



Texas Agricultural Extension Service

How to Secure and Maintain A Business Loan

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Borrowing money is an essential business activity that has become more competitive and more time consuming over the years. The relationship between lender and borrower can be very crucial to the well being of a firm. Therefore, it is important to plan for financial needs by presenting a well prepared loan proposal and cultivating a strong, positive relationship with a lender.

This publication provides insight and guidance on how to obtain a business loan and maintain it. It will give an overview of how to choose a lender, how to prepare a loan proposal, what criteria lenders use to make their decisions, and tips on building a beneficial relationship with the lender.

Choosing a Lender

When looking for a lender, you want to look for the same qualities you would with any other supplier or business associate. Since the relationship could be long-term, you want to spend time searching for the best lender to meet your business financial needs now, as well as in the future. The best procedure in choosing a lender is to contact prospective lenders and to gather information such as:

- Types of loans offered – The traditional and most common loans include revolving credit, uncollateralized, mortgage and term loans.
- Sizes of loans available – Loan limits may be imposed by regulation or established by the

institution, which puts restrictions on loan size depending on the firm's industry and the loan request.

- Types of industries – Some financial institutions have expertise in certain areas and prefer to only loan to those industries.
- Credit requirements – Standards regarding amount of equity, collateral, number of years in business and management history are usually required.
- Ability to understand your needs – Do they understand your business and how it works?
- Ability to supply your needs
- Flexibility of loan terms
- Familiarity with government programs
- Willingness to work with other lenders
- Current interest rates
- Time required to go through the loan process
- Compensating balance requirements**

If your financial needs include a variety of services, such as long-term funds and working capital, one lender may not be able to meet all your needs. In that case, you want to find a lender who is willing to work with other lenders to develop a plan that will meet your needs. This scenario is common and is known as "combination lending." It may involve several lenders ranging from federal programs, like the Small Business Administration, to state programs and

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** See definitions

regional lending pools. Many times a bank will monitor and disperse the funds, while the other programs will guarantee a portion of the funds or provide long-term financing for expansion or capital improvement. It is beneficial to know about these different lending sources and to locate a lender who is willing to work with such a plan if needed.

One lender may not be able to meet all your needs. In that case, you want to find a lender who is willing to meet all your needs.

If financing sources are very limited, thorough research on the available lending institution and loan officer is very important. Information on how and on what the lending decision is based will help determine the best approach and required information needed to persuade the lender to provide funding. However, choices may be more numerous by considering federal and state government programs and searching a wider geographical area.

Once a lender has been selected who can serve the needs of your firm, then develop the loan proposal to emphasize the institution's and loan officer's requirements for loan approval.

Loan Proposal

Business owners must plan before developing a loan proposal. Lenders respect and prefer to deal with people who make a special effort to plan their financial needs. A well-structured and documented loan proposal highlights a business owner's credit risk attributes. It also shows that the business' top managers know what to expect from their operation.

While preparing a loan proposal, remember that the main goal is to obtain a loan. To do so the borrower must sell the idea to the lender. The borrower must convince the lender that granting the loan will satisfy the lender's goals and be a profitable business decision. Focus the preparation, writing and structure of a loan proposal for the intended loan officer and financial institution. Careful planning improves your chances of getting a loan proposal accepted.

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The standard loan application form is designed to gather the required information, but does not adequately describe the business goals, operational strategies and the management capabilities of the firm. Therefore, it is advisable for the borrower to first deliver the loan proposal and take the opportunity to sell the lender the loan request. Filling out the application afterwards will be a mere formality since the information has already been presented to the lender in a manner more favorable to the borrower.

A loan proposal is usually not required of a potential borrower. However, it will illuminate the attributes of the firm, good and bad. Preparation of a well-structured, documented loan proposal provides many benefits including the following:

- Forces thorough research of a business and development of a written plan for its operation.
- Provides an opportunity to identify company goals and develop appropriate strategies.
- Reduces the time a lender must spend deciding whether to approve a loan proposal.
- Reduces the time a borrower must take to provide additional information to the lender.
- Identifies potential business problems, allowing time for plans or adjustments to be made.
- Lays the groundwork for intelligent and frank lender/borrower communications.

Criteria for Lender's Decisions

Lenders base their decisions on four basic criteria: character, capital, capacity and collateral.

Character – This deals with the *integrity* of the owners and managers of the firm. The lender tries to assess the management's trustworthiness and the firm's past credit history in order to determine the reliability of the firm's key personnel and owners to adhere to the agreement and repay the loan.

Capital – This information is derived from the balance sheet. It refers to the amount of money used to finance the company's assets and operations. The main concern is that the owners have enough of *their own money or equity* invested in the firm to motivate them to manage the firm in a prudent manner with continued operations and maximizing profits as their main goals. The lender also evaluates whether the business has enough equity to protect the operation from unexpected adversities.

Capacity – This information is derived from the income statement and cash flow projection. To assess capacity, the lender evaluates the projected sources of repayment, the expected outflows and the probability that the amounts and timeliness of each will occur as projected. In other words, will the borrower have *enough cash* coming in to pay off the loan as planned?

Collateral – This information is also taken from the balance sheet. The lender is looking for assets that would qualify as a *secondary source of repayment* or security for the loan. Often a lender will require an independent appraisal of assets, including an evaluation of their liquidity or how easy the assets can be sold at their market price.

These four criteria are used to answer one basic question, how risky is this loan? The lender is trying to compare the firm and its condition against other firms and individuals that would also like a loan. The lender's main concern is repayment of the loan as agreed without any additional administration costs by the lender.

Loan Proposal Format

There is no standard format for preparing a loan proposal. The style and format of an appealing proposal varies among financial institutions and the lending officers within them. In many financial institutions more than one lending officer will review a specific loan proposal. In some cases it will be

Guidelines for preparing a loan proposal

1. Identify the lender's needs.
2. To enable you to include all pertinent written information, determine who in the financial institution will review the loan proposal.
3. Prepare the proposal in an orderly format that enables the lender to make a decision as quickly as possible.
4. Write and target the proposal for the lender(s) to whom it will be presented.
5. Be realistic in the proposal and keep it short, factual and to the point. A typed, double-spaced proposal should be seven to 12 pages long, not including supporting financial statements. To expedite the review process, provide at least two extra copies to the lender.

reviewed by a senior lending officer, other credit department personnel and even members of a special loan committee. A loan proposal must be written and structured in the style and format preferred by the financial institution and the lending officers. Regardless of the style and format of the proposal, it must clearly and accurately describe your business and portray its potential for success.

An outline of what typically should be included in a loan proposal is shown in Table 1. Modify as needed to suit the lender and financial institution.

Human Relations

Your personal appearance and approach to doing business with the lender is important to the loan proposal being accepted. You are the image the lender associates with your business. Appearance is important because it conveys how you feel about the relationship with the lender and it gives an impression of how you do business. By being well groomed, regardless of your business activities, you have made a positive statement. Your personal approach to the matter is important because it shows your confidence and business mannerisms. Being prepared, knowing answers to questions and paying attention to detail will give lenders a good impression of your management skills.

Your approach to servicing the loan ensures future requests. Since the loan is an integral part of your business, keep the leader in touch with your business. Suggested ways to do this include:

- Provide unsolicited periodic reports of your business.
- Inform the lender of how your business is doing, the good and the bad. If an unexpected problem arises, let them know as soon as possible. Informing them promptly increases the possibility that a workable solution can be achieved. It is also much better for the lender to hear the news from you than an outside source.
- Make the loan payments a few days early. This demonstrates you are sensitive to the lenders' needs, not just your own interests.
- Inform the lender ahead of time if a payment is likely to be late.
- Let the lender see you bring in the deposits and loan payments on time and for the full amount.

Table 1. What to include in a loan proposal.

Topic	Number of Pages	What to Cover
Cover page	1	List the name of the business and of the borrower, date of request, amount of money being requested, purpose of the loan, source of repayment, address/telephone number of the business and type of business. Include a table of contents in the second half of the cover page to direct readers to specific information.
Business	4	Explain the business' history, products, industry, marketing strategy, major customers, management structure and key personnel and number of employees. Also describe the experience and management capabilities of the principals in the company; and, if the business is a sole proprietorship, include a resume of the owner.
Proposal	1/2	State the amount of capital requested, purpose of the loan, terms of the financing requested (time period and length of loan), sources of primary and secondary repayment (sales, profits and collateral) and interest rate desired. Also list and describe any equipment to be purchased as part of the loan request.
Justification	1/2	Indicate why the lender/investor should favorably accept the proposal. Why is the proposal a good loan or a good investment?
Financial statements	1/2	Show in condensed form a projected balance sheet and a profit and loss statement covering the period for which the loan is being requested, plus historical comparative income statement and balance sheet data for two to three years. Prepare a monthly cash flow projection for the same period to demonstrate how the loan will be repaid.
The future	1	Comment on where the company will go over the next three to five years (business objectives, strategies, plan of action).
Supporting information	1/2	This optional section includes provision of the principals' personal financial statements, personal income tax returns and reference letters attesting to their managerial experience, character, honesty and integrity.

By maintaining contact with the lender, you are reassuring him that he or she made the right decision and that you are a reliable customer. By being a good loan customer the lender is assessed favorably by his or her superiors, which makes future loan requests easier for you to obtain.

Summary

Borrowing money is an essential business activity. By *carefully choosing a lender, planning and preparing a loan proposal and treating the lender as a valuable business associate*, your financial needs will be met more easily.

Lenders are not all alike. They specialize in different industries, provide different services and compete for different kinds of customers. It is important to find a lender that is sensitive to your needs, able to offer the services you need and understands your particular business. Choosing a lender you are comfortable with and can effectively communicate with is also very important.

Loan proposals should provide a lender with a complete picture of a firm's goals, operations and financial requirements. A proposal should portray the soundness of a firm's operating plans, the capability of its management team, the credibility of its financial statements, its potential profits and the adequacy of its capital investments. By presenting this information, business owners demonstrate that they are effectively managing their business operations and that they are sound credit risks.

By carefully choosing a lender, planning and preparing a loan proposal and treating the lender as a valuable business associate, your financial needs will be met more easily.

Maintaining a close relationship with the lender is beneficial for your business. A customer that is easy to work with, supplies the information requested, and adheres to the planned agreement will be highly favored by the lender. In addition, the customer that goes out of his or her way to keep the lender informed and takes special care of his or her financial matters is a customer that builds trust. Such business relationships take time, but the benefits well exceed the costs.

Glossary of Lending Terms

Compensating balance – A designated sum of money that is required by the loan agreement to be left in the firm's checking account. A compensating balance is a common practice but does increase the effective interest rate or overall cost of the loan.

Equity – The amount of money a company would have left if all the assets were sold and all debts were paid; also referred to as net worth. Lenders look at this amount to see how much the owners have invested and risked in the firm and therefore determine how safe they think their money would be in the firm.

Fixed-rate loan – Any loan in which the interest rate stays the same throughout the life of the loan unless another contract is negotiated. An advantage is that payments are known, which helps in planning cash needs.

Line of credit – An operating loan that is usually expected to be paid back within a year or a business cycle. A maximum amount is set from which you may borrow. The amount decreases each time you use funds and is not replenished when paid back. Excess funds can be used to lower the amount owed at any time, which decreases interest costs. Good projections of cash needs are helpful to ensure that sufficient funds exist throughout the year, as well as minimize interest expense.

Loan terms – Agreements in a loan contract that include such details as when payments are due, interest rate of loan, compensating balance, collateral, certain financial ratios that need to be maintained, stipulations on buying costly items, approval by lender of changing certain company policies such as credit terms to customers, and other agreements. Financial institutions usually have policies to help determine these factors. However, if the firm has special needs that are hurt by certain terms, a flexible lender will work to find an agreement that will cater to the firm's special needs while still protecting the bank's interests.

Mortgage – A loan in which land or buildings are put up as collateral. It usually is for the purchase of the items being used as collateral, however, the funds can be used for other needs as well.

Operating loan – A loan negotiated every year to finance anticipated cash flow cycles of your firm. It traditionally finances funds for inventory, accounts receivable and other lags within your business, and is expected to be paid off sometime during the year, normally the month of highest cash inflow. This is not to be used for financing new items that will be used in the firm over a long period of time.

Revolving line of credit – A loan that works similar to a personal credit card because a limit exists from which you can borrow and repay as often as you like, without going over the limit. This type of loan is usually granted to very strong firms, since the lender has less control over why and when the money is withdrawn. This type of loan gives the borrower more flexibility.

Term loan – A loan that has a set pay schedule such as an automobile loan. The life of the loan can range from less than a year to over 10 years. These can vary as to penalties and terms. This is a typical loan for capital improvements such as plant and equipment.

Uncollateralized loan – A loan that does not require a lien or pledge of specific assets to obtain the loan. This type is granted to strong firms with a good credit history. Pledging of collateral can reduce the

interest rate of the loan, while it also reduces flexibility of the company to sell assets since the lender must approve the sell of any items held as collateral.

Variable rate loan – Any loan in which the interest rate varies with some market indicator such as the prime interest rate or treasury bill rate. An advantage is a lower interest rate compared to a fixed rate loan, however, you are assuming the risk of having higher or lower interest costs in the future depending on what the interest rate does in the future.

For Further Reading

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Notes

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