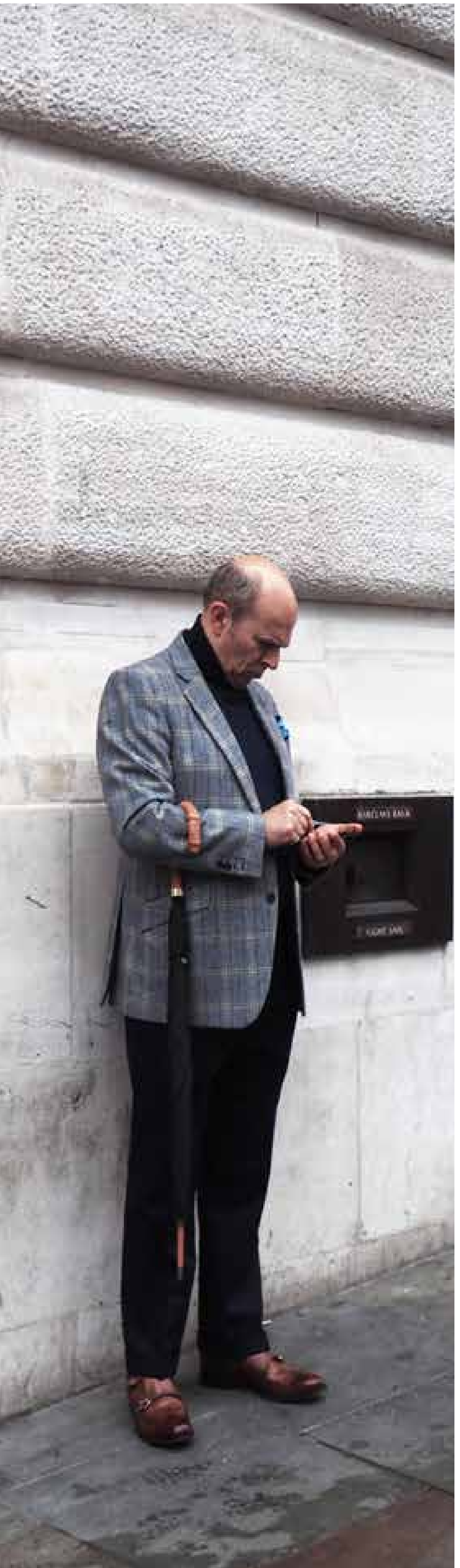

How a Banker Thinks

by **BOB KING**

No matter what stage of growth your business is in, there will come a time when extra funding will be necessary or helpful. When that time comes, don't be nervous. Be prepared.

By understanding how a banker thinks, you can feel better prepared to secure the funding you need, when you need it. Most bankers are taught the same principles to apply when extending senior debt (make you a loan). In my 35 years of experience, I've worked at a few financial institutions, and there are many overlapping principles that I look forward to sharing.

Most of my experience has been in the commercial and industrial (C&I) space, working with closely held businesses. While financial institutions have many products to offer, I plan to address the credit piece, specifically for loans to help grow and support your business. We will also focus on C&I operating businesses versus pure commercial real estate (CRE) deals. The underwriting process for CRE is much more formulaic and less subjective, but it includes many of the elements that I'll share.

THE ROLE OF A BANKER

There has been a trend in banking over the past 15 years to separate the sales function from the credit approval process. Some of this is regulatory-related, and some of it has to do with efficiency. This means that your banker may or may not be credit trained. Some bankers will take your information and turn it into a credit underwriter or centralized credit department to decision your loan request. Other bankers will underwrite the loan request themselves.

I was fortunate enough to attend a formal credit training program in the first full year of my employment. It consisted of two months of graduate-level accounting and finance, followed by six months of direct credit underwriting for new and existing credit commitments. It was more challenging and more complicated than any of the classes I took in college, but very rewarding! One of the first important lessons I learned is, "Why is a loan is different from almost any other product?"

do's and don'ts from your banker

don't...

SURPRISE US
Don't surprise your banker! Bankers do not like surprises.

OVERPROMISE
Don't commit to a plan or expectations you cannot meet.

BE VAGUE
Don't ask for a loan without sharing your intention and the amount needed. Understand what you need and why.

LEAVE ANYTHING OUT
Don't provide a bank with incomplete or inaccurate financial statements.

BE HASTY
Don't spend the money before you get the loan.

BE IMPATIENT
Don't get frustrated by all the questions bankers ask.

FOCUS ON INTEREST RATE
Don't choose a loan solely based on the interest rate. Terms and structure are important as well.

do...

CHOOSE WISELY
Do choose a bank that takes the time to understand you and your business! Not just make you a loan. Do choose a bank that can be a true financial advisor—one who can deliver forward-thinking strategic advice.

KEEP IN TOUCH
Do meet with your banker at least two times a year to discuss your operations and upcoming needs. Your banker should be doing this already.

MAKE TIME
Do make time to meet your banker in person and set expectations.

BE PRESENT
Do be open and honest, responsive, prepared, and ask questions.

BE UNDERSTANDING
Do realize the quality of your financial statements matter as the loan amount increases.

BE FORTHCOMING
Do realize a bank will want to understand your global financial picture and the underlying entity applying for a loan.

Different indeed! When you purchase almost every other product, you order it, pay for it, receive it, and then own it. For example, think about a refrigerator. Once you pay for it and it is delivered, the company who sold it to you does not want it back. But with credit (a loan), the product is money. The bank wants the money back plus some spread over their cost of funds. A bank wants its product back, plus interest. This has always stuck with me and is why you have a personal relationship with your bank instead of a transactional one. It is also why a bank wants to understand your prior financial performance and gain a feel for how your company will operate in the future. It is why you are required to continue to provide banks with updated financial information for as long as the loan is outstanding. This prior performance is used as a basis for predicting what will happen in the future, while current operations and future cash flows repay the debt. This is also why banks often require projections.

THE FIVE CS OF CREDIT

So how does a bank make you a loan? What principles are applied? The credit underwriting process is very extensive, but the primary tenets used are called the five Cs of credit. They are as follows:

Character – This is by far the most important. A bank wants to deal with good people. Those who are honest and have high integrity, those who do what they say they are going to do, who address any problems or issues early, and those who do not evade the reality of any situation. This is on top of the "reputational risk" issue, which has only become more critical in this age of social media. Given the current environment and challenges we had in 2020, this could not be more important.

Cash Flow/Capacity – This is quite simply assessing one's track record and ability to generate cash flow/profits from operations to repay the loan. In banking terms, this is typically referred to as the primary source of repayment. The cash can also be generated from the conversion of assets, but this is less common.

Collateral – A bank likes to have two sources of repayment. The secondary source is typically collateral. If cash flow is challenged or a business fails, the liquidation of collateral offers a fallback.

Capital – How much of your own money have you put into the deal

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or retained over the years? A bank wants the borrower to have some "skin in the game." An interesting conversation I have had many times in my career is, "Why is this needed?"

The borrower says, "If I just had a loan…I can build this business."

This may be true, but if anyone could borrow 100 percent to start any business, how much competition would your company have? And how vested would these people be? If things do not work out, they can walk away, and the bank takes the hit.

Conditions – This is the catch-all category and deals with business acumen, industry trends, economic trends, raw material costs, etc. and how a business will fare as conditions change and evolve.

THREE LEGS OF A STOOL

In addition to the five Cs of credit, another golden nugget comes in trio form. Successful, credit-worthy businesses also think about the importance of maintaining the proper balance between cash flow, liquidity and leverage for long-term success. As I like to tell customers, they are the three legs of the stool.

Cash flow represents the ability to repay your debt and support operations. Liquidity, or savings, represents a safety net in the event cash flow becomes challenged. Leverage, or the ability to borrow money, is vital in case cash and liquidity become challenged. If you are overleveraged, there may be nothing to offer to secure more bank debt or raise capital.

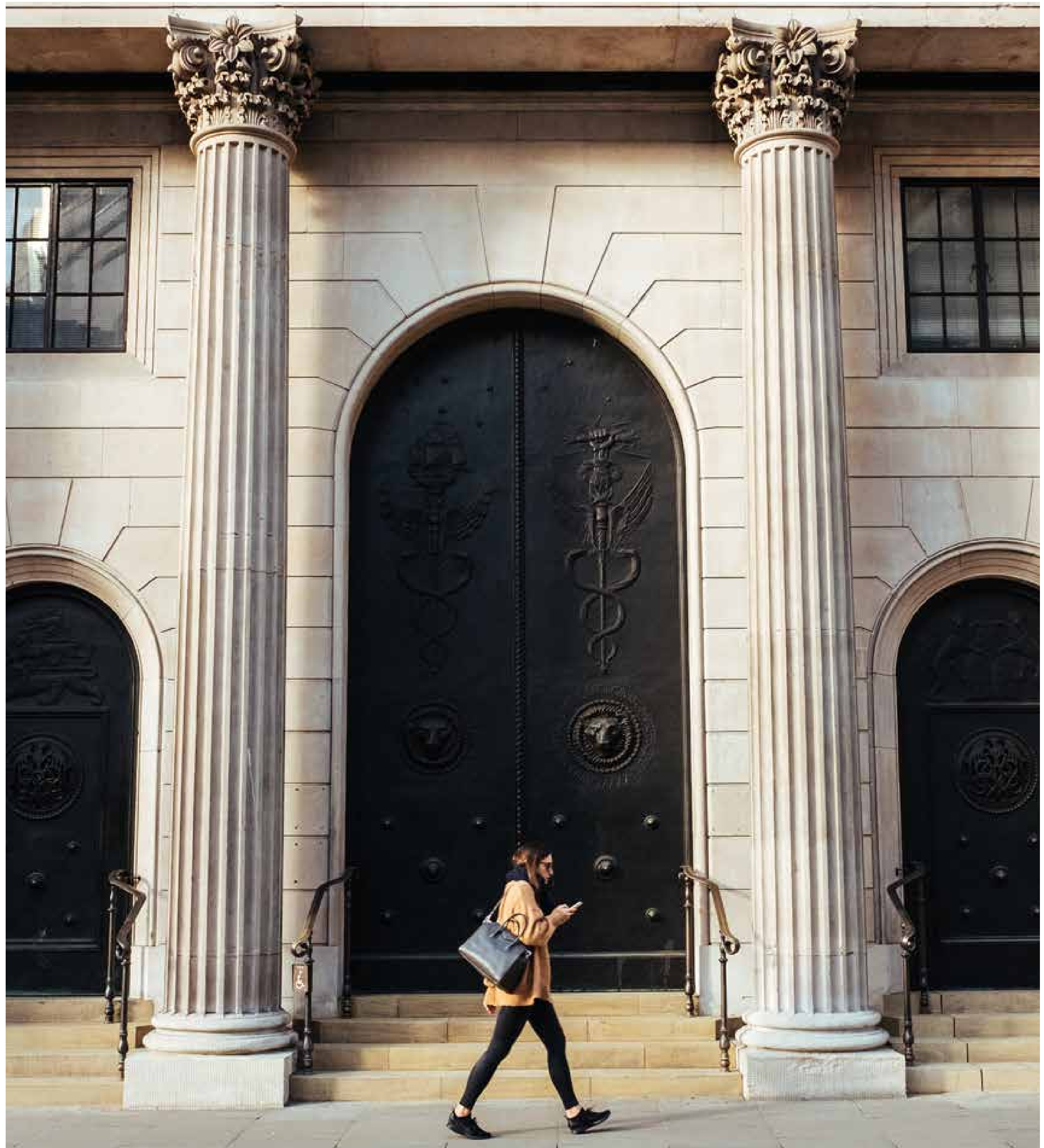
Many businesses undervalue the importance of liquidity. They may feel safe if they are debt-free and own their assets. While this is nice, they may not be able to get a loan against those assets if cash flow dries up. They may be forced to sell assets in a down market to produce much-needed liquidity. It is important to make sure you have the proper balance between the three. You will then enjoy the good times and be well-positioned in the downtimes as well.

HOW TO APPLY FOR A LOAN

A client once told me, "It is impossible to give a banker too much information!"

The following is a general outline of what to share with your bank, but more or less may be requested. While it may seem like a lot, only a few lines are needed for each, and these are the things you and your management team know very well already.

I. Background and Overview of Your Business
   a. History and Nature of Business (high level)
   b. Management (bios and ownership structure)
   c. Overview of Operations – detailed
      i. Products
      ii. Markets
      iii. Distribution Channel(s)
      iv. Suppliers
      v. Customer List by Percent of Sales
      vi. Competitive Positioning
      vii. Labor Market Overview



      viii. Physical Locations and Nature of Each
      ix. Operational Challenges/Opportunities
      x. Industry Outlook from Your Perspective
      xi. Goals and Objectives for the Next 3-5 Years

II. Outline of Loan(s) Requested
   a. Purpose of loan(s)
   b. Amount and terms desired
   c. Source of repayment
   d. Overview of collateral (include any recent appraisals)
   e. Address personal guaranty – Full/Partial/None

III. Financial/Other Information to Include
   a. Last Three Years Fiscal Year-End Statements - Balance Sheet and Income Statements
   b. Tax Returns last Three Years
   c. Most recent interim statements and prior year same period
   d. Current schedule of accounts receivable and accounts payable (including aging report)
   e. Proforma (sometimes required)
   f. Personal Financial Statement if Needed
   g. Real Estate Schedule (locations, age, lease or own, debt schedule)

While this may seem like a long list, these are things you should have on-hand and readily available. You can always leverage your accountant to help as well, and most bankers are happy to work directly with your CPA to obtain financial information. If you find any gaps in pulling this together, it might be time to address those items. Note that the financial statements' quality (internal, compiled, reviewed, audited) will differ as the loan amount increases. Lastly, your banker will need to understand your business and your financial performance for you to get that "yes" answer. The process usually takes place over several meetings and discussions. Still, your banker will be impressed the more complete your package is, and it also demonstrates that you know your business.

Now you know how most bankers think! Hopefully, you have a better understanding of what information to provide, how to position the conversation, and how to get that loan to help run and grow your business.

BOB KING *is a commercial banker with 35 years of experience working with C-Level executives of closely held and public companies. He is currently a Middle Market banker with Ameris Bank. Bob specializes in delivering strategic advice and financial tools to help business owners achieve financial success and long-term security. He is a powerful force in the workplace and uses his energy to encourage others to work hard and succeed. If you have any questions or would like additional information, he can be reached at 404-240-1556.*