Creative Business Planning Incorporated CBPX

Operating Your Business Takes Planning - Creative Business Planning Incorporated

The Entrepreneur's Guide to Financial Maturity ®
Lines of Credit

Obtaining necessary capital is arguably the single most difficult hurdle a small business experiences. Lack of cash flow can seriously impair your company's financial health and its very existence. Obtaining financing can be a long and arduous process, and we often fail to adequately package our company for financing. Many times we are too busy with the day-to-day operations of our business and we fail to prioritize, delaying financing requests until it is an absolute necessity of survival. This results in business owners' getting "sticker shock" when they discover their cost of capital on a "priority" basis.

The time to look for a working capital line of credit, or any other type of financing, is when you do not need the money, not when you need it. A Line of Credit (Line) should be sought in anticipation of your business needs, allowing for ample time to secure financing. Your financing request may have become your top priority, but it is not your financial institution's top priority. Since delays are commonplace, however long you anticipate it will take to close on your financing request, double it and add a cushion. Remember most institutions, especially banks, reject more applications then they approve. Be prepared if your request is declined. Hopefully by providing ample time to obtain financing you will be pleasantly surprised, and not suffering from cash crunch that can jeopardize your business.

In order to successfully obtain financing, you should think like the institution that will be providing you with a loan. You must provide information in a coherent, logical manner that answers questions before they are asked. Very often that is done in the form of a story that includes the company's history, mission, vision, objectives, track record and how the additional financing will assist in achieving those goals.

When a Lender receives a loan request, the Lender will have several basic questions, such as:

- What is the purpose of the loan?
- Was it poor cash management that created the need for financing?
- Was this cash shortage a surprise or was it predicted with careful cash flow analysis?
- What events led to the situation?

If you fail to provide your Lender with a clear understanding as to why you need to borrow, your loan request will, in all likelihood, be declined. Often times the need to borrow is a function of growth, business seasonality or a wide array of predictable or other understandable reasons. If the financing request is attributable to poor cash management, you will need to demonstrate to the lender that you will avoid the situation in the future.

The primary purpose of a Line should be to:

- Stabilize cash flow when fluctuations are seasonal and predictable
- Finance the purchase orders that have already been received
- Implement programs such as public relations or advertising program that should generate sales within 2 to 6 months after its implementation
- Finance inventories for your peak selling season or for an anticipated sales increase attributable to a new advertising campaign
- Seize opportunities where you need immediate access to funds and you will be able to replenish the line within a relatively short amount of time
- Purchase items too large for a credit card but too small for a loan

Lines should be used to even out your cash flow or as a back-up source of funds in the event of a "cash crunch." **<u>Lines should not be used to defer making unpleasant decisions such as reducing overhead or payroll.</u>** Lines are intended to allow you have access to cash anytime for routine operating expenses. You can borrow up to the maximum amount of the Line and pay it back when cash flow permits. Once you draw down on the Line, your Lender will want to see you make some payments on the outstanding loan balances. Lenders get nervous when a borrower draws a significant portion of the available credit and the borrower fails to repay any portion of the balance after 4 to 6 months.

Generally, Lines are for a term of 12 to 36 months and require you maintain certain minimum financial requirements (financial covenants), such as profitability, liquidity etc. If you fail to adhere to the Lender's terms or your actions or lack of repayment create concerns for the loan officer, the lender may "call the loan" (require you to repay the loan) or not renew the loan when it becomes due.

Lenders' Analysis:

Once the lender is interested in your specific funding request, the lender will conduct due diligence on your company. You should anticipate that key components of any Lenders' analysis are:

- Credit – The borrower's credit history and credit scores
- Capacity – Business' history and projections for loan repayment
- Collateral – What collateral, loan guaranties or additional forms of security can the borrower provide?
- Conditions – What is the purpose of the loan? What are the economic justifications for the loan? - The impact on the business' earnings and cash flow potential?
- Capital – How much equity the borrower has "at risk" in the business
- Character – Besides the borrower's credit history (an excellent indicator as to the borrowers character) the general impression the borrower makes to the lender. This may include background, experience, trustworthiness to repay the loan and quality of references.

If there are significant inconsistencies between the information you provided and the due diligence, your loan request will, in all likelihood, be declined.

As a small business owner, most lenders will be looking at your credit score to determine your business' credit, capacity etc. If you, as a small business owner, have a number of credit "dings" or you are considered be "sub-prime" credit risk (a FICO score of 620 or less), there is a strong likelihood you will not qualify for bank financing. Maintaining good credit is of paramount importance, especially when pursuing any bank financing. If you do not have good credit, you might qualify for funding from second and third tier institutions. If you are unable to obtain a bank Line, you should develop and.

implement a program that will enable your company to qualify for bank financing.

The Importance of Cash Flow in Underwriting Your Loan:
You should expect to show the lender that there is sufficient cash flow to repay the Line, as if it were fully extended. This is true irrespective of whether the Line is secured by collateral (a Secured Line) or is not collateralized (an Unsecured Line). The cash flow analysis might include a:

- Review of the Business Plan
- Management Review
- Analysis of Financial Statements
- Cash Flow Analysis

Your banker not only considers your ability to repay the loan utilizing financial ratios and trend analysis, but will also scrutinize the cash flow within your company. In order for the funding institution to underwrite your loan you should anticipate providing your loan officer with, at a minimum, the following documentation:

- Business Plan
- Resumes of primary members of the management team
- Past two years of your company's annual financial statements
- Interim company financial statements
- Certain support documentation such as accounts receivable or payable aging reports
- Projected cash flows and assumptions
- Estimates of market and/or liquidation values of collateral to be provided
- Marketing and advertising materials used by your company
- Documents supporting any long term commitments your company has
- Personal financial statements
- Personal tax returns

If your company is approved for a Line, in all likelihood the lender will require the personal guarantee of the business owner. This is true whether the Line is secured or unsecured.

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