

Small Business Loans

The purpose of this publication is to give you basic information on small business loans. If you are interested in US Small Business Administration guaranteed or direct loans, please ask for the publication "SBA Loan Basics."

Where do I get a loan?

Most banks and some credit unions will make small business loans. Usually, a savings and loan institution will only make consumer or mortgage loans. The US Small Business Administration (SBA) may be an alternative, if your business qualifies. SBA generally does not guarantee business loans unless you are unable to obtain the required financing on reasonable terms due to the risk of your venture or lack of collateral. The SBA has some of the same lending rules that commercial banks follow, but relaxes requirements for collateral. Ask for the publication, "SBA Loan Basics," for more information on the US Small Business Administration.

What types of loans do banks offer small businesses?

There are many types of loans that your bank may offer, listed below are a representative few. Specific availability of loan products varies greatly across the financial services industry. For specific information, ask your loan officer about the types of products offered business borrowers.

The most common type of loan is for a fixed term of a set number of years at either a fixed or variable interest rate. Often, the loan may be amortized over a longer period of time, resulting in lower monthly payments, but have a "call" feature that enables the bank to renegotiate interest rates and terms periodically based upon the performance of the business and other lending conditions.

Often, a business may need a line of credit upon which a set amount of money may be drawn. These loans operate similar to credit cards, where you pay interest only on the portion that you actually borrow. Usually, credit lines are for short-term financing needs, such as working capital, inventory, or other current asset financing.

Banks may also offer mortgage loans for commercial property. Usually, these loans are for much longer periods of time than typical term loans or credit lines, due to the fact that the loan is used to purchase a fixed, or durable, asset such as land, buildings, or in some cases, capital equipment.

How do I qualify for a bank loan?

Banks are highly regulated by our government, which means they must meet certain standards set by regulatory agencies, as well as their internal board of directors. Banks are usually in business to earn a profit, and have the responsibility to stockholders to seek and make loans that have a low likelihood of default and a reasonable assurance of earning a profit. The banking industry uses the "Five C's" of creditworthiness to determine your borrowing and repayment ability, and whether your loan proposal merits consideration.

The 5 C's of Creditworthiness

Character

"Character" refers to your personal credit history. The bank feels that good character is reflected in an excellent repayment record, and therefore personal credit history. Your credit report needs to be very good to be considered for a loan, although policies may vary among different banks. The US Small Business Administration typically does not look favorably on those with poor credit histories. It is a good idea to review your credit report *before* you make application for the business loan. You may obtain copies of your report from the three major credit bureaus at minimal cost. These agencies, and their telephone numbers, are: Equifax (800.685.1111), TransUnion (800.888.4213), and Experian (888.397.3742).

Capacity

"Capacity" refers to the ability of your business venture to repay the debt. Just as a bank will not finance an automobile if you cannot afford the monthly payments, lenders also will not finance

your business if you are unable to repay. Your business must have a proven cash flow history if you are an existing business. For new businesses, your business plan must prove that there is a demand for your products and/or services, and that you are capable of meeting that demand. Considerable market research is usually necessary to convince a bank of a new business's ability to repay the debt.

Capital

"Capital" refers to the money and/or assets that you have available to invest in your business venture. Often referred to as "down payment," capital actually refers to your equity in the business venture. Banks minimally require at least 20% equity in your business, *after the loan*, in cash, inventory, or other assets. Most banks do not do 100% financing for homes, automobiles, nor businesses. Additionally, SBA will summarily reject your application without consideration if you do not have sufficient equity investment in the project.

Collateral

"Collateral" is the property offered as security to the lender if you are unable to repay the loan. It is a secondary source of repayment in the event of default and will be sold to satisfy the unpaid debt obligation. Collateral is often misunderstood for many people, because banks typically require more than 100% collateralization for the loan. The risk inherent in small business dictates that banks undertake additional security measures to protect themselves when dealing with an uncertain future. Additionally, many banks will discount your collateral offering, which means that they will allow less than market value for the asset. The reason for this is that the bank often liquidates the property at auction or through a quick sale, and may only receive a fraction of what you paid for the asset. Additionally, many assets may be highly specialized, will depreciate rather rapidly, or may even "disappear" when businesses fail.

Conditions

"Conditions" refers to the marketplace that you are entering and the management experience or skills that you bring into the business. Banks realize that the number one reason for business failure is the inexperience or incompetence of the management team, so they look carefully to assess your chance of success. Banks also evaluate the experience of your management team, carefully scrutinizing whether they are fully qualified to handle the project. Loan officers will also evaluate the local economy to determine whether your venture has a reasonable chance of success, if the business expansion is timed properly, and whether the deal makes "sense."

How do I apply for a business loan?

Most bankers prefer that you make an appointment to see them, rather than just dropping in to make a loan request. You may only have one chance to have their full attention, and you need to be completely prepared. Your business plan should be in writing and should be concise, yet thorough. The executive summary should grab the reader's attention, pointing out the key details of your project in less than one page. For more information on business plans, ask for the publications "Sample Business Plan," and "How to Write a Winning Business Plan." The Small Business Development Center Consultants can provide technical assistance with your plan as well, although they cannot write the plan for you.

After you make your presentation to the bank, the loan officer will thoroughly review your business plan, critiquing the 5 C's of credit mentioned above. If your deal is appealing to the officer and fits their loan portfolio, your deal may be referred to a loan committee for further review. This committee consists of people you probably will never meet that consider loans for approval or denial. The executive summary of your business plan may be read aloud, and your financial projections will be carefully scrutinized. If your loan is approved, your loan officer may ask you to complete preliminary paperwork and will inform you about the closing process. If rejected, you should receive a letter from the bank stating the reasons for rejection. Occasionally, a deal may be referred to the Small Business Administration for more consideration. For more information, contact your local Small Business Development Center, or refer to the publication "SBA Loan Basics."