but also for the management team. It defines the mission of the business, its goals (1, 3, 5 years out), who is the target market, provides an industry overview, what is the competitive landscape, etc. It educates your lender on who you are, shows you've put thought into your objectives and that you have weighed the risks and rewards. Your CPA, CFO and/or Controller should be part of the process. Resources are available locally at the Rutgers Business School, US Small Business Administration, NJ Economic Development Authority or from your banker. The business plan should be reviewed periodically by management and adjustments made as appropriate for changing conditions.

## PROJECTIONS:

Your banker may also request projections and this could be part of your business plan, as well. The projections show where you are headed from a financial standpoint and take into consideration some of the choices you made in your business plan. The projections could be for one, three, five years out, etc., but for whatever period they need to contain realistic assumptions given your marketing analysis, demographics, competitive landscape, industry trends, etc. A business plan and projections may not always be required by your banker, but can still be a good planning and management tool for company leadership.

## SOURCES OF REPAYMENT:

Three (3) key focal points of all lenders in underwriting are as follows: Cash flow; Collateral, and Personal Guarantor support. In other words, these represent the primary, secondary and tertiary sources of repayment (in that order). To measure cash flow, the primary source of repayment, you will be asked to provide three (3) years of corporate financial information prepared by an independent CPA. The fiscal year end statements show where the company has been, achievements along the way and help predict where it may be headed. Therefore, the historical financial statements carry the most weight in the underwriting analysis. The trends over these three (3) years will be analyzed by your lender and any meaningful variations positive or negative should be discussed. An open dialogue is important to understanding on both sides and could avoid issues, while also possibly disclosing unusual or non-recurring expenses that could be added back to your company's cash flow figure. The cash flow figure





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for the fiscal year is matched against the company's debt service to derive the Debt Service Coverage Ratio. Debt service is the principal and interest due in the statement period (12 months). The ratio typically needs to be no less than 1.25:1. This means that for every $1.00 in debt service, $1.25 in cash flow is the required minimum. Therefore, the higher the figure the better is the ratio. The debt service figure encompasses existing debt on the books already and would include the principal and interest associated with any new debt if for example you are financing an equipment purchase, the acquisition of a building or need additional working capital, etc. So, this helps answer the question – how's the company covering its current obligations with the existing cash flow it is generating and can that cash flow also cover the payments on the new debt?

The financial statements are also analyzed to determine various other important metrics, such as liquidity (as measured commonly by working capital, current ratio, AR and AP turnovers) and leverage (ratio of debt to net worth) of the balance sheet. This demonstrates how well the company is managing its assets, operations and financial activities. Again, trends will be analyzed by the lender and meaningful variations should be discussed. Future plans that may impact these metrics and the company's financial condition should be reviewed with your banker. Nobody likes surprises!

Collateral support is another key component in credit evaluation. Although an important part of the review, it is agreed by all parties that the goal is never to get to this secondary source of repayment. It is the fallback if cash flow dries up or becomes insufficient to cover the repayment of debt obligations. The general rules of thumb for a bank's advance rate against different forms of collateral is 80% against the lesser of purchase price or appraised value for real estate, 80% against accounts receivable no older than 90 days from invoice date, 30-50% on eligible inventory and 70-80% depending on age/type of equipment (100% for most leasing arrangements). So, the business owner should be prepared to pay for a real estate appraisal. Federal regulations require the bank to engage the appraiser, due to conflict of interest and it is recommended that this not be done until the agreement of sale is finalized, bank approval in place and commitment letter or signed approved term sheet in hand. The cost and turnaround time on appraisals vary considerably. For loans supported by accounts receivable or inventory periodic reports will likely be requested by the lender to make sure collateral support remains sufficient. For equipment loans the invoice or bill of sale with details will be necessary to show collateral value.

The final and tertiary source of repayment is the personal guarantors. These are typically the owners and most cases in Business Banking the operators of the company that have 20% or more ownership interest. So, what will the banker ask you for? Two to three years of personal federal tax returns and a personal financial statement (like a personal balance sheet). This information along with a credit report demonstrates to the banker how well the owners have managed their own finances, which studies have shown correlates to the performance of the business they own. In addition, a personal debt coverage calculation may be performed. The personal information also shows the resources available from the guarantors and their ability to support the business with additional capital, shareholder loans, etc. during periodic fluctuations in operating activity and cash flow.

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So, why doesn't my banker advance 100% against the purchase price of fixed assets or my receivables? Why do I need to keep equity on my company's balance sheet? And why do I need to guarantee? These requirements admittedly protect the bank, which is in turn protecting depositors. The protection is against fluctuations in asset values and not having enough support in case there needs to be a liquidation event. The guarantee and equity support represents the owner's commitment to the company and that the bank is not taking all the risk in a deal. A bank is beholden to depositors and this is heavily enforced by the federal and state regulators.

The keys to a successful relationship with your lender/banker are centered in constructive two-way communication, trust and planning. A good banker wants to understand your industry, your company and its needs.

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