 3C's Character Collateral Cash Flow credit

Ask Your Banker: The Loan Request, What do Banks Look For?

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Getting your Foot in the Door

Frustration is not a big enough word to describe what you may have to go through getting a loan from a bank. Different banks have different policies regarding what they will lend money for, what their pre-qualifications are and what they require to complete a loan package.

Let's examine the pre-qualifications. You first must call the banks to find out what they will and won't finance, as well as each bank's exact pre-qualification tests, before you approach them.

There are four basics used by a banker to separate the good from the bad. Three are financial ratios and the fourth is your personal and business credit.

Debt-to-Net-Worth Ratio

This reveals how much you have in equity compared with how much debt you are carrying. This is also called "leveraging." For example, if you own an established business, the debt-to-net-worth ratio (D/W) could be 4.0x, which is the SBA standard. Most banks want a 3.0x D/W or lower. If your net worth is $10,000, multiply that times three to equal $30,000; this is the maximum debt you can have after the new financing is in place. You have leveraged your equity three times.

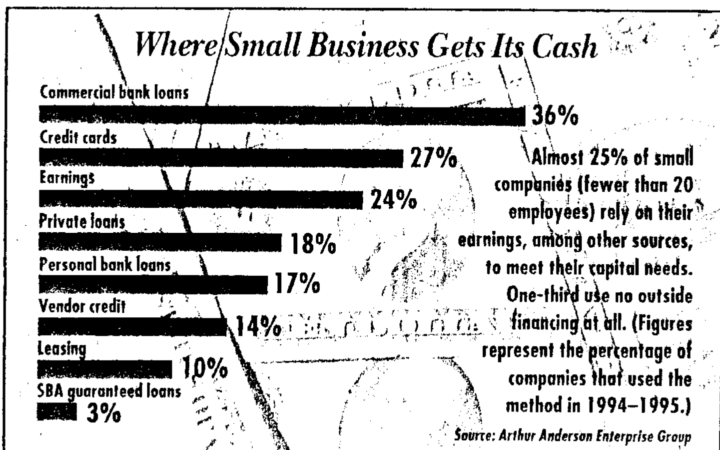
Debt Service Coverage Ratio

This lets the banker know if you can repay the loan and how much money is left after loan payments to use to help the company grow. Banks also allow some room for business mistakes when calculating this ratio. The qualifying ratio depends on whether it is a mortgage on commercial real estate (ratio: 1.25x) or an established business for a commercial loan (ratio: 1.5x) or a start-up (ratio: 2.0x.)

The bank looks at the annual net profit and adds back depreciation to arrive at the amount available to service debt (cash flow.) Then, they annualize (multiply monthly payments by 12) present debt and new debt payments. The annualized payments are divided into the annualized cash flow to determine the ratio. For example:

Your company has $20,000 in net profits and $6,200 in depreciation; this equals $26,200. Present debt payments are $250/month x 12 = $3,000 plus the new debt, which is $1,200/month x 12 = $14,400. Added together, this totals $17,400. Divide this figure into $26,200 and you will determine that 1.5x is your debt service coverage ratio. This means that, for every $1 you have to pay, you have $1.50; this leaves you $.50 for growth and/or as error allowance. If you are an established business, you're all right; if you're a start-up, go back to the drawing board and see if you can logically increase revenue or decrease debt to arrive at a qualifying ratio.

Banks look at past performance to project the future, so be certain that your projections are based on historical figures and provable assumptions regarding how you're going to reach the revenue goals. If your business is a start-up, your marketing research has to be thorough, deep and provable to set the revenue goals.



Collateral Coverage Ratio

This is the bank's exit strategy. How do they get out of the loan and get their money back if the business fails? Most of us know this as loan-to-value ratio (LTV), however, bankers like to use collateral coverage because it covers all types of collateral. The amount the banks will advance on any assets varies depending on the bank, the company, the type and quality of receivbles, the inventory or the funiture, fixtures and equipment. Here is how a bank may compute this ratio, assuming the loan amount is $100,000:

- Accounts Receivable (75% of those less than 60 days): $75,000 x 75% = $56,205
- Inventory (50% of saleable only, no goods in process): $5,000 x 50% = $2,500
- Furniture/equipment (50% of market depreciation value): $100,000 x 50% = $50,000
- Equity in real estate: value is $150,000 x 75% = $112,500 less the first mortgage of $75,000 = $37,500
- Discounted value of collateral $176,250

(Note: The bank wants first lien on all business assets, but many will take a second on real estate.)

A loan of $100,000 divided into collateral value of $175,250 equals 1.76x or, for each $1 of the loan, there is $1.76 in collateral. Banks like 1.0x or better. If you are short of collateral, sometimes an SBA guarantee on the loan will make it bankable.

Good Credit

Fourth, as mentioned earlier, your credit must be good, and if there are blemishes they must be explainable. Poor credit almost always is impossible to get financed unless you have marketable collateral and are willing to pay high rates and fees.

These secrets will help you determine if you can qualify.

Ask Your Banker

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much time and aggravation. Calculate these simple ratios and communicate them with the banker up front. If the banker is interested, you will be informed immediately. If there is no interest, take the proposal to another banker and try again. Keep in mind that these ratios are guidelines; banks have their own guidelines and therefore may require higher or lower ratios—but these simple ratios are a good starting point.

Ask Your Banker: Commercial Loan Pre-approval As Simple as 1, 2, 3

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Generally, bankers like to simplify the process used to weed out loan requests having no merit from those warranting another look. It doesn't matter how complicated, or the size of the loan request, the basic procedure is as simple as 1, 2, 3.

Following is what the cautious eye of the banker considers to pre-qualify the request:

- **One** times discounted collateral coverage of the loan ($100,000 loan x 1 = $100,000)
- **Two** times the annual loan payment (principal plus interest) in annualized cash flow (cash flow is net profit plus depreciation less taxes). If cash flow were $30,000 divided by 2 = $15,000 maximum annual payment, or $1,250 monthly.
- **Three** times equity or net worth to calculate the maximum loan ($25,000 in net worth or equity x 3 = $75,000 maximum loan.)

Actually, the banker does this in reverse order, looking at number three first, then two and finally one. In the above case, the maximum that can be borrowed in number one, supported by collateral, is $100,000. Bankers refer to this as collateral coverage ratio.

The maximum repayment amount, supported by example number two, is $73,000. Using an 11 percent note and a seven-year amortization, borrowing $1,000 would cost $17.13 per month; therefore $15,000 annually divided by 12 months = $1,250 monthly. This amount, $1,250 divided by $17.13, yields $72,971, rounded to $73,000, and the maximum loan that can be supported by cash flow. Bankers refer to this as the **debt service coverage ratio.**

The maximum that can be borrowed based on net worth is $75,000, but that is only if there exists no other debt. Actually, in an existing company, the banker would reconstruct the balance sheet, based on the use of proceeds, adding to the assets any purchases of inventory or fixed assets and then subtracting any debts that will be paid from the liabilities. Then, any loans from the company principals would be added to the net worth. The balance sheet will be recalculated to obtain a new ratio. Bankers call this the debt-to-worth ratio.

So, which number wins? The smaller of the three, of course.

Remember

#1 Collateral base—$100,000

#2 Payment ability base—$73,000

#3 Net worth base—$75,000

Maximum loan will be $73,000 and, yes, there are mitigators for each, as follow:

1 Bring in more collateral and/or personal assets, such as home equity. Also, part of the loan proceeds may be used to purchase assets, which become more collateral. This equates to a larger loan amount based on the collateral.

2 Loans are paid from future cash flow. If the proceeds will be used for marketing or new equipment that will increase revenues—and subsequently cash flow—this will increase the ability to repay debt, thereby increasing the loan amount.

3 There may be loans or other debt that can be subordinated to the bank, or additional monies can be injected to increase net worth, thereby leveraging into a larger loan.

Knowing the one-two-threes of pre-approval and applying them to a proposed loan request will save you

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Finally, A Guidebook that Speaks their Language

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