WHAT DO LENDERS REALLY NEED TO GRANT SMALL-BUSINESS LOANS?

They Need You To Do Their Work For Them!

George M. Dawson

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My answer is two-fold. I will explain.

Answer #1: DINKs and two-thirds of a Mercedes-Benz.

Answer #2: Certainty of repayment, adequate collateral, and an "efficient" transaction.

DINK is a shorthand demographic description for a Dual Income household with No Kids. The couple (he's an accountant with a national firm and she's an attorney with local city government) want to finance the purchase of a high quality car that holds its resale value over time. They have a one-third down payment. The banker will do it all day long. Fill out the loan application, order the credit reports, contact the auto dealer - at most 25 minutes work for a solid $35,000 loan. A slam dunk.

The more your small-business loan request lacks the characteristics of a DINK dunk (see answer #2), the less your chance of getting And you experience a double negative if you want a small loan, under $20,000, for a small business.

What is a small business? The SBA's definition includes about 90 percent of all businesses in America. For the purposes of this article, I define a small business as one that has neither a knowledgeable, full-time chief financial officer nor audited financial statements. The business owner handles the loan application process, with some assistance from the outside tax accountant and the company's bookkeeper.

The basic challenge is to make the business loan look as much like the Mercedes loan as is possible

Certainty of repayment

Repayment ability is a two pronged-consideration. Are you willing and able to repay? The best evidence of willingness to repay is a good personal and business credit record. Order personal and business credit reports before you approach the bank. You will likely be shocked at the amount of stale or erroneous information. Get a copy of your consumer's rights from the credit bureau and clean out any errors in your report. If there are some accurate "black marks," you may include your side of the story, up to 100 words, in the credit file. Also, you should provide an explanation in your loan package narrative.

Your business' ability to repay is judged on both its historical and its projected earning power. Include your last three years' personal and business income tax returns in the loan package. Bankers assume that you are not likely to overstate your Income to the Internal Revenue Service. Also, include the last three years' company or accountant-prepared balance sheets and income statements. Explain any meaningful differences between the tax and the company-prepared statements. Complete an interim income statement and balance sheet if you are more than 30 days past your year-end.

Prepare a cash flow projection, by month, for the next 12 months if you are asking for seasonal financing. Extend the cash projection out another two years by month if you are after a long-term loan. Build the repayment of the loan into the projection. Your accountant can help you with this projection, but you must explain It in detail to the banker. You must justify all the business operating assumptions underlying the cash projection. Don't take your accountant to the bank. She's not going to guaranty your loan, is she?

"Now wait!," you say, "Give me a break. I'm a small business. Surely the bank understands and will cut me some slack from all this paperwork." Wrong! These are minimal expectations for any well-managed business. Do you want slack or do you want the loan? Besides, all too few business owners come this well prepared. Therefore, you stand out and look like a winner.

Get the bank's personal financial statement form before you even talk to a banker about your loan. Then fill it in carefully, neatly, and in great detail as part of your loan package. Review the statement with your accountant for accuracy. Overstated assets or

understated liabilities are presumed lies, not mistakes. Banks don't knowingly lend to liars.

Most personal financial statements look as if they were completed in the car on the way to the bank. They don't add up correctly. Entries made on the wrong line. Supporting schedules left incomplete. You want to be different. The loan process slows down every time you make the banker ask you a question because you failed to supply complete information. It is unnecessary sand in the gears.

I am a great believer in business plans as part of a loan package. But in reality too few businesses have one. And if they do a plan just for the loan proposal, it usually isn't very good. Even if you don't have a business plan, some plan elements must be in the loan package. Include a thorough functional (as compared to historical) resume. Business management ability is a constant theme running through the loan approval process.

The loan officer doesn't care what you did in the past, if it has no bearing on what it takes to succeed in your business today. Don't make her wade through your job history that describes positions held instead of skills learned, time spent instead of experience gained, and assigned responsibilities rather than tasks completed. Instead use a functional resume to highlight those acquired skills, abilities, experiences, and knowledge essential to running your business today and tomorrow. Show why you will succeed and prosper.

Since you cannot do it all alone, the bank also wants to know about the rest of your team - even if it is only two or three key employees. Also, identify your CPA, your attorney, and insurance agents in your proposal. No business is too small to be professional and businesslike.

Adequate collateral

Banks want collateral. Unsecured loans to small business are rare. The bank is lending you its depositors' money and it wants it back. Collateral is to repay the loan if all else falls. It's that simple. The bank wants the loan value of your assets pledged as collateral to equal the amount of the loan.

You will not find the definition of "loan value" in any accounting or economics textbook. It is not what you paid for your assets. It is not what you show they are worth on your balance sheet. It is not what it would cost you to replace them. Loan value is what the bank can get for your collateral after they take it away from you and sell it in a hurry. It is a liquidation value. The bank liquidates collateral at auction or through dealers or through sale to your customers, your competitors or your suppliers. None of these buyers will ever pay top dollar! They lick their chops when they see the bank coming.

At the time the loan is made, the bank makes an informed guess as to the future liquidation value of the collateral. Bankers guess higher if you are in a healthy industry and if there is an active resale market for your type of asset. They guess higher if it is not specialized collateral, if the assets hold their value over time, or if they are easily liquidated. The best collateral is the bank's own certificate of deposit. The worst is a custom-designed specialty sausage-making machine, bolted to a concrete slab in a refrigerated, sterile manufacturing room.

Loan value is really a judgment call. It is a very easy call with a car. Just look it up in the dealer guide. Publicly traded financial securities and cash surrender value of life insurance are easy to value. After that it becomes more difficult. An appraisal is simply an informed guess. It is your job to influence the bank's judgment.

Show the banker "indirectly" how to liquidate your collateral (not that such a thing would ever be necessary!). Discuss secondary or resale markets, provide a list of dealers, show current prices for new and used equipment, include pictures of the assets, maintenance records, and so on. Only you can help the banker with this very industry-specific information. Only you know what helps assets in your industry retain their value.

Bankers hardly bother guessing loan collateral value at all, if they can get the Small Business Administration to insure the loan. One of the best new programs is the SBA's Low Documentation (or "LowDoc") program. It's specifically designed for loans under $100,000 to borrowers with a good credit record. LowDoc reduces the level of paperwork floating between a bank and the SBA. It does not reduce the level of paperwork between the bank and the borrower. SBA promises a response within three to five business days. Lack of collateral is specifically not a deterrent to obtaining an SBA loan guaranty.

An efficient transition

One of my clients, observing his 3/4 inch-thick proposal for a $20,000 line, said, "With this package it's a no-brainer' for the bank." He understood the game! Do all loan applicants have to go that far? Not really, but most should.

Bankers have job performance standards they must meet to earn raises and promotions. The loan officer is squeezed between increasing the size total loan portfolio under her supervision and minimizing loan losses from that same portfolio. Loan officers try to avoid small loans that require large amounts of investigative and analytical work or, as banks call it, "due diligence." Too much work for too few dollars is the poison ivy of the banking industry.

Make the banker's due diligence easy! Prepare a well-organized loan proposal. Explain your business, its risks and opportunities. Analyze your competitive strengths, but don't knock the competition. Explain the industry and economic conditions that you cannot control, but to which you must respond. Include trade association industry analyses or forecasts. Use pictures, promotional materials, special internal management reports, and customer testimonials.

Describe your physical assets by type, manufacturer, serial number, date of purchase, book value, estimated market value or current appraisal or tax valuation. After he has had a chance to look at your proposal, get the banker out to your place of business for a tour.

A borrower will always have to answer seven questions:

How much money do you need? Answer with an exact amount. You can include a justified allowance for contingencies in your loan request.

How will you use it? Give great detail. Include construction estimates, vendor price quotes, budgets, etc.

Why do you need the bank's money? Show you have a down payment. Prove you have not squandered past business profits.

How will you repay the loan? Your cash flow projection will show repayment from excess cash flow from profitable operations, or asset liquidation or new equity or another loan.

When will you pay it back? Again answered in the cash flow projection.

What happens if something goes wrong? The answer is the loan value of the collateral and the strength of your personal guarantees.

Why is this loan good for your business? Explain how the loan proceeds reduce costs or increase revenues or add efficiencies, etc. Banks want to make productive loans that increase employment and create profits.

These questions are first in the banker's mind. Try to weave the answers into the first five minutes of your discussion with the banker. Watch him or her pay attention and start to treat you seriously. Maybe you aren't poison ivy after all.

In the last few years, the consolidation of the banking industry and the need for greater efficiency have led many banks to centralized credit decision making. This means the loan officer across the desk from you has virtually no authority to say "Yes." He must "sell your loan upstairs" to a decision-maker you will never meet. Your task then is to make the loan officer into an enthusiastic advocate - a champion - for your loan. You can do it only with information.

Are you doing the banker's job? Certainly. For the small loan, if you don't do the work, neither will the banker. You may find this a discouraging and daunting task. In the past it often was too easy to borrow money. Now it seems too hard. The act of preparing a complete loan presentation will greatly benefit your business. Don't be afraid of it. Help is probably available through your local Small Business Development Center, the Service Corps of Retired Executives, or a local economic development agency.

Finally, maybe the answer is not a bank loan at all. The last seven years have seen a substantial growth in alternatives to bank financing. Small dollar leasing companies are not as stringent as banks. Commercial factors are more interested in your customers' credit strength than in yours. Many community-based micro loan programs (loans under $20,000) are more forgiving

of poor credit and less demanding of collateral.

Requirements Vary Depending On Your Business's Life Stages
Charlotta F. Nordyke

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In the late 1980s and early 1990s, many small-business owners believed that lenders would make loans only to companies that did not really need the money. Philippe Heriat, a 20th-century French novelist and playwright, declared, "To learn the value of money, it is not necessary to know the nice things it can get for you, you have to have experienced the trouble of getting it." Although the credit "crunch" experienced by our nation a few years ago appears to have lessened, small businesses continue to face trouble getting a loan.

Owners' difficulties in the loan application process can be lessened by understanding what information the lender needs. Because each bank has its own requirements to make a commercial loan decision, borrowers should visit with their lenders to determine specific information needed well in advance of the time they will need funds.

To discuss what information may be required, potential borrowers must be segmented. The information needed to make a loan decision for a well-established business with demonstrated ability to service debt will differ greatly from that needed to determine the credit worthiness of a start-up venture.

Businesses with historical repayment capacity that have no plans for significant changes or expansion should provide their lender the following information:

Historical financial statements for a minimum of three years of operation and for any interim period since their last fiscal year end. Significant departures in any year from what is normal for the business should be explained in writing and attached to the statements. The financial statements should accurately reflect the history of the business and should include a reconciliation of retained earnings from year to year.

Many small-business owners spend considerable time assuring that the income statement accurately reflects the business, yet they pay little attention to the balance sheet. Having an owner admit that he or she is unsure of the accuracy of the balance sheet is very disturbing to a lender. When the lender is faced with financial statements that do not balance or where retained earnings cannot be reconciled, he or she will most likely question the validity of the numbers.

Personal financial statement for any person owning more than 20 percent of the company. Many lenders prefer that this information be provided on the personal financial statement (PFS) form provided by their institution. Accurate completion of the PFS is necessary because the information will be compared to the credit bureau report and discrepancies will be noted. Too many discrepancies may indicate a lack of attention by the owner to personal finances or, unfortunately, a purposeful withholding of information by the borrower. Many small business owners do not realize that their personal spending habits and their use of credit card or personal installment debt impact the business lending decision. An owner with a lot of personal debt may be less likely to sustain a reduction in personal income caused by a slow period in the company.
Written description of the business and a request for funds. Two or three pages discussing the company's background should be adequate for a well-established company, even for a lender unfamiliar with the company. Departures from this rule of thumb would include companies where the cash flow cycle is difficult to understand or where the historical financial statements do not reflect a stable profit history.

The business summary should include a detailed use of the funds being sought from the bank. Working capital needs should be specifically spelled out. A lender will want to know if the working capital being requested is for inventory purchases, operating expenses, advertising, payroll, reduction of accounts payable; or if the owner is attempting to finance his or her salary with the loan proceeds.

Businesses with plans for significant changes or expansion should provide the same historical financial statements for the business and personal financial statements. In addition, owners should prepare a plan explaining the changes or expansion they

anticipate.

Does the lender need a full-blown business plan? Probably not, unless the changes are so significant that the request more closely resembles a start-up request. The plan should explain why the change or expansion is occurring and how the financial condition of the business will be impacted. Assuming that the change involves a new product or a new market segment, an in depth discussion of the proposed marketing plan will assist the lender's evaluation.

The plan, at minimum, should include monthly cash flow projections for 24 months. These should show the impact on sales, expenses and debt service. All assumptions used in the preparation of the projection should be included and fully explained. The U.S. Small Business Administration work sheet for cash flow projections is easy for most borrowers to understand and can be used to demonstrate the impact of the anticipated change. Completed pro forma annual income statements and balance sheets (using the same assumptions as the cash flow) will help the lender make a more timely loan decision.

For all established businesses lenders will need a schedule of current indebtedness indicating loan balances, payment schedules, maturity, and collateral. If facts exist that increase the value of the collateral, such as guaranteed buy-back arrangements for inventory, a paragraph regarding these arrangements will assist in the decision making process.

Start-up business requests require the personal financial statements discussed above, plus a thorough business plan. The plan should provide an understanding about the nature of the business, the management skills of the owners, the competitive advantage the business will have in the marketplace, and the likelihood of financial success. If the plan doe not tell the lender how this business will be different from its competition, even a well-organized and well-written loan will fail in its primary objective of demonstrating a competitive advantage.

Every first-time borrower asks how long the plan should be. The plan should be as long as necessary to convey the important facts about the business. For an uncomplicated service business, as few as five written pages, plus the financial projections, may be enough. For a start-up manufacturing concern, far more information will be required. In all cases, a well-written business plan should require no more than 20 typed pages, plus the projections.

Many borrowers believe that more is better and will include every piece of literature or product brochure that they have used in their research. Certainly, the borrower should have the information indexed and available if requested, but a two inch business plan will often sit on a harried lender's desk longer than a concisely written plan that appears less intimidating.

Start-up financial projections for 36 months and pro forma annual income statements and balance sheets for five years. All projections should use the same assumptions and the assumptions should be fully documents. If monthly cash flow projections reflect a payroll of $5,000 per month, the pro forma income statement should indicate $60,000 for the annual payroll. That may seem obvious, but forecasts may be changed many times and the changes may not be consistently reflected in all projections presented in the plan. When you consider that lenders are uneasy with projections to begin with, discrepancies only raise their anxiety level and decrease the likelihood of a favorable decision.

Start-up loan decisions often rely heavily on the owner's commitment to the business. An owner must be willing to have a significant investment in the business. What is significant? Of the total cash needed for start-up and working capital for the early months of operation, most lenders will expect the owner to inject cash into the business equal to 20 to 40 percent of this total. What is the owner does not have the cash to inject? Many lenders will consider a subordinated debt made to the business by a friend or family member, on which no principal is repaid, as "quasi-equity." Details about an subordinated loans should be provided.

Loan approval is just the beginning:

For all businesses, when the loan is approved, the borrower can anticipate providing additional information during the loan closing process. This may include articles of incorporation, proof of taxpayer identification number, legal descriptions of all real property, copies of leases, machinery and equipment inventories with serial numbers, and proof of insurance on anything being pledged as collateral. Often, the list of required pieces of paper may seem unending because one piece of information provided, may make it necessary for the bank to ask for another. The first-time commercial borrower is usually unprepared for the detailed documentation required to close a commercial loan.

The commercial lending process can be lengthy and information-intensive, especially for the small-business owner who needs an immediate answer. Another French writer, 16th-century Michel Eyquem de Montaigne, provides advice that seems timely for these borrowers, "A man must learn to endure that patiently which be cannot avoid conventionally." Banks are striving to simplify

the commercial lending process, but detailed information will always be required for prudent lending decisions. A well-prepared business owner, who anticipates the need for information, will be the borrower most likely to receive a timely decision from the commercial lender.

Communication is a Critical Part of the Process

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Bankers, even beginning lenders, are familiar with the six "Cs" of credit: character, credit worthiness, collateral, cash flow, capacity, and capital. Borrowers also seem to understand that their banker or prospective banker is looking at these factors. The informed evaluation of a borrower's "Cs" of credit is vital to good lending practices. The process not only establishes the relationship, it allows the tender to monitor and maintain sound and mutually beneficial long-term borrowing relationships.

Often overlooked, however, in these days of sophisticated computer models and credit analysis, is perhaps the most important "C" of lending - communication. Communicating to the customer the bank/banker's expectations with regard to that "last" advance may be the difference between a sound loan and an "evergreen," a loan in danger of needing collection efforts and the associated costs.

Let's look at an example of a lender/ borrower relationship that we recently came across. We will include our thoughts on how a problem that developed could have been avoided.

Marian B. is a lender for a commercial bank in a mid-sized Midwestern community. George L. is Marian's customer of 15 years. George recently had his loan called by the bank. The common and known facts are:

Total outstanding loan balance, which has resulted in rolling past notes together on an amortized term loan with a one-year balloon, is $415,000.

The loan is secured with business real estate, an apartment building, a business crane and truck, receivables and inventory, and a $1,00,000 certificate of deposit in the bank. Solid (realistic) market value of all collateral is approximately $445,000.

George has never missed a payment on his loans.

The loan was increased by $55,000 this past year partly because a "young" college educated accountant hired for the business failed to deposit withholding taxes for several quarters. The failure to deposit was not known by George. The bank advanced the money to stop levies by the IRS.

Sales in the business have increased from $400,000 eight years ago to $2,700,000 last year.

George's contracting business averages a gross profit of 20 percent with higher margins for jobs with materials supplied and lower margins for labor-only jobs.

The business regularly loses out on trade discounts because there is not enough cash to pay suppliers on discount terms. In fact, last year, loss of discounts ($35,000) and service charges for late payments ($26,250) cost the business $61,250.

Marian's position

The bank needed to call George's loan because - among other reasons - the bank's loan limits were being pushed. The bank was also the only party injecting anything into the business to fund growth, and while the bank agrees the business is increasing, costs seem to be increasing in the same proportion or greater. There do not appear to be any efficiencies of scale. In addition, Marian told George when the last $55,000 was advanced, he needed to have a plan to reduce the debt. The $55,000 withheld for

taxes had obviously been used elsewhere, and it should now come out of the business to reduce the debt. All of the circumstances cause problems for Marian to fund additional needs. Finding another bank willing to participate in this loan is highly unlikely.

Marian has told George that the bankers feel his business needs to internally generate working capital or he needs to put more money into the business himself to fund continued growth. Another solution, according to Marian, could be to increase bids on jobs to yield better margins on fewer jobs and incur fewer out-of-pocket costs. Marian has also suggested that George obtain outside business planning help.

George's position

George feels the bank's position is unfair and potentially puts him in an impossible position. He acknowledges that he has not exactly followed Marian's recommendations. However, he has been extremely busy running a growing business; and when he hired what he thought was competent help, the IRS problem happened. He felt that with the business continuing to grow he could generate increased profits to fund the growth. George also blames the bank's unwillingness to better fund job contracts he is working on (work in process) for his loss of the $61,250 in trade discounts and service charges that could have been used to provide cash for the business.

It is George's position that he has made every payment to the bank, and he has "proved" himself with the bank and in business. Based on his currently demonstrated level of business, the bank should therefore be willing to not only continue his loan but to "take a chance" on funding his growing need for receivables and inventory. He believes that eventually the business will level off and the profits generated will be able to pay off the loan. George realizes that this may be several years down the road, but as long as he makes the payments (and stays current with his taxes), he asks why the bank should tare.

Our analysis

It seems that Marian and George both recognize that the business has problems. In fact, it appears that both agree that the major problem is the need for cash to fund fast-paced growth. Of the six "Cs," only two cash flow and capital - appear to have adversely changed significantly over the years. Unfortunately, what appears to be lacking is an understanding of why George's loan is structured as a term loan with a one-year balloon.

George is not atypical in his lack of understanding of the financial terms and measurements used by his banker. It is our experience that small-business borrowers typically do not look at their businesses from a financial point of view, as their banker or their accountant might. George understands his business from contract-to-contract or from an income (profit per job) standpoint. He even understands that he needs financing to support investment in working capital. But what he does not understand is why he has a one-year term loan and the bank will not or cannot lend him money to complete his contracts.

George understands that banks make different types of loans for different types of needs:

A loan to finance real estate is normally made for a period of years and should be tied to the revenue (rents) generated.

Fixed assets loans are for shorter periods and should be tied to earnings generated by the asset and the life of the asset.

Working capital loans should reflect the relatively rapid turnover of the asset being financed.

While we are not questioning whether the bank was correct in structuring the loan in the manner in which it did, the problem, as we see it, is that the reasoning for the structure and its effect were not communicated to the borrower. If the banker had clearly communicated her reasoning and her expectations with regard to the loan structure, then George could have taken action to prevent his current cash crisis.

If the bank had decided not to enter the relationship with George, that would have been its decision. However, once the bank entered the relationship, it took on certain liabilities. One of those responsibilities is to not mislead the borrower - either intentionally or unintentionally. Related to that responsibility is the responsibility to help the business owner understand the dynamic nature of his business. Had Marian explained the bank's position on the loan structure, both George and Marian would have been forced to acknowledge that there would be no additional funds available from the bank to finance any further growth in George's business.

Communicating the bank's expectations at the time a loan is structured is important to the long-run success of both the borrower's business and to an ongoing, profitable relationship with the borrower on behalf of the bank. A well-structured loan that is clearly communicated to the borrower is a "win-win" situation for the borrower and the lender, and in most cases will have a positive impact on the other "Cs" of the borrower.

George's situation is not particularly unique. Small-business owners usually understand very well that their businesses make money, i.e., generate a profit. They are less likely to put a lot of thought into the relationship between the growth of the business and the need for financing that growth. The general thought is that as long as "widgets" can be sold for more than they cost to produce, the bank should be willing to finance the growth in sales. The banker knows (or should know) better, and she or he should prevent false expectations on the borrower's part by carefully communicating that fact.

The dynamic nature of the relationship between asset growth and how a bank is interested in financing that growth needs to be clearly understood by borrowers. They need to know how much the bank is willing to finance, over what period, and how the financing will affect cash flows.

As an example, George needs to understand that it is not the bank's responsibility to ball him out when he finds that the short-term trade credit offered by suppliers may not offer sufficient time for him to complete the job, receive payment, and pay off his accounts payable. He needs to fully understand why the bank cannot and should not ball him out. Finally, and most importantly, he needs to understand how to manage the growth of his business so he does not find himself facing a cash crisis.

It is our opinion that bankers can be instrumental either in helping small-business owners understand these financing issues or where to get help in this area. Proper application of this seventh "C" with regard to loan structure and expectations may be the key to preventing many problem loans, and thus benefits both banks and their commercial borrowers. The seventh C makes the other Cs work.

Local Development Lenders Pick Up Where the Bankers Leave Off

Laurence R. Steenberg

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In early 1993, George and Carol Mihelic moved to Evansville, Indiana so that they could help care for Carol's ailing father. The move forced George to quit his job as district director for six franchised shoe repair outlets in Lansing, Michigan, a position he had held for three years. He felt that his Lansing experience, however, would make it easy for him to find a comparable job in Evansville.

When he found that no comparable jobs were available, he decided to open his own shoe repair store. He believed that his background and managerial competence would combine to give him a comfortable profit. He located an existing business whose owner wanted to sell, and negotiated the purchase of its inventory and equipment. George calculated that the project, including working capital, would require a total investment of $10,000 and that he could afford to invest $2,500 of his own money. He sought a loan of $7,500 from a local bank.

The bank denied his loan application on the grounds of inadequate collateral and the newness of the venture. The Mihelic's personal financial statement showed about $50,000 in net worth, but virtually no liquidity. The collateral value of the business assets was low because they were old and not readily salable. It didn't help that George and Carol were new to Evansville and not known at the bank.

Following the bank's denial of his loan request, George applied to our local Certified Development Corporation (CDC), Evansville's Metro Small Business Assistance Corporation. The CDC accepted the loan and closed the deal in September. The loan committee liked George and believed that his business plan could create a solid small business. George pledged the inventory, receivables, and equipment of the business as collateral and signed a personal guarantee.

In the ensuing 18 months, the business performed as George had projected. He made every loan payment on time. His managerial skill and experience showed in the growth of the business and the financial results. His character shows in the

constantly improving appearance of his store and the loyalty of his customers.

The not-for-profit CDC that I serve on was established to promote the growth of small business in the Evansville area. The CDC deals exclusively with small business people who, like George, are unable to obtain sufficient financing through conventional channels. Its resources come from government grant programs set up for this purpose. There are about 400 CDCs currently in operation in the United States, dispersing a federal allocation of $1.5 billion, as well as additional funds appropriated by state and local governments.

I would like to give you an inside perspective on the Certified Development Corporation program. While each corporation is a little different, here is my synopsis: The purpose of the CDC program is the creation of new jobs through the support of small business ventures. Loan applications are evaluated both in terms of the economic value of the business project and the number of jobs that the project will create or save.

In order to accomplish its mission, the CDC must operate like a bank with both a risky loan portfolio and a social purpose. It must discriminate between those projects that are not economically sound and those projects that are worthy but not bankable. If the CDC is too conservative, the capital needs of small business will not be met. If it is too lenient, it will waste public money on bad loans and help lead unwary entrepreneurs into trouble. If it does not seek job creation, it will fall to support the social purpose behind public support of small business.

Are there many worthy but unbankable small-business projects that create jobs? During the past 11 years, the CDC with which I am associated has packaged 139 loans to small businesses totaling $12,104,486. This activity has resulted in the creation or preservation of 1,713 jobs in the community.

The economic viability of these projects can be measured by the quality of the loans. Nine of the 139 loans have resulted in default, amounting to a loss of $102,521. More than 40 percent of that loss occurred in 1984. Since that time, losses have remained below 1.3 percent of outstanding loans. This number represents loan quality that many banks would be proud to report. The high loan quality has allowed the CDC to operate profitably every year since 1985. The high repayment rate has also permitted the recycle of old repaid loans into new loans.

The success of job creation from these projects can be measured by the cost incurred to create the jobs. Using government definitions, $12,104,486 in small-business loans has created 1,713 jobs for an average cost of $7,084 per job. But calculating the cost of a created job in this way is misleading. The CDC disburses money in the form of loans and fully expects the loans to be repaid with interest. If the CDC made a loan, jobs were created, and the loan repaid with interest, it could be argued that there was no cost to the public for the creation of those jobs other than the cost of operating the CDC. The "opportunity cost" of the grant money to the government was less than the interest charged to the small-business borrower.

The cost of job creation is better defined as the cost of defaults suffered by the CDC added to its cost of operation. Defaults between 1983 and 1993 totaled $102,521. If an appropriate provision from for future losses from existing loans is added, losses from the program would be $144,715. The cost of operations during those 11 years was $831,807. Combining these numbers, the cost of each Job created or salvaged by the CDC was $570. Compared with the cost of unemployment insurance, the cost of welfare, or the anticipated employment tax revenue, this is an attractive result.

Not all certified development corporations are successful, but this one shows that successful operation is feasible. What decision process makes it possible to lend money successfully to unbankable small business projects? The process cannot be similar to the processes used by banks since banks are rejecting good loans. Nor can the process be tied to charitable or social obligations, however strongly those obligations might be felt. Success, for both borrower and lender, depends on repayment. The process must be based on objective business standards different from those used by banks.

Banks reject small business loan applications most often because of:

inadequate collateral,
the newness of the business, or
the lack of relationship between the owner and the bank.

Since CDC loan applicants have all been rejected by banks, the CDC must be able to identify high quality loans from a group that has one or more of these characteristics. Three criteria form the basis of the CDC's decision process.

Character

This is an inherently subjective characteristic but some assessment can be made through personal history: employment records, experience in business, records of pas ventures, credit history, and references. Character is viewed as a good substitute for collateral in this type of loan.

Cash flow

The CDC looks to cash flow for repayment since collateral is always inadequate and collection can lead to personal failure. It is the success of the business that must provide the loan payments. The CDC evaluates cash flow through review of the applicant's business plan. A loan application is rejected unless a rational business plan accompanies the application, and that plan passes the review of the CDC's loan committee. The committee reviews the plan both for reasonableness and for demonstration of repayment. Often, the CDC's staff, along wit others, helps inexperienced applicants create these plans.

Commitment

Most financial institutions, from commercial banks to venture capitalists, believe that business success requires commitment from the entrepreneur. They seek demonstration of that commitment through the entrepreneur's investment of personal assets in the venture. The size of the investment needs to be significant compared to the worth of the entrepreneur. The CDC agrees with this idea, but is usually dealing with potential borrowers who have little or no net worth. The CDC obtains commitment by requiring that borrowers invest some of their own funds and personally guarantee the entire loan. The guarantee is valuable not so much as a source of total repayment, but as a statement of seriousness from the borrower.

Using character, cash flow, and commitment as loan evaluation criteria means that the CDC members think more like an equity investor than a lender. This certified development corporation's success depends more upon its evaluation of its client's business prospects than its ability to rate the client as borrower. Its only source of full repayment is the long term success of its client's business.

The use of these criteria results from the failure of traditional credit evaluation methods to accurately rate applications from small businesses. Some commercial banks are coming to the same conclusion. They are opening commercial lending departments which specialize in small business lending. These new departments use different procedures for credit evaluation and are often located outside of the central banking office. Should these special departments become effective and more widespread, the job of the CDC will become harder, but access to capita for small business will become better.

They Need to Be Forthright, Just Like They Expect Their Borrowers to Be!

Sandra Brandl

Ms. Brandl is owner of Photo Mania, a one hour photo processing and photography education business in Schofield, Wisconsin.

As I write this, my business is about to celebrate its first anniversary. If I had the kind of service from lenders that I initially thought I would get, the business would now be several months past its first anniversary.

I hope my experience as a first-time business borrower is atypical. I also hope this response can prepare others for what may lie ahead.

The idea for Photo Mania was born when I worked as manager for another one-hour photo processing operation. I had different ideas about customer service than the owner, and decided I could best act on those ideas by opening my own business.

The biggest investment I would need to make would be in a building, because in the fast-turnaround photo finishing business, a high-traffic location is key. The best location available was on a corner, down the road from a unit of one of the fastest-growing discount chains in the country.

I had nowhere near the cash it would take to purchase that location (only about 10 percent down payment) so I spoke with a

banker. He told me to write a business plan.

A coworker at my former job referred me t the Small Business Development Center that serves my community. After an initial meeting with an SBDC counselor, I began working on a business plan. I spent most of eight months writing, meeting with counselors, and rewriting the plan.

I presented my loan request and business plan to a local bank. It included my personal financial statement, and a spreadsheet for the first year of operations, including a loan repayment plan. My business plan detailed how the business would be different than existing competitors.

It included:

Letters of intent to do business with me from 16 commercial accounts (heavy users of photo processing) in the area.

Market data, market trends and census data for the three-community area I identified as my primary market.

Field research on competitors, including observations of their clientele and complete information on their pricing structures.

Detailed information on the cost of start-up equipment.

The bank's response was that they would like me to have a 50 percent down payment on the real estate. Unless I had that kind of money, the answer to my loan request was "no."

After hearing of the decision, I asked my contact person at the bank to take my request back a second time. This time the response was that even if the bank could get the SBA to back the loan, they would lend me only a certain amount, and could I come up with the balance? In effect, this, too, was a "no," because I did not have enough money to make the difference.

One of the members of the bank's loan review committee was also a member of the board of an area "development loan" authority. He told me he would make copies of my plan for all the members of this authority's board, and that the board would review my request.

After I waited a week for my contact to return from an out-of-town trip, he returned my call. He assured me that the board members would look at the plan, but that I might have to be present at its meeting to answer questions. I told him that would be fine.

By this point, the scheduled opening of the business was delayed a month. (It was the first month of the annual peak of the photo finishing season.)

Another week passed, and I heard nothing. tried to reach my contact, but my calls were not returned. Three more weeks passed. Then, I contacted some of the members of the board, and they told me they had not seen my plan and loan request, and that they had never heard of either my request or of me.

When I finally did reach my contact, I was told that the building was not within the municipal limits for its lending authority, and for that reason they could not consider it.

Suddenly it dawned on me, "You're not in with the good old boys, Sandra, and that's why you're getting the runaround!"

This was my lowest point in my quest for financing. I was in regular contact with my SBDC counselors, and they gave me moral support. One of them wrote me a most helpful letter. I quote from it: "While you may be ready to punch someone right about now, I am sure you know that this is only the first of many times you will experience frustration and a sense of, 'this just isn't fair,' throughout the course of your business."

The next player was the community block grant board in the city where the building stood. They actually reviewed my financing request and business plan. I met with their 16 members and answered their questions with all the confidence and assurance I could muster. The group was chaired by a woman who fought for me.

I'm certainly glad I wasn't playing baseball, because after three strikes you're normally out. This was my fourth swing, and fortunately it turned into a home run!

With financing from the community block grant board, I opened my doors two months later than scheduled, but at least Photo Mania was up and running. And the financing deal was sweeter than I could ever have gotten at the bank! Despite the fact that I had lost 60 days of peak-time business, it has generated nearly twice the gross dollars I projected it to do, to date.

Am I making any money yet? The capital equipment will be paid off in less than five years. Then I will be drawing a salary. If my first 10 months are any indication of what Photo Mania will do, it will be okay.

The financing process took a whole lot more persistence than I ever thought I'd need. I can see why many people - especially those with no support or encouragement - give up.

I'm told that after I complete my first year in business, the bankers will be pounding on my door, asking for my expansion financing business.

But that's not when I needed them.

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