

# **Building a Business Plan for Obtaining Financing: What banks look for when they evaluate a small business loan request**

## **Business plans and applying for financing**

To a banker, a business plan exists solely for the purpose of supporting and explaining the financial information. In every case of applying for financing, the first and most important piece of the package is complete, accurate, signed, accrual-based financial statements. Other required documentation includes personal financial information. A business plan is a narrative that explains the logical steps that were followed in compiling the numbers.

## **Is a business plan even needed for my loan request?**

In practice, a business plan is needed only when historical financial performance of the company is not sufficient to support the current request for financing. Start-up ventures need a business plan.

Businesses experiencing a significant change of business model may need a plan, depending on how easy it will be for the loan officer to understand the change and how it relates to the financial projections through an in-depth verbal conversation.

## **Okay, so I need a plan. What should the plan say?**

The business plan should describe how the business meets, or will meet, the basic criteria in each area of creditworthiness (the Cs of credit, outlined below as 6 items for simplicity's sake).

---

**Conditions.** We want to know that the conditions are right for the type of business. We want to make sure there is a market for the business, based on the conditions of the local, regional and national economy, the type of industry, the competitiveness of the business and the owners' experience in the industry and in managing a business.

## **Documentation**

- Industry Trend Reports
- Target Market Demographic Studies
- Competitive Analysis
- Resumes

## **Area of business plan discussion**

- Industry Analysis
- Market Analysis
- Competitive Analysis
- Ownership/Management

## **Level of discussion needed**

We want to have confidence in your financial information, and this is the first step. If your industry is uncommon (we generally know the market for common industries such as medical/dental, restaurants, and real estate investment/development), you will explain the industry from a global, national, and regional perspective, including the prospects and trends for the industry over the next several years. You will want to compare and contrast the larger nationwide industry to what is happening in the industry locally.

You will describe your target market in detail, proving numbers for how many entities are in the target market, existing and expected market share, and the market's buying patterns. Together with an analysis of the competition, this will form the basis for existing or projected revenue. For example, there are 10,000 in my target market, I expect that we'll get a 2.5% market share because my main competitor has a 42% market share and they are ripe for losing customers because of their terrible service, the average client spends \$4,000 per year on my product, and therefore I expect annual revenue of \$1 million. Explain why you have confidence in the assumptions that you are using, in terms of industry experience or any other valid reason.

**Bank's formula for measurement**

In this, we have to have faith in the plan. We will apply a common-sense test. We know from experience that there are various industries in which start-ups rarely succeed (i.e. coffee shops) and that there are industries feeling particularly high levels of stress (i.e. mortgage brokers). We have to have confidence that the owners have sufficient experience to know what they are doing.

---

**Character.** This is the general impression that the business and its owners make on the lender. The educational background and business experience of the owners will be reviewed.

**Documentation**

- Resume
- Personal Financial Statement
- Business and Personal Financial Information

**Area of business plan discussion**

- Management/Ownership
- (The whole plan, really)

**Level of discussion needed**

Describe why the owners are suited to the venture, using specific examples from the resume or successes experienced since the business started.

**Bank's formula for measurement**

The bank wants to see that the owners have sufficient experience to run the business successfully. We look at education as well as management and industry experience. Consider the loan application package and discussion to be like a job application and interview.

---

**Capital.** How much equity does the business have? This is a measure of the owners' personal investment into the business – what is on the line should the business be unsuccessful.

**Documentation**

- Business Tax Returns
- Business Balance Sheet

**Area of business plan discussion**

- Description of Loan Request
- Financial Analysis

**Level of discussion needed**

With a start-up, should describe how much cash or personal assets the owners intend to contribute to the venture, and on what schedule. With an existing company, should describe the current equity position, how it got that way, and where it will end up after the loan request is approved.

**Bank's formula for measurement**

- Debt / Equity = Leverage (usually needs to be not more than 3)
  - Current Ratio
  - Quick Ratio
- 

**Credit.** This is the general impression that the business and its owners make on the lender in terms of the ability to effectively manage debt repayment. The educational background and business experience of the owners will be reviewed, along with their credit score. It's important for small business owners to

manage their personal credit carefully. Statistics show that the way owners handle their personal credit is a strong indicator of how they will manage their business credit.

#### **Documentation**

- Business Credit Report
- Business Balance Sheet and/or Tax Returns
- Personal Credit Report
- Personal Financial Statement

#### **Area of business plan discussion**

- Financial Analysis
- Owners' Personal Financial Condition

#### **Level of discussion needed**

Describe the business' credit arrangements in detail, including balances, minimum required payments, rates, and other pertinent terms and conditions. Describe the owners' personal financial condition in detail, including descriptions of assets and liabilities, and full explanations of any credit challenges.

#### **Bank's formula for measurement**

- Business credit is evaluated generally. Business credit reports are often unreliable and are used in conjunction with other measures of creditworthiness to form an overall picture.
- Personal credit scores should be at least 630 (varies from bank to bank), with good quality of accounts. Scores above 700 are considered good. We want to see experience with all types of accounts – revolving and installment, credit cards and mortgage accounts. We generally want to see at least 60 months of credit experience, and at least 7 open accounts. We do look at the kinds and types of accounts, and the debt-to-limit ratios on revolving accounts, along with information on the personal financial statement, to form an understanding of credit personality. A couple of 30-day slow pays are okay – they happen to everyone, especially busy business owners. Slow payments of 60 days or more, as well as bankruptcy, collections, judgments, and/or tax liens require significant explanation.

---

**Capacity.** The business plan and/or prior year(s) financials must show that the business can produce enough cash to repay the loan. This is the primary source of repayment, and most critical of the five Cs.

#### **Documentation**

- Business Tax Returns
- Business Income Statement
- Business Cash Flow Statement
- Personal Tax Returns

#### **Area of business plan discussion**

- Financial Analysis
- Owner's Personal Financial Condition

#### **Level of discussion needed**

Line-by-line explanation of each income statement and cash flow statement item, describing the logical process by which you arrived at that particular figure.

#### **Bank's formula for measurement**

- DSCR = EBITDA / Total Debt Service (should be at least 1.15x to 1.40x, depending on several factors)
- Global Cash Flow Coverage Ratio = EBITDA + Personal Income Sources – Personal Debt and Living Expense / Total Business Debt Service
- DTI = Total Personal Income / Total Personal Debt Service (should be 40% or less)

**Collateral.** A lender looks at collateral as an additional credit enhancement. It won't necessarily make the monthly payments, but it could, if liquidated, help to repay the loan. Federal banking regulations limit and dictate how much collateral is required. This is the secondary source of repayment, and therefore the next most important aspect after Capacity.

**Documentation**

- Business Tax Returns
- Business Balance Sheet
- Accounts Receivable Aging
- Inventory Report
- Depreciation Schedule
- Appraisal of Real Estate (must be ordered by a financial institution to be valid)
- Purchase order or invoice
- Personal Financial Statement

**Area of business plan discussion**

- Description of Loan Request
- Owners' Personal Financial Condition

**Level of discussion needed**

Should describe the type and condition of each type of collateral. For equipment, should describe the market for used equipment of the same kind and condition.

**Bank's formula for measurement**

Advance rates are limited by federal regulation, but are subject to interpretation by individual banking institutions. General guidelines are:

- Accounts Receivable      80%
- Inventory                      50%
- Equipment                    50-80%
- Real Estate                    65-85%

In general, loans need to be fully collateralized. Some exceptions can be made on a case-by-case basis, and are generally done in conjunction with a government loan guarantee (deficiency guarantee).

---

*Amaya Urzaa is a consultant with Waters & Associates, LLC, a business valuation and consulting firm in Portland, Oregon. Please see [www.watersassoc.com](http://www.watersassoc.com) for more information.*

*Justus Poling is Vice President in the Commercial Banking Division of Umpqua Bank in Portland, Oregon. He can be reached at [Justus.Poling@UmpquaBank.com](mailto:Justus.Poling@UmpquaBank.com).*

## The Loan Process

1. **Initial meeting** – The loan officer meets with the prospective borrower to discuss the loan request. The discussion will generally cover the history of the company and the management team, the current state of the company and its financial arrangements, the expected future of the company, and what new financial arrangements may be necessary to facilitate the management's plans for the future of the company. The loan officer, by the end of the meeting, should be able to say whether or not the deal sounds like a fit for his/her bank's credit policies. If a possible fit is identified, the loan officer will provide a list of required documentation and forms that the applicant will need to collect in order to be considered for the credit. Expect to spend one hour on this meeting.
2. **Collection of documentation** – Most often, the applicant does not have all of the information that the loan officer would like to see, or does not provide it all together. Most commonly, the applicant provides the information as it becomes available. Typically, we see business financial statements, then business tax returns, then personal tax returns, then personal financial statements. This process can take anywhere from 10 minutes to a year, depending on the applicant's state of readiness.
3. **Underwriting** – After the loan officer collects a "full package" from the applicant, the file moves into underwriting. At community banks, the loan officer is often also the underwriter. At larger banks, the file is usually submitted to a centralized underwriting center, where the file goes into a queue to be worked on by the next available underwriter. In either situation, this stage of the process usually involves a series of questions between the underwriter and the applicant. Depending on how many questions come up and how quickly the applicant can respond with answers, the underwriting process can take from 1 to 30 days. The end result of the underwriting process is an approval, a counteroffer, or a decline. If the approval or counteroffer is accepted by the applicant, the process moves to the next stage.
4. **Collection of closing conditions** – In order to create the loan documents, the bank may require additional information that was not included with the original loan package, such as:
  - Appraisal
  - Title insurance (preliminary title report)
  - Environmental investigation and/or reports
  - Construction budget review
  - Flood search
  - UCC search
  - Entity documents, such as Articles of Incorporation, by-laws, meeting minutes, etc.
  - Business permit or license
  - Copies of driver's licenses
  - Executed Purchase and Sale Agreement
  - Copies of lease agreements
  - SBA borrower information forms
  - Authorization to verify citizenship status
  - IRS 4506-T forms
  - SBA approval

This part of the process can take from one to 90 days, depending on the requirement and the responsiveness of the applicant.
5. **Documentation and closing** – After the bank has all of the necessary information, loan documents are produced within one to three days and signed by the appropriate parties. The loan's proceeds are generally disbursed the same day as the signing or on the following business day.