



Dealing With Your Banker & Other Lenders

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Your financing

The success or failure of your business will depend on whether or not you have enough capital to:

- buy the equipment and inventory you need;
- pay overhead costs such as rent, salaries, etc.; and
- have a large enough reserve fund for extra working capital which could be used to take advantage of "specials"; and for surviving temporary setbacks.

What funding do you need?

Your funding requirements can be broken down into two main categories:

1. Initial costs (i.e. land, building, fixtures, machinery, supplies, vehicles, pre-opening expenses and opening inventory).
2. Daily operating costs, rising inventories, payroll, rent, taxes, advertising, accounts receivable, etc.

It is essential to know the sum of all these costs. You must prepare a cash flow forecast, which will give you a reasonable estimate of your cash requirements for the first 12 months. If you cannot do a cash flow forecast yourself, it would be best to hire someone to do it for you.

The money required to operate your business can come from several sources, including: your own savings or loans from friends, relatives, investors, chartered banks, credit unions, or the Business Development Bank of Canada. Other financial assistance may include lines of credit from your various suppliers.

Two types of borrowed funds:

Long term financing

Long term financing is used to buy fixed assets such as buildings, machinery and fixtures; paid back in equal monthly instalments.

Short term financing

Short term financing is used to pay for current assets such as inventory, accounts receivable and other working capital requirements. It is usually covered by a demand note at the bank, and fluctuating weekly or monthly depending on your needs.

It is easier to borrow money by pledging fixed assets, so don't put all your equity into machinery or buildings; instead save it for working capital needs.

What lenders need to see:

- you can repay the loan out of normal business activities;
- the loan is big enough to do the job;
- a description of your project in writing;
- cash-flow projections for the first 12 months, including repayment plans;
- projected profit or loss for the first and second year;
- list of stock and equipment;
- list of assets you can offer as collateral;
- short history of your business experience; and
- statement of your personal net worth.

Cash flow forecasting

A cash flow forecast is your most useful tool to help ensure financial solvency. With this forecast, you can estimate the funds that you will receive and disburse, and the resulting surplus or deficit. You can take into account not only the operating and capital budgets, but also the ratio of cash sales to credit sales and the paying habits of your customers. To estimate cash outflow, you must also consider how promptly you intend to pay for your materials and merchandise.

By making a cash flow analysis you can estimate:

- how much cash will be needed to operate your business each month;
- when you will need additional short-term funds from the bank; and
- when you will have any surplus funds to reduce your bank loans.

This information can assist you in timing your capital expenditures more appropriately, accelerate collection of accounts receivable, ward off a cash shortage, plan short-term borrowing well in advance and perhaps invest any temporary surplus.

Finding a source of funds

The most common source of financing for small businesses is the chartered bank. To provide working capital, banks can provide short-term loans, long-term mortgage loans and loans against inventory or accounts receivable, etc.

Banks also offer a full range of banking services, including: personal and business deposit and loan accounts, buying and selling of foreign exchange, purchase and sale (or safekeeping) of securities and other valuables, letters of credit and the provision of market and credit information in Canada and other countries.

Other leading sources of finance are: insurance companies, trust companies, credit unions, commercial credit and acceptance companies, venture capital loan companies and factoring companies.

Equity capital represents the net value of the business less all other financing amounts including loans and other forms of borrowing that must ultimately be repaid. Also, business profits can be reinvested as additional financing once your business has started. Leasing may also be considered as a source of funds. The interest rates are relatively high, but payments are deductible from income tax. Leasing arrangements are usually used for machinery, vehicles and office equipment, where it is desirable to avoid heavy capital cost outlays.

Getting the most from your bank

Bank loans

Your involvement with the banking world begins even before you start your business. Develop a good working relationship with the bank of your choice from the very beginning. Faster and better services are supplied when a bank is familiar with its customers and their business. In this environment, suggestions for keeping a business financially healthy are more readily given, crisis borrowing can be avoided, and good loan planning can be developed.

Never surprise your banker with sudden or unplanned requests for funds

Unless you are independently wealthy and insist on using your own money, you will require financial aid from the bank in the form of a term loan, for any of the following purposes:

- to assist in establishing your new business;
- to purchase an existing business;
- to purchase new equipment;
- to provide additional working capital; and
- to provide funds to retire a bond issue or outstanding preferred stock.

Dealing with your banker

Points to keep in mind:

- Bankers are impressed only by your standards of management excellence. Experience counts heavily in planning, organizing, supervision, directing, control, development and demonstrated success.
- Arrange your borrowing needs well in advance. With time on your side and banks being in competition to attract top calibre business accounts, you may find the bank more willing

to negotiate competitive terms, such as security margins, interest rates and collateral requirements.

- Risk-taking must be a calculated endeavour not a speculative gamble. Remember, bankers are risk avoiders, not risk-takers.
- Always put your loan request in writing and finalize all loan documents before making any other financial commitments.
- Do not borrow by way of overdraft unless your line of credit is established for such borrowing. Any verbal line of credit for recurring overdrafts should be formalized as soon as possible.
- Negotiate your credit needs at your year end while your financial statement is still correct. It may be tempting to anticipate that your next interim statement will improve six months later, only to find that you would have been better off with a reduced line of credit at the beginning of the year, than to have none at all in the middle of a poor season.
- Keep yourself current on the prevailing lending attitudes so that you can adjust your own administration of receivables and collections accordingly.
- The only constant human element in your banking relationship is yourself. There is about an 80% chance the banker you are dealing with today will no longer be handling your account two years from now.
- There are countless instances where bank customers will casually sign just about anything while they are in the bank office. Read, understand and retain copies of all bank documents before you sign.

Developing good bank relationships

To develop good bank relationships:

- find out the services your bank offers (location, hours, etc.) and, if practical, use the same bank as most of your customers and potential customers;
- give the bank manager all the information he/she requires for head office approval of the loan;
- annually arrange a line of credit to meet peak requirements (but borrow only what is necessary, when necessary);
- adjust the loan level as actual requirements change;
- make realistic repayment commitments;
- avoid overdrafts; and
- be prepared to provide security for the loan.

What a lender needs to know

The lender will require the following information:

- amount of loan and period for which it is needed;
- reason for the loan;
- brief history of the company;
- financial statements of the business for the past three years;
- details of current financial position including specific data on:

accounts receivable;
accounts payable;
inventory;
fixed assets;
short and long-term debt;
special accounts;
facts about company operations;
facts about management and officers;
details of the project to be financed;
cash flow statements for the next 12 months (perhaps indicating an operating line of credit);
projected financial statements (indicating present requirements); and
the security you're offering.

Evaluation by a Lender

Your application will be evaluated on:

- your debt paying record;
- ratio of debt to net worth;
- past earnings and potential future earnings of your company;
- value and condition of the collateral for security;
- your character and management ability;
- the prospect that the business opportunity is too volatile; and
- the fact that you have prepared a business plan.

Collateral Accepted by a Lender

The lender will accept the following as collateral:

- granting of a floating charge debenture;
- personal guarantees of officers of limited companies;
- co-signers or guarantors;
- pledging of inventories;
- assignment of accounts receivable, leases, savings, warehouse receipts or securities;
- pledging of cash surrender value of life insurance; and
- agreement to restrict salaries, drawings and loan payments of proprietors, partners and principal shareholders.

Restrictions Imposed on the Borrower

- maintain working capital at a specified amount;
- furnish financial statements annually or semi-annually;
- share structure;
- limit dividends;
- sell the company or the assets;

- create no new debt except as agreed;
- provide no guarantees on behalf of others; and
- restrict drawings or benefits to shareholders.

Security for Term Loans

The following will serve as security for term loans:

- mortgage on property or chattel;
- floating charge debenture on other assets; and
- personal guarantees.