

How To Borrow Smartly

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“Cash is king” – every small business has heard this phrase. The reality is that every business must have cash to start the business, maintain operations, and grow. With the recent credit crunch and the economic downturn, what should every business consider when examining its supply of cash and applying for a loan?

If possible, don't borrow at all. Remember, equity (cash) is king:

- You do not have to pay it back.
- It enables more margin for error if your business does not perform as expected right away.
- Debt must be repaid right away, and it can deplete your working capital at a time you could least afford it.

If you absolutely must borrow, don't forget to **run the numbers** – figure out the cost of the loan (the amount it will cost you on a monthly basis) versus the additional income your business will generate as a result of the loan. If the difference is negative, do not borrow. If the difference is positive, the loan will help move your business to the next level.

Approach your lender with a business case that makes financial sense. When you make your request, always:

- **Have a well-written, and well thought out business plan** (especially if you are a start-up business). There are many resources, like the local SBDCs and SCORE, available to help you prepare this plan.
- **Know how much you need to borrow.** Nothing leads to being turned down faster than asking “for as much as you can get.”
- **Make sure the loan structure matches the purpose of the loan.** Do not use a line of credit to purchase a fixed asset; it is best financed with a longer term loan. Short-term loans (lines of credit, etc.) are to be used for exactly what the name implies – the short term. You should not borrow on a line of credit if you cannot repay in 30 to 60 days. If you borrow on a term basis to buy fixed assets, then...
- **Don't let the term of the loan exceed the life of the assets.** Equipment, real estate and other assets are typically financed over longer periods of time with regular monthly payments. If the life of the asset is less than the length of the loan term, you could be stuck making payments on an item with no value that isn't even a part of your business anymore.
- **Remember that working capital is a short-term asset.** It is usually financed with short-term debt and its term is typically less than one year. Borrowing in the long term to pay for recurring, everyday expenses can lead to “pyramiding” debt. In other words, if you take out a five-year term loan to pay business taxes, you will still have a balance on that loan when it comes time to pay next year's taxes, leading you to borrow more on top of what was already borrowed the year

before. This cycle is vicious and repeating, and can lead to a business failing even while showing an accounting profit.

If you approach your lender with a well thought out request along with the documentation to support it, you and your business will have a better chance of getting an affirmative answer.

Once you have applied for your loan, most lenders will underwrite your request by considering the following basic factors. All lenders review these same factors; however, lenders may weigh each factor differently:

- **Collateral to secure your loan.** This could be the asset you are purchasing if you're looking for a long-term loan, or the assets of your business such as receivables and inventory if you need a short-term loan. Some businesses, particularly start-ups, use the personal assets of the owners (their homes, for example) to secure their loans.
- **Your capacity to repay the loan.** The lender will look at the cash available to repay the debt. For a start-up, this will include a careful review of your business plan for reasonableness and conservatism, and also if there is any outside income available to help pay the debt in the event the business cannot. For existing businesses, the lender will look at your operating history, profitability and how much other debt you owe.
- **Your character, which is typically measured by a credit report.** When you are just starting out, the lender often has to rely on their faith that you – the business owner – will execute your business plan and repay them as agreed. Make sure your credit is in order, and if it isn't, take steps to correct any credit deficiencies. A lender is not going to be comfortable in your ability to run a successful business if your credit report shows that you can't manage your own finances.

In summary, only borrow if you absolutely must, make an intelligent request, and do your homework by providing the lender with all the information he or she needs to approve your loan.