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Get the Loan You Need

This factsheet explores how lenders evaluate loan applications and how you can prepare for that all-important meeting with a potential lender. This information is intended to give business owners an edge in securing the financing they need to develop their business.

Getting financing

Agriculture-related businesses vary greatly and so do their needs for funding and financing. These businesses can be capital-intensive and may need a cash infusion from time to time to increase working capital or to acquire capital assets.

Business needs for funding and financing vary a great deal

Getting financing can be one of the most challenging aspects of starting or expanding a business. Understanding how a lender evaluates your application can help you be successful when applying for financing.

In Alberta, many sources of funding are available for agriculture-related businesses. An overview of types of funding can be found in the Alberta Agriculture and Forestry (AAF) three-part factsheet series called *Funding Your Agricultural Business* (Agdex 832-3, 832-4, 832-5).

This factsheet will deal with one of the most common forms of business funding: debt financing through a bank, credit union or other financial institution.

How lenders evaluate loans

Lenders are in the business of making money by extending credit. They want to help make your business plan a reality, but they also want to ensure their risk is covered. The lender's job is to analyze your business plan for credit risk.

Lenders will use a variety of financial tools to assess your request and may also take into account other factors like your character or external conditions affecting your business environment. Your task is to make the lender feel confident that you have a solid business plan and that you understand any potential risks and are taking steps to mitigate them.

Step one: know your credit rating

One of the first tools a lender will use to review your financial strength is your credit report. A credit report is a record of your past and present use of credit cards, lines of credit, bank and car loans. In Canada, Equifax Canada and TransUnion Canada are the two main credit reporting agencies that keep personal credit information on file.

These companies assign a credit score that represents the probability of you paying back your debt. The scores are ranked on a scale from 300 to 900, arrived at through a statistical analysis of your information. Good scores are typically 600 and higher, with any score over 750 considered excellent. The higher your credit score, the lower the risk for the lender.

Before you visit a lender, make sure you are aware of your own credit score by getting a copy of your credit report. It is available to you through Equifax or TransUnion and is often free. If you want a more detailed report, or want to be advised of changes to your file when they occur, you can often obtain this information for a fee.

Although credit reporting agencies do their best to maintain accurate and up-to-date information, it is possible that your credit report contains errors. If you believe there is an error on your credit report, refer to the federal government's Financial Consumer Agency of Canada website for steps you can take to have the information corrected.

Be aware that every time a credit check is performed on you or your business, the activity has a negative effect on your credit score. If you plan to "credit shop," you should get your own up-to-date credit score to take with you to the various financial institutions.

The 5 Cs of Credit

Other financial criteria used by lenders to assess or mitigate risk are sometimes referred to as *The 5 Cs of Credit*: cash flow, capital, collateral, conditions and character.

Cash flow

Cash flow, in its most basic form, is money coming in and going out of your business. Cash flow statements indicate (within a certain time period) how much cash remains after you have paid your expenses. Inadequate cash flow is one of the most common reasons that new ventures fail.

A lender will look at your previous cash flow statements – or future cash flow projections – to evaluate your ability to repay the loan. They may use a debt-service-coverage (DSC) ratio to determine risk and will likely want to see a ratio of around 1.25, but this figure will range depending on the nature of the business and the risks it presents.

For example, a DSC of 1.25 means if you have $1,000 of debt repayment to make each month, you should have $1,250 in cash left after monthly expenses. That extra 25 per cent represents a buffer of cash to protect you against unexpected business effects caused by a shortfall in sales or an increase in expenses.

Capital

Capital is the amount of money or resources you are personally willing to invest in your business or company, in addition to the funding you are requesting as a loan.

Sometimes referred to as "skin in the game," lenders want to see that you are able (and willing) to commit personal resources to your business or project. No lender will want to assume 100 per cent of the risk for a business venture, and the capital you pledge will show your commitment.

Typically, lenders will want you to contribute funds between 25 and 50 per cent of the required amount. The amount varies from lender to lender, so be prepared to negotiate this figure as part of your loan application.

Collateral

Collateral is a saleable asset you own that is pledged to the lender in the event that you cannot repay the loan. Possible collateral assets can include a house, land, cars, equipment and even inventory. Collateral helps lenders minimize the risk of extending credit to a borrower.

Some applicants are surprised that the value they estimate for their collateral assets can differ from the lender's assessment. It is quite likely a lender will assess collateral below market value to account for liquidating it in the event of a loan default. Lenders also apply loan-to-value ratios to collateral that limit them from lending up to the full value of the collateral pledged.

Requiring collateral to be pledged as security for a loan is common practice for lenders. Do not be concerned if you're asked for this security as a requirement of your loan. Lenders use collateral like insurance – it is only there if it is needed. A lender will typically access collateral as a last resort and only after other options are explored.

Conditions

Even with the most thorough planning, every business is subject to conditions outside of its control. A lender will likely consider external conditions related to your business environment to assess the effect conditions could potentially have on your business and its profitability.

For agricultural businesses, a lender will want to see that you have made attempts to mitigate fluctuations in market price, weather conditions or pests that could negatively affect your production. Including risk management strategies in your business plan would be one way to ease the uncertainty of external conditions.

Character

When assessing a loan application, a lender will also consider your character by reviewing your personal and professional capacity to run a successful business.

Character assessments and reference requirements will vary from lender to lender. Character can be demonstrated in a number of ways, including the following:

- previous business experiences or successes
- referrals or references from professionals you have relationships with
- past experiences with a lender
- involvement in your community

Promote your management experience

Lenders will appreciate you having direct experience within the industry or market where you plan to start or expand your business. If you do not have this experience, do not be discouraged. If you have successfully run and/or sold a previous business, a lender might take that activity as transferrable experience. After all, many management skills are relevant across different industries.

Demonstrate any past business successes and personal capabilities you have in the following areas:

- building and retaining customer relationships
- marketing and promotional skills
- production management
- human resource expertise
- strategic decision-making skills
- past success with credit
- financial management

Remember that you do not have to be the one who performs all these duties or personally oversees these areas. Just make sure these key business areas are covered in your business plan, even if doing so means hiring outside expertise.

Present your business plan

One of the key documents a lender will want to review is a business plan with detailed financial statements. You will want to include a strong executive summary and description of the business. If you are looking for financing to expand into other markets, your market analysis and strategies will need to be fully developed.

Typical sections included in a business plan:

- Executive summary
- Description of the company
- Product or service
- Market the company operates in
- Marketing or sales plan
- Operational plan
- Management team
- Financial statements and projections

For more information on creating your business plan, refer to the Alberta Agriculture document *Elements of a Business Plan* – see the department website at http://www1.agric.gov.ab.ca/$department/deptdocs.nsf/all/agp4957

Getting ready to meet a lender

As a business owner, you want to be thoroughly prepared when you meet with a potential lender. Your focus should be on presenting your plans and anticipating any questions potential lenders may have about those plans. The better prepared you are, the faster and more successful the process is likely to be.

The specific documents required for your meeting will vary with each lender. Here are a few common documents you may be expected to present in a meeting with a financial institution:

- personal and/or business financial statements (balance sheets, income statements)
- one to three years' worth of income tax returns
- a detailed summary of start-up or expansion costs
- cash flow statements (if you have an existing businesses) and cash flow projections (one to three years, depending on the lender's requirements)
- evidence of ownership on collateral that may be pledged as security
- an up-to-date business plan
- reference letters or referrals that are relevant

Other questions to consider:

Have you created a budget to show exactly how much money you need?

Does your business plan convey your idea in a concise and persuasive way, so the lender can understand what you are trying to achieve?

Do your financial statements and projections show your profitability and demonstrate you are able to pay back the loan?

Have you identified the weaknesses and/or potential risks in your business plan and presented mitigation strategies to address them?

Do you have personal references from professionals you have worked with that show you are reliable and reputable?

Have you reviewed your credit report and can you answer any questions a lender may have about your credit score?

Different lenders will have different tolerances for credit risk. Have you contacted several lenders to find the best fit for your financing proposals?

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