

Overview

The expectations gap

The late 1980s and early 1990s have not been happy times for banks: news of massive bad debts, accusations of inaccurate bank charges and claims that small businesses have been ruined by their bank's unwillingness to lend have been commonplace. However there is also another side to this story.

Most banks are owned by shareholders ranging from individuals and life assurance companies, to investment trusts and pension funds. These shareholders expect their investments to be managed prudently, to grow in value and to pay a market rate of return.

Banks and their shareholders have no legal obligation to support the small business sector, or to subsidise its profits. They also have no duty to the economy or the government, and no responsibility to ensure that the country enjoys economic recovery.

But, of course, this is not how the public and media see it - and as a result an expectations gap has appeared between what banks are willing to offer and what the borrowing public feels they ought to be offering.

Using these notes

If you are going to be successful in persuading your bank to say "yes" it is essential that you understand what they need and want from you. These notes are designed to help you to do exactly that.

If you want to get straight to the key points you can move straight to the 10 golden rules on page 11. If you prefer to understand what lies behind that action plan you should read pages 5-10.

What do banks need?

Overview

All banks like to say "yes". They really do. After all, they are in the business of lending money and providing services. But they are also in business to make a profit - and they can't make a profit on loans that they believe will never be repaid. Therefore they sometimes have to say "no".

As a result banks want a quality solid customer base into which to extend reliable and profitable lending (with highly-profitable add-on business such as insurance being sold as a bonus) And, of course, having won a customer, they would like to keep them, but *not* at any cost.

If your business already meets your bank's specification for a "quality" customer then you should already be enjoying a mutually profitable relationship with them. But if you are not getting as much out of your bank as you would like, read on to discover why - and more importantly, what you can do about it.....

Competition

Banks don't want customers with too many bank relationships since this forces them to compete purely on price, breeds resentment, limits their opportunities to bid for add-on business, and inhibits their willingness to take risks. Most banks would like to do business with you on the basis of price, reputation, delivery and quality of service - not just on price.

Single point of contact

Most banks also prefer to have a single point of contact with a customer, or at least to have a knowledge of the customer's management structure, and the names of all relevant decision-makers.

Honesty and trust

Banks want to deal with their customer on the basis of complete honesty and mutual trust. Bank and customer must both be as good as their word. There must also be full disclosure of all relevant information as soon as it becomes available, particularly in the areas of the representations, warranties and covenants in loan agreements.

There must be no surprises for the banks, and your disclosures to them should not be confined to matters which concern them directly. The more you confide in your bank manager, the greater will be the mutual trust and the stronger will be your relationship.

It is also important never to promise what you cannot deliver. In particular, don't promise information you haven't got or can't get, and don't promise add-on business you have no intention of giving to them.

Accurate information

An important implication of all of this is that you must have accounting and reporting systems that are good enough to give the bank all the information they need, when they need it! This means being able to provide regular and accurate financial information - including budgets, forecasts and commentaries - which should demonstrate your continuing ability to service and repay any debt. You should also have clear corporate and financial objectives and business strategies designed to meet those objectives.

Commitment

You should be prepared to make a long-term (ie not less than three years) investment of your time and money in your relationship with your bank, in return for expecting them to take a long-term view of your business. A long-established relationship between bank and customer is by far the most potent force binding the two together, but such a relationship needs constant investment and renewal. Both sides must be committed to it and to work at it.

How do banks decide?

Principles

When banks consider your application to borrow money they are trying to achieve four main things:

- To assess your credibility as a borrower. One key to success here is to ensure that you have a face-to-face meeting since lending decisions can sometimes depend as much on the impression made by the management of a company as on the quality of a business plan.
- To ensure that your business plan demonstrates your ability to service and repay the loan according to agreed interest and repayment dates. Here the bank will scrutinize the projections and underlying assumptions contained in the business plan supporting your loan application. It is important to recognise that banks usually apply much stricter lending rules to new businesses - in particular, the capital structure and the credibility of its management will be even more important for a new business than they are for an established businesses.
- To ensure the finance sought is appropriate to the nature and the term of the investment. This means that the type of finance you are asking for should be similar in term and flexibility to whatever it is that you intend spending the money on. For example, if you want to spend the money on a fixed asset that you expect will pay for itself over five years, the bank will probably expect you to ask for a five year loan rather than an overdraft.

Another implication of this principle is that the amount of money you are asking to borrow should be enough to meet all foreseeable events, and should also include an allowance for contingencies - or to put it another way, "borrow more than you think you need!"

- To ensure that you can provide enough security for the loan. This can take the form of "primary security" ie charges over the tangible assets of the business. Alternatively it can be "secondary security" ie personal guarantees.

The business plan

When asking to borrow money you must, of course, always support your application with a detailed business plan. In addition to satisfying the bank's

information needs, such a plan will help to convince the bank of your professionalism - a quality which many banks complain is often absent in many small to mid-sized corporate borrowers.

Types of risk

When banks are considering your application to borrow money they will assess three types of risk:

- Business risk
- Financial risk
- Lending risk

Business risk

Business risk is the risk that the purpose for which the money is borrowed will not produce the expected profits and cash flows sufficient to service and repay the debt. This risk is usually assessed by making a thorough and rigorous analysis of your business plan.

As a result your business plan should set out:

- Your objectives and reasons for borrowing, including the nature and description of any assets or investments to be acquired, a justification for the investment and a detailed analysis of the risks;
- A description of your strategies for the product or service development, marketing, maintenance, capital expenditure, finance and personnel;
- An assessment of the competitive environment into which the product or service from the investment is to be sold;
- An assessment of the risk environment in which your business operates (including economic, political, regulatory, social, technological and legal risks);
- A description of your management team, to include evidence of the ability and commitment of the owners and managers, their age, background, qualifications, experience, etc; and
- Sensitivity analysis on all major variables showing their effect on the financial projections, and third party corroboration of the reasonableness of assumptions made in your business plan.

Financial risk

Financial risk is the risk that your financial structure (ie your balance sheet and income gearing) will prove unsustainable.

For example, the bank will look at your *balance sheet gearing* (ie the ratio of interest-bearing debt to equity). Their main concern here is that, whilst equity providers (ie shareholders) may be willing to forego dividends on their investment, lenders such as banks and building societies will insist that interest is paid on a regular basis. So if your business's balance sheet is too highly

geared (ie there is too much borrowing and not enough investment from shareholders), there is an increased risk that the cash-flow from the business will be insufficient to meet the repayments and interest. This will, of course, make your bank nervous - regardless of how attractive, successful or profitable your business is.

The bank will also look at your *income gearing* (ie the ratio of interest charges to pre-tax profits) and *interest cover* (ie profit before interest and tax divided by interest charges). These are important considerations in loans to businesses where the repayment is to be made from profits generated from the business, rather than from sales of assets.

To help the bank assess the financial risk your business plan should contain financial projections for the next three to five years, including:

- Integrated profit and loss, cash flow and balance sheet projections;
- The projected all-in cost of the investment - including the cost of interest payments, repairs, maintenance and refurbishment, but deducting any contributions from shareholders or grants;
- An analysis of key post-investment ratios (return on equity, return on capital employed, debt gearing, income gearing, etc);
- An assessment of the likely impact of tax;
- An assessment of the likely impact of interest rate movements, particularly if the borrower is highly-g geared; and
- Reasonable sensitivity analysis on all major variables, and evidence that you have sufficient contingency finance available to meet those sensitivities.

Lending risk

Lending risk is the risk that, should you get into difficulty, the loan documentation is inadequate to ensure that early warning is given to the bank so that it can take measures to protect its position.

Banks will always want to minimise this risk by building-in as many early warning signals and escape routes as possible. For example, if it has adequate warning, a bank can control the damage and protect its position by granting waivers or perhaps restructuring the debt. If all else fails, it will want to be able to call a default, demand repayment, insist that you sell the assets over which the bank holds a charge, or use any personal guarantees you have given to make you personally liable to settle the debt.

The bank manager's risk

It should be remembered that for the average banker with, say, 50 accounts to manage, one bad debt can eliminate the profits from his other 49 accounts.

Recent changes

The main change in lenders' perspective over the last few years is that today practically no bank will lend solely on the strength of security - however good that security may appear to be.

In the 1970s and early 1980s, it was a golden rule of banking that no lending should ever be advanced purely against secured assets. Lending should only be made where there was reasonable certainty that the debt would be serviced and repaid. Security should only give the lender a warm feeling - in other words, it should be the icing on the cake.

With high rates of property and asset value inflation in the 1980s, this golden rule was forgotten, and anybody with a property asset could obtain a bank loan in the 1980s. However now the old principles have re-emerged - you will only be able to borrow money if you can offer security *and* adequate profits and cashflows to meet the repayments.

The golden rules

A 10 step plan

In this section we have consolidated the key principles from the earlier pages into a ten step action plan that should greatly increase the chances of your bank saying "yes" when you ask them to lend you money.

1 Understand banks

Make sure that you understand what the bank will need from you - eg

- Commitment and reasonable loyalty
- Honesty
- Mutual trust
- No surprises or false promises
- Accurate and timely information

Ensure that you are in a position to be able to meet these expectations.

2 Understand yourself

Think carefully about

- Why you want to borrow and what you are trying to achieve?
- Is borrowing really the answer?
- How much money do you need to borrow?
- What type of finance would be most suitable (overdraft, loan, leasing, factoring etc)?
- Can you afford to pay it back?
- What security can you offer?

This will usually involve preparing detailed financial forecasts.

3 Get on the phone

Telephone two or three carefully chosen banks, outline your needs and find out if they are interested (it is often advisable to ask your accountant to do this on your behalf since he will already have a relationship with the bankers and will be in a position to present your case in a fair but favourable light). Try to choose branches that are likely to be able to give you a decision without referring it to their managers. In general, the bigger the branch, the more likely it is that they can make their own decisions. But it is probably not a good idea to contact the same bank that you use for personal savings and borrowings - they may eventually apply pressure on you, for example, to sell your house to repay your business loans.

4 Plan to succeed

Produce a detailed business plan and review it with your accountant. Banks will not seriously consider a proposal unless they are satisfied that:

- Your management team are capable and

competent, honest and reliable

- The business can generate enough cash and profits to repay the loan and service the interest
- There is genuine commitment on the part of the borrower
- The type of finance you are requesting is suitable (ie they are unlikely to offer you an overdraft to finance an expensive new piece of equipment - instead they may recommend a term loan or leasing)
- There is enough security available to the bank should things start to go wrong.

Make sure that your business plan provides reassurance on all these points. But don't lose sight of reality - your plans must be realistic.

5 Over-cook it!

It is a sensible precaution to ask for a larger loan over a longer period than you think you are actually going to need. Ten to 20 per cent more money for a 25 per cent longer period are probably about right. That way you will have a margin for negotiation and error, and hopefully will not have to go back to the bank in a few months time asking for more. If it turns out that you really did borrow too much, you can always earn extra brownie points by paying the loan back sooner than agreed.

6 Produce a summary

When you are satisfied with your business plan, produce a very well written one or two page summary. Then send the business plan and summary to the "friendly bankers" you identified in step 3.

7 Use home advantage

Ensure that your first meetings with the bank managers are at your business premises. The chances are that you will be more relaxed and they will be more impressed if you meet on your home territory.

8 Be prepared

Treat your meetings with the banks in the same way you would a major potential customer. Thoroughly prepare yourself. Think about the types of questions they will ask, and make sure you can answer them.

9 Don't negotiate (yet)

Don't even think about negotiating interest rates until they have indicated the likely terms of an offer. At this point the manager will probably have half to one per cent of room for negotiation over the interest rate.

10 Be security conscious

Make sure you understand the nature and meaning of

the security you are being asked to give. Offer charges over the businesses assets rather than guarantees. If the bank insists on personal guarantees, try not to agree to unlimited guarantees. Instead offer a guarantee with an upper limit equal to the amount of the loan less the other security available.

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