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Get a Bank Loan More Easily

By Brian Hamilton, CEO of Sageworks, Inc., July 27, 2011

Before diving into the specific tactics for getting a loan, you have to understand how banks think and act and why there are good reasons for what they do. A bank lends money. Let's say they make six percent in interest from you on a commercial loan. Let's say they pay two percent interest to their depositors. This gives them a "net interest margin" or spread of somewhere around four percent. If they lend $1,000, they make roughly $40 to pay operating costs and salaries (assuming that all loans are repaid). Let's say a bank has $1B in assets. These assets yield approximately $40M in income with which to pay operating costs. Now, let's say that, of the $1B, five percent of their loans are uncollectible. This eliminates the bank's entire net cash flow from the interest they should have collected and in fact makes them unprofitable; there is no money available to pay any operating costs. Suppose, instead, that only one percent of loans are not repaid. Now, the bank has $30M in revenue, but, again, this revenue has to cover *all* operating costs. The real numbers—the bank's net interest margin—are telling. For the past two years, the average net interest margin for all U.S. banks (the difference between the percent interest collected and the percent interest paid out) has been slowly decreasing, from 3.84 percent at the end of March 2010 to 3.57 percent at the end of March 2011.[1] Their cushion is getting smaller and smaller.

Frame it this way: if a bank has 100 loans at $1 each and if even one or two of the 100 loans actually default and do not repay principal, the bank loses money. For a bank to profitably exist, around 99 percent of its customers have to pay their debt. So, while the typical businessperson might be willing to try a venture if 4 of 5 times it works (they would win 80% of the time), the bank can only take the risk if something will work 99 percent of the time. On top of that, banks have regulators breathing down their necks and angry depositors (who are actually creditors) pushing for more security. So, it is not that bankers are risk averse because they were born that way; they have to be risk averse to even stay in business. I hear many people complain about a bank's unwillingness to lend, but I have been on both sides. The argument that bankers are somehow risk intolerant (wimpy) is a cheap shot that really demonstrates a misunderstanding of how they operate. That confusion makes the loan application process frustrating for all people involved because the people who borrow money need to package their loans to suit the basic needs of the banks.

With that context, you are now prepared to borrow money. In your loan application, you have to assure yourself and the bank that there is little/no possibility that your individual loan will go bad i.e. you won't pay your bills. There are two ways that banks assess a commercial loan:

1. Does the business have the cash flow necessary to support the loan? They look extremely closely at the cash flow of your business. It is not just about whether the business makes a profit—there must be a large cushion. So, if the profits of the business are $5, the bank might be willing to make a loan such that the profits will reduce to $4 or so. Generally, the average cash flow to debt ratio must be around 4 or 5 (cash flow divided by principal and interest payments). Even if the business has that covered, if the business is a small one, the bank will also consider whether the cash flow of the company is sufficient to

[1] "Net Interest Margin for all U.S. Banks," Federal Financial Institutions Examination Council (July 2011). Accessible at http://research.stlouisfed.org/fred2/series/USNIM.

cover the principals' personal expenses. All this makes common sense for both the bank and the borrower because everyone wants to be sure that a loan is repaid on time with little discomfort to the borrower.
2. If the loan goes "bad," can the bank sell some collateral to recoup the debt? They look at a secondary source of repayment in case the first source—company profits—is insufficient. This is called security. Unless a business has incredibly strong cash flow from operations and is large, I am amazed a bank would even consider making an unsecured loan. Remember, when offering collateral, you need to understand that the bank will have selling costs and recovery challenges, so even the collateral has to have a cushion.

To help your commercial loan application pass these two tests, here are a few tactics you can deploy:

1. Have well-documented cash flow documentation for the past three years. This includes tax returns for both the owners and the business. Compare cash flow to principal and interest costs. By the way, while any business should have a good cash flow forecast, banks don't lend on what a business will do; they lend on what a business is doing and has done for the past three or four years. Again, they cannot be optimistic (they must be right 99 percent of the time), so you have to prove that your current cash flow is sustainable and will support the new debt when coupled with your other, existing obligations. Forecasts are terrific tools to run a business, but banks don't rely on them and shouldn't except in atypical situations like large development deals.
2. If you own real estate, have documentation available that validates its value and mortgage balance(s). Be prepared to take out a second mortgage on your house; if you won't gamble on your business, why would a bank?
3. Look into the SBA guaranteed loan program, but also *be sure to use a bank that really knows this specific process*. The SBA (Small Business Administration) guarantees loans under its program, so the bank is guaranteed to recover up to 85 percent of its loan if the borrower/you default. This makes the bank slightly more willing to make a riskier loan. Use a lender that has done a slew of these and can navigate the process.

Before you borrow, put yourself in the bank's shoes. Knowing just a little about the economics of a bank can help you receive a loan because you will learn how to package the loan application that will appeal to the bank. Finally, remember the bank only makes money by lending and making interest. They want to make good loans, *and you are helping them by giving them good business.* Just because a bank has the money does not mean they hold all the cards although it can certainly feel that way sometimes.

About Brian Hamilton: Brian Hamilton is the co-founder and CEO of Sageworks, a financial information company, and Inc. 500 honoree. Hamilton is an original co-developer of "FIND" (Financial Information into Narrative Data), Sageworks' core artificial intelligence technology which converts financial numbers into plain language. FIND is the basis of the ProfitCents and Sageworks Analyst applications that are used by financial institutions and accounting firms throughout North America and the United Kingdom.

Brian Hamilton holds an MBA degree from Duke University and a bachelor's degree from Sacred Heart University, where he graduated summa cum laude. Brian is a noted expert in finance who has been published and quoted in most major national media outlets.