National Tooling & Machining Association

NTMA

PRECISION

Business Management Advisory

For Precision Custom Manufacturers

AC26 **FILE: ACCOUNTING AND FINANCE**

ESTABLISHING AND MAINTAINING AN EFFECTIVE BORROWING RELATIONSHIP

Summary

Strong and productive borrowing relationships can be vital in determining the success of small businesses. Bank share owners' desire success but must, necessarily, approach potential lending opportunities with prudence and diligence. This article outlines some of the important steps in the development of mutually fruitful relationships.

IS THERE A MATCH?

Small business owners often feel frustrated in their attempts to understand just what bankers look for when evaluating a borrowing relationship. Certainly, risk acceptance and target market criteria may vary from bank to bank; but certain constants prevail when a small business owner is being considered for credit. The better you understand a bank's "due diligence process," the more effective you will be at obtaining the best financing for your company.

Your first step should be to determine whether or not you and your company meet the bank's market profile, i.e., its target market. Banks have different strategies. Some target certain size companies, some target certain industry profiles and others restrict their business to a specific geographic territory.

Next, you need to determine what are the bank's general lending criteria, i.e., its risk acceptance criteria, so that you do not waste your time, because obtaining credit is a time consuming process. Most banks will be pleased to explain their general criteria, such as minimum loan size, maximum allowable leverage, minimum interest coverage and debt service coverage requirements. A word of caution; however, the fact your company may meet the general criteria is no assurance that you will be successful in obtaining credit from a particular lending institution. Let's discuss why that is and what a bank will do in its due diligence process to arrive at its ultimate decision.

UNDERSTANDING YOUR BUSINESS

Assuming you are not an existing customer, the bank will first make sure your company does meet its target market profile. Then it will review your strategic objectives and overall financial structure. In other words the bank will want to know what your specific request is and what your immediate and long-term credit needs are. What caused your need to borrow? How long do you think you will need the funds?

The bank will then conduct a "source of repayment analysis." This involves a business risk analysis which includes a review of the trends and risks which affect all companies in your industry. And the bank will want to know what risks you must manage successfully to repay the requested loan.

By this time you probably will have already provided three years of complete financial statements (audited are preferred; outside preparers are generally required). For term loan requests the bank may also want 3-5 years of projected financial results. The bank will undertake a thorough financial statement analysis and will seek to answer a number of questions. What do the financial statement trends show about your management of the business? What trends will influence your ability to repay?

You, the business owner, are all too aware how critical cash flows are to survival as well as success. After all, the core of your business activity is the asset conversion cycle-the process of converting assets to cash. The bank's cash flow analysis is the foundation for evaluating repayment capacity and determining loan structure. The analysis will first examine actual cash inflows and outflows. Secondly, the analysis will review the financial changes resulting from the cash flows such as sales growth, expenses and profit margins and turnovers of accounts receivable, inventory and payables as well as capital expenditure requirements.

Questions the bank will attempt to answer may include the following: Will the company have sufficient cash to repay the loan in the requested manner? What is the effect of sales growth or decline on cash requirements and therefore leverage? What is the effect of expense management, not just on profitability, but also on cash requirements? What is the effect of leverage on cash requirements? Which risks will have the greatest impact on the ability to repay? What does historical cash flow suggest about future cash flow? How is the future likely to be similar to or different from the past? The bank will integrate information from the historical analyses of the business and financial statements into a forecast of future cash flows and projected profitability.

The business and financial analysis also will serve as the basis by which the bank identifies the need for the loan - is it caused by short-term or seasonal sales increases, is it caused by slowdowns in the operating cycle or is it caused by purchases of fixed assets or changes in the equity structure? The bank will then suggest a structure appropriate to the credit, including terms, repayment schedules and support that will meet your needs yet also comply with the bank's requirements. This is the point at which a more detailed discussion of documentation and covenants will occur.

A MUTUAL COMMITMENT

Throughout this entire process, it is important to remember that full disclosure is essential if you are to establish a good working relationship with your lender. Be sure to disclose all contingent liabilities. Be prepared to disclose personal financial information, because banks who lend to closely held businesses typically require personal guarantees. Banks generally want owners to be as committed as the bank when lending to their closely held businesses.

Smaller businesses are not simply scaled-down large businesses. It is critical you feel the bank understands your business, your industry and your financial objectives. A good business banker can explain its requests and need for information as well as its analytical process. If something seems obscure, you should ask for and expect a rational answer. The better you understand the bank's process and procedures, as well as its basis for extending credit, the more successful you will be at establishing the best relationship possible for you and your company.

Once established, maintaining a good relationship means keeping the bank informed of significant changes in your business, its profitability or cash flow requirements. Frequent communication is advised in order to minimize surprises.

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This BMA was prepared by Susan A. Bass, Senior Vice President and Manager of IBJ Schroder's Private Client Services Group. The Group specializes in working with high net worth individuals, their businesses and their families. Contact Ms. Bass at (212) 858-2739 for information.