

CHAPTER 3 – THE IMPORTANCE OF KNOWING HOW MUCH, WHY, AND HOW

The following are three examples of small business owners applying for loans, who failed to establish credibility with lenders from the very first meeting.

1. An entrepreneur with a wealth of experience in managing convenience stores approached a lender with a request to finance his own first store. This gentleman had several things lenders look for in a prospective business customer: business knowledge, a modest amount of cash available as an initial equity investment, and even a business plan indicating that all key areas were thought out in advance. A hitch arose when the lender asked this applicant how much money he wanted to borrow. The response was: “I probably need between \$50,000 and \$60,000. Better yet, let us make it \$75,000, just in case.” The lender’s immediate note to himself was: “How can I trust this man’s projections and ultimately his ability to repay the loan, if he does not even know how much money he needs to open his own store?” **You need to know how much you need to borrow.**

2. An owner of an existing architectural firm with about \$4 million in gross revenue approached the bank with a request for a new \$500,000 line of credit. Her company had an existing 3-year relationship with the bank, but had never borrowed more than \$250,000. When asked to explain why she needed this amount of money, the owner confidently responded that she wanted to have some extra money to pay year-end bonuses during a traditionally slow time of the year. However, an analysis of projected financial statements that came with the loan request revealed that the company would need up to \$300,000, while the loan request was for \$500,000. When asked about the discrepancy, the owner was slightly surprised by the question but then explained that the remainder might be needed for unforeseen events. The lender’s immediate note to himself was: “The customer is either not careful with

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estimating the actual financing need or may not be telling the whole story. Do I trust the customer for whom a \$200,000 difference is only a chunk of change?" **You need to know why you need to borrow.**

3. An owner of a high-end women's clothing store approached a lender with a request for a \$200,000 term loan to finance the opening of her new store. She also indicated that she would be providing \$50,000 in personal capital for that purpose. The lender was given a detailed 3-year budget for the new store. It seemed like a perfect addition to the three existing stores. However, the lender noticed that the explanations provided about how the \$200,000 loan would be used were minimal. The expense categories, such as \$50,000 for store equipment, were too broad and did not tie into the lender's familiarity with the industry. The lender also discovered that the costs of opening the last store, of similar size, just two years ago were almost half of the expected costs for the new store.

When asked about the discrepancies, the applicant responded that these were rough estimates to account for cost increases and to allow for contingencies. Moreover, the owner was requesting a loan for three years, while her own projections were showing that the company was likely to repay the loan in five. The lender's immediate note to herself was: "The customer was able to figure out the budget, but could not realistically estimate the very first cash outflow (cost of opening the store)? Not to mention a 200% increase in cost from two years ago and not knowing when her company will be able to repay the loan. Am I being given the full picture, and is the owner able to open and successfully run another store?" **You need to know how quickly your business can repay the loan and whether it can generate sufficient cash flow to repay the loan.**

I should note that these findings did not necessarily preclude these small business owners from securing the funding they sought. However, the above weaknesses certainly did not help them instill confidence in lenders that their loans will be repaid. Financial statements may indicate on paper that loans can be repaid. Nevertheless, if lenders do not believe in you, or get the impression that the numbers are not valid

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or that you do not know what you are doing, the opportunity to get the loan your business needs will be lost.¹

Before you submit your loan request, you must be able to answer these four questions:

1. Why do I need the money?
2. How much money do I need?
3. How fast can I or my company repay the loan?
4. Will the company generate sufficient cash flow to repay the loan?

These four areas should be at the top of your list if you are preparing a formal request for a loan proposal, a formal business plan, a one-page summary of your company's financing needs, or even if you deliver your loan request verbally. By addressing the above issues you will achieve several goals: establish credibility in the lenders' eyes, demonstrate that you have seriously planned for this business decision, and provide documentary support of your planning efforts. Credibility is a very important part of your relationship with any lender. I am confident that my banking colleagues will agree that even when your business has the necessary cash flow and collateral, and your management team has the necessary experience to shape a successful enterprise, a lack of credibility can seriously hamper your ability to secure loans.

Banks and other financial institutions take the lending of money to small business owners seriously. Even large banks that historically overlooked this market niche have come to realize that small business loans can bring significant profits. While individual loan officers lend their companies' money, their professional reputations and jobs are on the line. Bad loans can and will get them fired. This is why lenders want to make sure that you are serious about how you will use their money. They want to make sure that you took the time to estimate your financing needs and evaluate the risks involved in supporting your company's operations with their money.

A word about projections – they do not have to include complex and extensive financial calculations. Many loan requests are pre-screened,

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using what is known as a back-of-the-envelope analysis (very simple financial analysis). However, all projections should be based on sound assumptions and include key elements, which are discussed later in this book.

¹ Remember that the inability to make your case during the very first meeting does not always mean that all hope is lost. However, focus on presenting your loan request the right way the first time. This will save you time and money in the long run.