CORE
Metadata, citation and similar papers at core.ac.uk
Provided by DigitalCommons@Pace

Pace University
DigitalCommons@Pace

Faculty Working Papers | Lubin School of Business

12-1-2002

Teaching the Realities of Small Business Financing

Peter M. Edelstein
Pace University

Follow this and additional works at: http://digitalcommons.pace.edu/lubinfaculty_workingpapers

Recommended Citation
Edelstein, Peter M., "Teaching the Realities of Small Business Financing" (2002). *Faculty Working Papers.* Paper 7.
http://digitalcommons.pace.edu/lubinfaculty_workingpapers/7

This Article is brought to you for free and open access by the Lubin School of Business at DigitalCommons@Pace. It has been accepted for inclusion in Faculty Working Papers by an authorized administrator of DigitalCommons@Pace. For more information, please contact rracelis@pace.edu.

WORKING PAPERS

No. 208   December 2002

Teaching the Realities of Small Business Financing

by

Peter M. Edelstein, J.D.
Professor of Law
Lubin School of Business
Pace University

TEACHING THE REALITIES OF SMALL BUSINESS FINANCING

by

Peter M. Edelstein, J.D.

Peter M. Edelstein is Professor of Law at the Lubin School of Business of Pace University.

ABSTRACT

Our business courses may teach our students the theoretical matters relating to institutional financing of a new or small business but the realities of obtaining such financing are sometimes learned only through experience. This paper addresses the practical and meaningful steps an entrepreneur can take to enhance the ability to obtain a loan commitment and to close the loan as expeditiously as possible.

INTRODUCTION

Some of our students, after four (or more) years of business studies may be tempted to venture into the apparently promising future of entrepreneurship. Small businesses are said to offer, among other features, greater flexibility, faster decision making, more efficient operation, and greater opportunities for individual satisfaction.

In many cases entrepreneurs initially use their personal savings to finance their firm. At the same time or shortly thereafter, friends and family may be approached for additional funding. Once these obvious and relatively convenient sources are exhausted, the next target is usually the bank.

There may not be much we can teach our students about using their own funds or about trying to seek financial assistance from friends or family, but there are a few things we can share with them about the realities of obtaining bank financing. Even though banks are wary of lending to small or start-up businesses there are, nonetheless, actions that can be taken by the potential borrower to enhance the chance that a loan request will be granted and that can increase the chances of success in the loan process. If our students can understand how a lender views the loan process and evaluates a loan application, he or she may then be able to anticipate and satisfy the lender's requirements.

Applying for a loan is typically viewed as a process involving a person in need of funds applying to an institution that has those funds but is reluctant to lend to the one in need. The borrower may commonly imagine that he or she practically has to beg for the loan. While that scenario may be true in some circumstances, it is not always the case. Lending is a business and lenders cannot make money if they do not lend. Typically, loan officers are motivated to lend because in many cases the amount of their compensation or bonuses, or their promotions, are dependent on achieving lending goals. But lenders only want to make loans that they believe to be qualified in accordance with their institution's credit guidelines. By empathizing with the loan officer, and seeing the process from his or her point of view, the applicant can present and package the loan request so it is perceived as one worthy of consideration.

The issue of the principal's guaranty illustrates the value of viewing the proposed transaction through the lender's eyes. If the borrower is a corporation, LLC, or other entity, which features limited liability, principals of the borrower tend to be cautious about, if not hostile to, the request to provide a guaranty of the entity's obligations. All the principal can imagine is the borrower's default followed by his or her liability on the guarantee. Yet, to the lender, the request for that guaranty is commonly the first and fundamental requirement for a small business loan. The lender has been taught to ask questions such as, Why should we lend our money? Why put our capital at risk? Are you putting your own money in the venture? If not, why should we risk our money in the venture? By inappropriately arguing this point, the loan applicant may not only demonstrate a lack of experience but may actually precipitate the denial of the loan request.

In most small business lending situations the personal guaranty is not, in fact, the actual source of repayment. It is considered a tertiary source, behind cash-flow and collateral. However, many lenders to small businesses view the unwillingness of the principal to risk his or her personal assets in the form of a guaranty as a substantial negative to be considered in the loan evaluation process.

A successful loan transaction between a lender and borrower consists of two phases which are the granting and the closing of the loan. By understanding and applying the following points our students may be able to expedite the loan process, contribute a positive response to their loan application, and close the loan in a professional and timely manner.

In the application process of obtaining the loan, there are five issues that one should address: These are character, cash-flow, collateral, credit and capital. The Five "C's" of credit analysis should be introduced to students as they prepare to function in the small business and lending communities. They represent a checklist of criteria against which loan applicants are analyzed. Lenders use each of the Five "C's" to inquire as to the following matters:

1. **Character**: Who are the principals and what are their backgrounds? What is their experience? How do they run the business? Is there a history of honesty and integrity? What is the quality of management? What is the depth of management? Is there an organizational structure in place? Is there a plan for succession of management if the key person is not available? What is the age of management? What is the lifestyle of the management? What is the condition of the health of management? Favorable responses make the lender more comfortable that the loan, if made, will be promptly repaid.

A banker recently commented, to emphasize the importance of the "Character" element, that in analyzing applications of small or start-up businesses, he considers the form of the borrowing entity to be irrelevant; that for purposes of this analysis he deems the loan to be made to the principals.

2. **Cash Flow**: Will the borrower be able to repay the loan from cash flow? What are the cash demands of the business? Can the cash flow be quantified? Is it consistent or unpredictable year-to-year? Are there seasonal patterns? Is it vulnerable to changes in the economy?

3. **Collateral**: What will be used to repay the loan if cash flow is not sufficient? What property is available to secure the loan? (Unsecured loans are generally not made to high risk businesses and the lender will want to receive a security interest in everything and anything available). The lender may seek to encumber the particular asset being financed (equipment, accounts receivable, inventory, real estate), or *all* the business assets, and if that does not suffice, personal assets. What is the valuation

of the collateral? Are there any problems associated with the collateral, such as environmental questions or lack of liquidity?

4. **Credit**: What is the credit experience of the borrower and its principals? Has the borrower promptly and fully repaid previous lenders? Has the borrower been current with its trade payables? How have the principals repaid their personal obligations?

5. **Capital**: What and how much do the principals have at risk in the venture? What is the ratio of owner's risk to others' risk? What is the debt to net worth ratio?

Students who familiarize themselves with these five components of credit analysis can anticipate the lender's concerns and present the loan application and related documents free of errors in basic matters concerning their credit profile.

Measures that are expected of applicants

1. **Preview the Credit History**
   If the applicant has a less-than-impeccable credit history, before applying for the loan, one should obtain his or her own credit report. This will show the applicant the information that the lender will see. The applicant will have the opportunity to correct any negative or erroneous data, if possible, or to prepare appropriate explanations.

2. **Research the Business and Borrowing Records**
   If the borrowing entity has been in business for some time, the applicant may wish to obtain a D & B report and UCC searches (Form UCC-11) before the lender does. The D & B will disclose general business information about the borrowers and the UCC search will disclose liens of record against its personal property. The applicant may then correct any errors or omissions in the D & B and may obtain any missing release-of-lien documents necessitated by the lien search.

3. **In-House Clean Up**
   The applicant should work with his or her accountant before submitting the loan application. Together they can study and clean up the borrower's financial statements, answering any problems. This may avoid potential embarrassment or worse.

4. **Be Realistic**
   It makes sense for the applicant to apply to sources of financing with real chances of success. Time spent with sources obviously unlikely to be responsive will be wasted. As a general rule, although there are exceptions, large money center banks are not anxious to lend to start-up or small businesses.

Large banks usually estimate the cost of servicing and the maintenance of small businesses to be relatively higher than corporations. In many cases small businesses can neither afford to maintain high balances on deposit which are a source of profits for institutional lenders, nor can they purchase many ancillary products from the bank such as payroll or investment services. Thus, financing small businesses is perceived as high risk *and* low reward.

In an effort to reduce the cost of loan application processing and analysis, to reduce their risks and to improve efficiency, some banks have adopted systems of credit scoring for small business loans. While credit scoring has been used for several years in the areas of credit card loans and automobile loans, it is now being utilized in small business applications. By this system the completed loan application is graded by giving each response a numerical score. If the total score is over a certain number the loan may be offered, or offered subject to certain conditions, including credit checks or receipt of satisfactory appraisals. If the score falls below the minimum off point, the loan is rejected. With credit scoring it is more important than ever to attempt to apply to receptive institutions and to submit an impressive loan application package.

A new or small business may have a better chance at securing financing from a bank that has an SBA lender or department, or to a community or regional lender. Despite the considerable number of bank consolidations in the last few years, there are still many local banks, which are approachable. It is often wise to communicate with the business's trade association or even speak to competitors to determine which lenders are already in the particular market and which are familiar with the particular trade or industry and its customs and risks.

5. Prepare a Business Plan

Preparation of a written business plan prior to submitting the loan application may be the most valuable step in the process. There are many books available on the subject. The applicant's accountant is probably an expert. The plan should *explain* the business and answer the following questions: How long the business has existed and who is involved? What is the nature of the trade or industry? Who or what is the competition? What may the future hold? If available, the business plan should include a minimum of three years of financial reports. Describe the intended "use of proceeds" and the total cost of the project. Explain how the requested funds will help the business. Indicate how much the principals have invested; How much are they putting at risk now? Explain how the loan will be repaid. Show how and what funds will be available to repay the lender.

The applicant should be forthright and strive to avoid having the lender discover any surprises. Any existing problems, any that are pending, or any that are anticipated to arise in the future should be disclosed. It is not only bad form to place the loan officer in the position of announcing problems that the applicant should have recognized, but many

lenders, by virtue of having handled other loan applications may be welltrained to help in matters of problem solving.

Merely attaching financials to the application is not an acceptable substitute for a business plan, nor does it impress a lender. The business plan should be used not only to explain, but it should also act as a sales brochure. The loan officer may have to present the loan application to members of a committee and the information furnished in the business plan may provide answers to their questions. The business plan should be reviewed and edited by the applicant's counsel and accountant to assure, to the extent possible, that it is accurate and not misleading.

6. **Create and Maintain Banking Relationships**
   The applicant should work at cultivating banking relationships, if possible, sometime prior to the actual need for funds. He or she should meet the loan officers at the bank that does or will provide the business checking or payroll accounts.

7. **Consider Impressing the Lender**
   Weigh the potential value of impressing the bank by consolidating the applicant's balances in a single institution against the value of having more than one bank and establishing redundant banking relationships. The business world is fragile and there is no assurance that a particular loan officer will be at any particular institution for any given period of time. Thus, it is not prudent for a borrower to invest all of his or her energies in the cultivation of a relationship with one lender.

8. **Be Creative**
   The applicant should be creative when necessary. Some alternatives to small business loan products are credit card loans, home equity loans, and refinancing of home mortgages.

Closing the loan successfully

Once the lender has agreed to make the loan, the process leading up to the closing begins. By being prepared and anticipating the needs of the parties, the applicant can substantially contribute to making the transaction a success. The following suggestions are offered to make the process a smoother and more efficient experience.

1. **Promptly Review the Commitment Letter**
   When the lending institution approves the applicant's loan application, a Commitment Letter is sent which sets forth the terms and conditions of the agreement. The applicant should review the Commitment Letter with counsel before it is signed to confirm that it accurately reflects his or her understanding of the transaction. Once the lender has decided to

go ahead (probably after a lengthy decision-making process), the applicant should not delay. There will be a lapse date contained in the Commitment Letter that should be noted.

2. **Promptly Address the Loan Terms**
   After reviewing the Commitment Letter, list all points that are incorrect or unsatisfactory. This is the time to raise business terms with the lender and legal terms with lender's counsel. If the Commitment Letter (or revised Commitment Letter) is satisfactory, promptly sign and return it.

3. **Request an Agenda and Designation of Responsible Parties**
   Sooner rather than later, the applicant should have his counsel request from the lender's counsel a written agenda or closing document list with "responsible parties" indicated. The applicant should determine what his or her responsibilities are and begin working toward completing them. Where is the property insurance policy? Who has the survey? Where are the corporate records? Obtaining all the required documents or information may be complicated or difficult, so make sure there is enough lead time.

4. **Promptly Exchange Documents**
   When the applicant has received or prepared documents that are its responsibility, the documents should be sent immediately to counsel for the lender for final confirmation prior to closing, to avoid surprises and unexpected delays as the closing date approaches.

5. **Review Costs and Expenses**
   The applicant should request all closing numbers prior to closing for review and obtain and bring the proper number and type of checks; e.g. bank or certified.

6. **Attendance of Necessary Parties**
   Arrange to have all necessary parties present at closing for the entire duration of closing. It never fails that if a party leaves the closing early, his or her signature is then required.

7. **Powers of Attorney**
   If the applicant or any party intends to use a Power of Attorney, obtain the lender's advance approval as to form and substance of the document.

8. **NoNew Issues at Closing**
   Attempt to have no new issues arise at the closing. The applicant should have raised and resolved all points in question prior to closing.

> The transaction, in which a start-up or small business is the borrower, may involve questions and issues not found in transactions involving more established and creditworthy businesses. By properly preparing, the borrower may be able to obtain funds and close the transaction as gracefully as possible.

CONCLUSION

We sometimes lose sight of the enormous difference between academic discussions and real-world demands. By exposing our students to the practical aspects of obtaining a loan, including the ability to view the process from the lender's point of view, and guiding our students in the steps towards a successful closing, we can add a real practical dimension to their classroom knowledge.