

## Tools

### How Do I Qualify for a Loan?

Borrowing money is one of the most common sources of funding for a small business, but obtaining a loan isn't always easy. Before you approach your banker for a loan, it is a good idea to understand as much as you can about the factors the bank will evaluate when they consider your loan. This discussion outlines some of the key factors a bank uses to analyze a potential borrower. Also included is a self-assessment checklist at the end of this section for you to complete.

#### Key Points to Consider

Some of the key points your banker will review:

##### 1. Ability/Capacity to Repay

The ability to repay must be justified in your loan package. Banks want to see two sources of repayment — cash flow from the business, plus a secondary source such as collateral. In order to analyze the cash flow of the business, the lender will review the business past financial statements. Generally, banks feel most comfortable dealing with a business that has been in existence for a number of years, as they have a financial track record. If the business has consistently made a profit and that profit can cover the payment of additional debt, then it is likely the loan will be approved. If, however, the business has been operating marginally and now has a new opportunity to grow, or if that business is a startup, then it is necessary to prepare a thorough loan package with a detailed explanation addressing how the business will be able to repay the loan.

##### 2. Credit History

One of the first things a bank will determine when a person/business requests a loan is whether their personal and business credit is good. Therefore, before you go to the bank or even start the process of preparing a loan request, make sure your credit is good. You can obtain a credit report by visiting <https://www.annualcreditreport.com/cra/index.jsp>.

It is important that you initiate this step well in advance of seeking a loan. Personal credit reports may contain errors or be out of date. In many cases, people find that they paid off a bill but that it has not been recorded on their credit report. It can take 3 to 4 weeks for this error to be corrected — and it is up to you to see that this happens. You want to make sure that when the bank pulls your credit report that all the errors have been corrected and your history is up to date.

Once you obtain your credit report, how do you know what it says? Many people receive their credit reports yet have no idea what the strange numbers signify. The following should help in interpreting and checking your personal credit report.

First, check your name, social security number and address at the top of the page. Make sure these are correct. There are people who have found that they have credit information from another person because of mistakes in their identification information.

On the rest of your credit report you will see a list of all the credit you have obtained in the past - credit cards, mortgages, student loans, etc. Each credit will be listed individually with information on how you paid that credit. Any credit where you have had a problem in paying will be listed towards the top of the list. These are the credits that may affect your ability to obtain a loan. If you have been late by a month on an occasional payment, this probably will not adversely affect your credit. However, if you are continuously late in paying your credit, have a credit that was never paid and charged off, have a judgment against you, or have declared bankruptcy in the last 7 years, it is likely that you will have difficulty in obtaining a loan.

In some cases, a person has had a period of bad credit based on a divorce, medical crisis, or some other significant event. If you can show that your credit was good before and after this event and that you have tried to pay back those debts incurred in the period of bad credit, you should be able to obtain a loan. It is best if you write an explanation of your credit problems and how you have rectified them and attach this to your credit report in your loan package.

Each credit bureau has a slightly different way of presenting your credit information. You can get specific information on how to read the report from the appropriate company. You can request a free credit report from [www.annualcreditreport.com](http://www.annualcreditreport.com)

If you need assistance in interpreting or evaluating your credit report you can ask your accountant or a friendly banker. If your credit report has a few problems on it, you may find that another bank may evaluate your credit report differently.

### 3. Equity

Financial institutions want to see a certain amount of equity in a business. Equity can be built up through retained earnings or the injection of cash from either the owner or investors. Most banks want to see that the total liabilities or debt of a business is not more than 4 times the amount of equity. (Or, stated differently, when you divide total liabilities by equity, your answer should not be more than 4.) Therefore, if you want a loan, you must ensure that there is enough equity in the company to leverage that loan.

Don't be misled into thinking that startup businesses can obtain 100% financing through conventional or special loan programs. A business owner usually must put some of his/her own money into it. The amount an individual must put into the business in order to obtain a loan is dependent on the type of loan, purpose, and terms. For example, most banks want the owner to put in at least 20 - 40% of the total request.

Example: A new business needs a \$100,000 to start. The business owner must put \$20,000 of his/her own money into the new business as equity. His/Her loan will be \$80,000. The debt to equity ratio is 4:1. Note that this is only one of many factors used to evaluate the business — simply having the right debt to equity ratio does not guarantee you'll get the loan.

The balance sheet indicates the amount of equity or net worth of a business. The net worth of the business is often a combination of retained earnings and the owner's equity. In many cases, an owner's equity will be shown as a loan from shareholders, and is therefore a liability. If a business owner wishes to obtain a loan, he/she will be obligated to pay the bank back first, not his/herself. Consequently, it may be necessary to restructure the liability so that it becomes the owner's equity, or subordinate the loan. If the current debt to net worth is 4 or over, it is unlikely that the business will be able to obtain additional debt/loan.

Understanding Financial Statements: The primary financial statements are represented in the balance sheet and income statement. Learn more about these statements.

- Balance Sheet

The balance sheet is a snapshot of the company's financial standing at an instant in time. The balance sheet shows the company's financial position, what it owns (assets) and what it owes (liabilities and net worth). The "bottom line" of a balance sheet must always balance (i.e. assets = liabilities + net worth). The individual elements of a balance sheet change from day to day and reflect the activities of the company. Analyzing how the balance sheet changes over time will reveal important information about the company's business trends.

- **Income Statement**

Known also as the profit and loss statement, the income statement shows all income and expense accounts over a period of time. That is, it shows how profitable the business is. This financial statement shows what how much money the company will make after all expenses are accounted for. Remember that an income statement does not reveal hidden problems like insufficient cash flow problems. Income statements are read from top to bottom and represent earnings and expenses over a period of time.

#### **4. Collateral**

Financial institutions are looking for a second source of repayment, which is often collateral. Collateral are those personal and business assets that can be sold to pay back the loan. Every loan program, even many microloan programs, requires at least some collateral to secure a loan. If a potential borrower has no collateral, he/she will need a co-signer that has collateral to pledge. Otherwise, it may be difficult to obtain a loan.

The value of collateral is not based on market value; that is discounted to take into account the value that would be lost if the assets had to be liquidated.

#### **5. Experience**

A client who wants to open a business and has no experience in that business should not seek financing, let alone start the business unless they intend to hire people who know the business or take on a partner that has the appropriate experience. Regardless, the client should be advised to take some time to work in the business first and take some entrepreneurial training classes.

Questions your banker will ask — The key questions the banker will be seeking to answer are as follows:

1. Can the business repay the loan? (Is cash flow greater than debt service?)
2. Can you repay the loan if the business fails? (Is collateral sufficient to repay the loan?)
3. Does the business collect its bills?
4. Does the business control its inventory?
5. Does the business pay its bills?
6. Are the officers committed to the business?
7. Does the business have a profitable operating history?
8. Does the business match its sources and uses of funds?
9. Are sales growing?
10. Does the business control expenses?
11. Are profits increasing as a percentage of sales?
12. Is there any discretionary cash flow?
13. What is the future of the industry?
14. Who is your completion and what are their strengths and weaknesses?

#### **Commercial Loan Evaluation Factors**

The following factors indicate the "ideal" situation for going to a bank for a small business loan. If you cannot respond "yes" to all of these factors, it does not mean that you cannot obtain financing. Lenders look at these factors in the aggregate. In other words, if you are weak with respect to one factor but strong in another, your overall situation may allow you to obtain a loan.

#### **Applicant Factors**

- Credit: excellent ratings and no personal or business bankruptcy.
- Arrest: no arrest for fraud, theft, embezzlement, or drug/alcohol abuse.
- Cash: applicant has 20% or more of cash needed for the project.

- Net Worth: applicant has net worth (for use as collateral) greater than 100% of the loan amount.
- Income: applicant does not need to draw income from the project for a period of time. Fixed payments per month (house, car, credit cards) do not exceed 40% of net income. (A working spouse who can cover living expenses is highly desirable. Must provide three years of tax returns to verify income and standard of living.)
- Experience: applicant has three to five years' general management experience as a minimum, and, preferably, one or more year's industry specific experience.

### **Business/Financial Factors**

- Buying an existing business
  - Profitability — must have good track verified by 3 years financials and tax returns.
  - Gross Sales — should be in excess of \$100,000 per year.
  - Asking Price — should have a thorough valuation, including appraisals.
  - Market Position — should have a good market position.
  - Financial Ratios — should compare favorably to industry standards.
- Starting a new business
  - Market — must have a thorough market analysis.
  - Location — must be a clearly good location.
  - Experience — applicant must have excellent experience.
- Expanding a business
  - Profitability — good track record.
  - Cash Injection — must have at least 10% cash needed.
  - Financial Ratios — better than industry standards.
- Any business
  - Liquidity ratio — 1.0 or better.
  - Coverage ratio — 1.2 or better.
  - Debt/equity ratio — 3 or better.
  - Detailed business plan, including three years pro forma statements.

## Self-Assessment Checklist

Whether you are applying for a microloan, SBA loan or a traditional bank loan, there are certain factors that improve your ability to obtain financing. The following is a simple checklist to do before you begin to seek capital.

Do you have a good personal credit history?	Yes	No
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Research indicates that good personal credit history is one of the most important factors in identifying borrowers that will repay their commercial loans. Many loan programs require perfect personal credit in order to qualify.

Have you filed all income tax returns?	Yes	No
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Lenders and government loan programs alike want to see that an individual has met their tax obligations for both filing and paying taxes. For SBA loans tax verification is obtained from the IRS before a loan is closed.

Are your Income Taxes paid?	Yes	No
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Many of the loan programs are in partnership with government agencies. These loan programs do not look favorably on individuals who have unpaid income taxes.

Does the business have the ability to repay a loan?	Yes	No
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(For existing businesses) If the business is profitable, then there are demonstrated profits to repay some amount of new debt. If a business is not profitable, then it becomes very important to prove how it will be profitable in the near future so that a loan can be repaid.

(For start-up businesses) It is very important that you find as much data on comparable businesses or industry statistics as possible, in order to "prove" the revenues you intend to generate and the expenses you anticipate incurring.

Does your business have a positive net worth?	Yes	No
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(For existing businesses) The net worth of the business should be positive. If there are loans from shareholders on the balance sheet and you are able to subordinate these (not pay the shareholders) while you pay the bank loan back, you may consider these loans from shareholders as equity.

Is your business not carrying too much debt?	Yes	No
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(For existing businesses) Businesses that have too much debt will find that their profits are directed at paying back loans and not building retained earnings in the business that can fund future growth. Consequently, banks and government loan programs look more favorably at loan requests that do not add too much debt to the business. Banks often look for a debt to net worth ratio of 4 or less (total liabilities divided by equity).

Do you have enough of your own money in the business?	Yes	No
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(For start-up businesses) All loan programs require that the business owner put their own money in the business. This owner equity injection shows that the owner believes in the business enough to risk his or her own money. Some microloan programs require only 10% owner equity; other programs require at least 30% and will look more favorably on a loan request the more equity is in the business.

Do you have collateral to secure a business loan?	Yes	No
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Business and personal assets can be considered collateral, or a way to repay the loan if the business defaults on a loan. Most collateral is valued at an amount less than face value based on a variety of factors.

Are you willing to personally guarantee a loan?	Yes	No
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Most business owners are asked for a personal guarantee in order to obtain their first business loans.

Does your business have qualified managers and advisors?	Yes	No
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(For existing businesses) As businesses expand, they need more sophisticated management as it relates to strategic planning, marketing, recordkeeping, inventory control, personnel, etc. When you apply for a loan, your banker will consider the qualifications of your management team and advisors in order to determine if they are capable of leading your business to the next level of growth. If there are sectors of your business that you need assistance with, we strongly recommend that you attend entrepreneurial training classes, visit a Small Business Development Center or women's business assistance center in your area, or contact your regional SBA office for information on local resources.

Do you have experience in running your own business?	Yes	No
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(For start-up businesses) For a new business especially, it is important for the business owner to demonstrate that she has experience in the industry and/or entrepreneurial experience. If you have never owned or operated a small business before, we strongly recommend that you attend entrepreneurial training classes.

**STOP! If you cannot answer yes to all the questions above, then you may have difficulties obtaining financing at this time. We suggest that you evaluate the needs of your business and take advantage of local business assistance centers.**