

A Lender's Perspective on Making a Loan

Over the years, financial lenders have developed several simple approaches to assessing the feasibility of making a loan. These approaches can be used regardless of the type or size of business involved. If you are planning to ask for a loan, use the following factors as a checklist to improve your chances of getting the loan. The process will identify weaknesses that can be corrected before you ask for the loan.

Getting approval for a loan is a good thing, getting rejected may be even better. Even after going through this exercise, the lender may reject your loan request. However, don't take the rejection personally. The lender is in the business of making loans. But something in your request caused the rejection of your loan. Talk to the lender and ask why the loan was rejected. The lender may have identified a weakness in your business that can be corrected before it causes major problems down the road.

The discussion below examines the lender's perspective of the borrower, the business, the loan itself and the circumstances surrounding the loan and the business.

The Borrower

- 1. Competency** – Does the individual have a thorough understanding of the market and industry in which he/she will be competing? Does the borrower have industry contacts and know the industry players? Does the individual have experience in starting and running a business?
- 2. Character** – Does the individual display characteristics of honesty and integrity? Borrowers should present themselves as upstanding, responsible members of the community and be able to back up this claim with references. Borrowers also need to show they can be trusted to be up-front and transparent about problem areas.
- 3. Commitment** – Is the individual committed to the business ventures and willing to do what is necessary to make it successful and repay the loan?

- 4. Track record** – Does the individual have a track record of successfully starting new businesses or did past attempts fizzle? Does the borrower have a track record of loan repayment?

The Loan

- 1. Returns (cash flow)** – Will the use of the loan funds create sufficient returns (cash) to repay the loan? Remember that the returns must first cover all of the costs associated with the project or business before funds are available for loan repayment. You may need to create a cash-flow budget to show how the loan funds will create sufficient cash flow to meet the loan principal and interest payments. It is also important that the timing of the cash flows correspond to the loan repayment schedule. If the loan will not create an income stream, describe and document how the loan will be repaid.
- 2. Risk** - What can go wrong with the project or business? What is the probability that something will go wrong? Is the business sufficiently capitalized to handle risk? What risk management strategies are available to help mitigate the risk? Are there contingency plans in place to mitigate risk? Are there alternative sources of cash from which payments can be made?
- 3. Collateral** – Lenders often want protection in case of default on the loan by the borrower. The lender may use the property being purchased as collateral for the loan. Additional collateral may be required as well as a personal guarantee by the borrower or other representative.

The Business

- 1. Track record** – If this is an existing business, what has been the financial track record of the business over recent years? Does the business model seem viable and profitable? Have sales increased? Has equity grown?
- 2. Leverage** – Can the business take on additional debt and maintain a reasonable debt-to-asset ratio? Is the business positioned to adequately meet its loan repayment requirements along with covering the other financial demands of the business?

The Circumstances

- 1. Industry** - The state of the industry in which the borrower will operate is also important to the lender. Is it a new and expanding industry or a mature and stable one? The lender will be interested in who your competitors are and your strategies for competing with them.
- 2. General economy** – What are the conditions of the general economy at the time of the loan request and the projected state of the economy for the coming several years (during the repayment period of the loan)? Are there societal trends that will affect the viability of the business and loan repayment capacity? Will impending regulations create problems?

Why Credit Lines Get in Trouble

There are many reasons why credit lines get in trouble. The following listing can be used as a diagnostic tool to identify the cause of a credit line problem. Solutions can be developed once problems have been identified. The listing can also be used as a prevention tool to identify potential weaknesses before they become a problem.

Failure to supervise the loan

Failure to supervise the loan by either the lender or the borrower is a common cause of credit problems. The loan should be monitored on a regular basis to insure that it will be properly repaid. Loan supervision is not the responsibility of just the lender but is also in the best interest of the borrower.

Lack of communication

Successful loan repayment is often based on open discussion between lender and borrower. Lack of communication and trust by either party often results in a breakdown of the business relationship.

Inefficient business

To generate sufficient income for debt repayment, the business must be well managed and achieve production efficiencies. To avoid repayment problems, the lender may want to monitor business and production efficiency.

Business too small

The business may be too small to generate sufficient income for family living needs. The shortfall is often covered by short-term borrowing. However, the accrued debt makes the income deficiency even greater.

Failure to analyze the business

Debt repayment capacity is based on the ability of the business to generate income and cash flow. Failure to accurately analyze the income, expenses, and cash flow of the business may lead to errors in projecting debt repayment capacity.

Unrealistic prices and production levels

Unrealistic assumptions may lead to errors in analyzing the repayment capacity of a loan. Typical errors pertain to estimates of selling prices and production or sales levels. However, poor assumptions about efficiency factors are also common.

The borrower may intentionally use unrealistic assumptions in order to obtain or keep a line of credit. However, the use of unrealistic assumptions can also be unintentional. The borrower may not have sufficient business records or outlook information to realistically describe the business.

Lack of partial budgeting

Partial budgeting involves projecting the added costs and added returns from a capital investment. Unless partial budgeting or a similar procedure is used to estimate the additional income generated from the loan funds, the repayment capacity may fall short. Just because an business decision involves new technology or is common among other farmers does not mean that it is profitable or financially feasible.

Uncontrolled living expenditures

Many small business owners are negligent about monitoring and controlling family living expenditures. Monitoring expenditures involves keeping records of the money spent for family living. Keeping the business and family financial transactions in separate checking accounts will often be helpful. Successful control of family living expenditures

often involves developing and monitoring budgets of expected family living needs.

Lack of business direction

The planning horizon for many small business owners is often one production period. So, the business lacks any long-term goals or direction. This lack of long-range business planning is often accompanied by a lack of progress on long-term debt repayment.

Failure to structure repayment

If possible, the repayment terms of the loan should be tied directly to the additional income generated from the loan. Unless the loan repayment is structured and the additional income designated for loan repayment, the income will be spent elsewhere and the debt carried over from year to year.

Repaying debt too rapidly

Reducing debt as quickly as possible is often a good objective. However, trying to repay debt too rapidly may unnecessarily cause a shortage of cash for operations. The length of debt repayment should be tied to a conservative estimate of the life of the assets the borrowed funds were used to purchase.

Purchasing capital assets with cash

Using cash reserves to purchase capital assets may result in cash shortages in the future. Sufficient cash should be maintained to cover intermediate and long-term debt payments, income taxes, family living expenditures, and other items.

Buying non-productive assets

Using borrowed funds to purchase non-productive assets requires the repayment to come from other sources. The alternative repayment sources should be carefully identified in advance.

Carryover debt

Short-term loans that cannot be repaid are often carried over from one production period to the next. Unless properly monitored, carryover debt may

grow until it jeopardizes the health of the business. Carryover debt is often too large to be repaid during one production period. It may need to be paid over a period of years. Progress should be made each year in retiring carryover debt.

Poor risk management

A cash buffer should exist between the projected repayment ability of the business and the business debt repayment schedule. For example, if the debt repayment schedule is based on the repayment ability in an average year, a shortfall will occur in low income years. This shortfall is often covered by borrowing additional money. Due to this additional debt, the total debt load cannot now be serviced in average years.

Poor use of profit windfalls

An abnormally profitable year often provides additional income. However, the additional money is often consumed or used to purchase non-productive assets rather than repaying debts. As a result, when below average years occur in the future, there is no reserve for debt payments.

Using multiple credit sources

Farmers often obtain credit from a variety of sources. Usually the larger the number of credit sources the more difficult it becomes to monitor overall debt repayment. Consolidating credit and reducing the number of sources may improve the ability to successfully project and monitor debt repayment.

Ignoring tax consequences

Although interest payments are tax deductible, principal payments are not. Debts must be repaid with after-tax income. This calculation needs to be included in the debt repayment analysis.

Selling assets to repay debt may also have significant tax consequences. The sale of low basis property may trigger a large tax liability and reduce the amount of funds available for debt repayment.

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