

# WHAT YOU NEED TO KNOW BEFORE YOU BORROW MONEY

## THE FIVE C'S OF LENDING AND LEASING



**W**e all know that money and our ability to manage it is what keeps our facilities running smoothly. Usually how we handle our cash flow needs can be the primary factor in whether the business runs smoothly and in some cases whether we, as owners, get paid. In the course of arranging financing for businesses all over the country, including some Children's Activity Centers (CACs), I have found that many gym owners have not prepared themselves and their businesses for borrowing money when the time comes to expand, consolidate debt or make purchases. The process of borrowing money for financing a building, equipment, or refinancing existing debt is similar in that all can be time consuming for the CAC owner, and even more so when the owner is busy with teaching classes or coaching competitive programs.

In an attempt to help CAC's be better prepared when it comes time to borrow money, I have developed a five-step checklist for the borrower to refer to before the search for funding. All five are equally important and must be addressed ahead of time. Deficiency in any one category can sink the borrower's ability to get financing. By addressing these five specific areas early, the CAC owner can make the financing process go much more smoothly and greatly enhance their ability to get funding.

### CREDIT

Credit is probably the single most problematic area that I have seen. While all of us know we have a credit score and that it is important, I have found that many don't realize just how important it is, or how to protect and enhance it. First, there are two different types of credit ratings you need to be concerned with, your personal

credit and your business credit. Personal credit is what we are most familiar with. Unfortunately, it is widely misunderstood by the very consumers who depend on it. Even when you are applying for a business loan or lease, your personal credit is just as important as your business credit. While I have to stress to you that I am not a licensed credit counselor, there are a few pointers I can share with you. First, in many cases the rate charged to you for borrowing is a direct reflection of your credit score. The better the score, the lower the rate. In order to get the best rates your credit score must be in the mid 700's.

1. Credit cards with high balances hurt your score, but so do not having any revolving credit. Try to keep all credit card balances between 25%-50% of the credit limit to maximize your score. Even if you have to carry a lot of revolving debt, it is better to have four cards at 50% of the high credit limit rather than two cards that are maxed out.

2. Late payments kill your credit score. In addition, you will have to write a detailed explanation justifying every late payment on your credit report, even those dating back several years. Avoid rolling lates, which happens once you get behind by more than 30 days and it rolls over to the next month. As you make the payment, you are actually paying last month's bill and this recurs over several months, thus creating several sequential 30 day late notices on your credit report.

3. Collections and judgments, especially within the last two years, drop your score dramatically. The medical bill that you disputed and refused to pay can end up in collections and will show up on your report. Avoid this at all costs. When paying off collections (or any debt for that matter) be sure to get a receipt or written letter showing the balance

is paid and in good standing, or closed. Collection agencies are notorious for reporting negative, but not positive credit activity.

4. A lack of diversity in types of credit will hurt your credit score. Having only one type of credit is not going to build your score. You need to have revolving (credit cards), installment (car loans, etc.) and mortgage lines all in good standing for at least 24 months in order to create the best possible credit file.

5. Too many lines of credit and/or too many inquiries. If you have too many open lines, even though you may not be using them, can also trigger a reduction in score. But even more important is the number of inquiries on your credit file. Whenever you apply for a credit card, get an insurance quote, shop for a mortgage refinance, get a new cell phone, rent a car using a debit card, or sometimes even apply for a job, there will be a coinciding inquiry to your credit status. Too many inquiries in a 90 day period can be detrimental to your credit score. In general, a score will go down approximately five points for 30 days with each inquiry. Additionally, when applying for credit, recent inquiries may have to be explained in a letter to the lender.

## CREDIBILITY

Credibility is all about the amount of experience you have in your industry. While it is always more difficult to finance a new business, the amount of time you have worked in the industry and what management positions you have held will be crucial to your ability to borrow money. A strong personal resume will go a long way in convincing a lender that you are worthy of their risk. If you are an existing facility, your time in business, the strength of your financial statements, community involvement, and business accomplishments all combine to create a type of resume for the business. Whether you are a start-up or an existing business, your personal resume is equally important in creating credibility for the company. Here are some things you can do to best present yourself and your company to potential lenders:

1. Make sure your personal resume shows roles in management, even if outside of the industry.

2. A well thought out business plan for both start-ups and existing businesses will speak towards your credibility. Beware of software programs designed to help you put together a business plan. Most are not for service-oriented businesses and will create a business plan with a cookie-cutter look to them. Many will include chapter and section headings that have little or nothing to do with a CAC. Unfortunately, instead of just deleting these sections, borrowers usually try to fill these sections in with irrelevant

information that can confuse, distract or even bore a potential lender.

3. For existing businesses, make sure your business plan has a history of the business included. This history should note competitive accomplishments, but also community involvement such as awards. If your gym feeds the homeless on Thanksgiving Day or sponsors community events, these things should be included. Include copies of news articles, brochures, and marketing materials.

4. Make sure your personal financial statement and all company financials are in good shape. When your house is in order, it speaks to your level of responsibility. The single biggest mistake CAC owners make is to wait too long to get financial assistance when things are tough. While breaking even or just showing a slight loss on your P&L's will not completely kill your chances of getting funded, the stronger your financial position on paper, the better your chances.

5. What's good for your tax return is not necessarily beneficial to your quest for new funding options. As small business owners, we want as much return from our business as possible, while showing the smallest net profit line possible. The reason for this is clear. If your net profit is low, you will have a lot less in taxes to pay. If you are an LLC or an S-corp, this profit shows up on your personal tax return. However, lenders look at the profitability of your company as an indication of the relative health of the business. So having a high net profit better ensures your viability to the lender as a good risk. By the way, a low net profit can also limit your return when you decide to sell the business.



6. Keeping your financials accurate and up to date on in-house accounting software will make your life much easier in the long run. When a lender asks for current or historical profit and loss statements, balance sheets, cash flow reports or even asset lists (equipment lists), having them essentially at your fingertips can save you time and money. Also, having up-to-date spreadsheets tracking all aspects of your business can help paint a fuller picture than just your tax returns. There are spreadsheet templates out there for you to track different revenue and expense categories and allow you to compare them to the industry standards.

## CAPITAL

Every lender wants to be comfortable knowing that you have the ability to pay back the loan or lease. And even though you need their money to buy the building or equipment, the lender will want you to contribute a portion of the purchase price. Even when restructuring debt where nothing new is being purchased, and even if you are getting loan proceeds for working capital, you will still have to provide some funds for a down payment. What's interesting here is that the more money you have available (thus the less need you have for financing), the better chance you have of getting financed. In a variation of an old adage, "It takes money to borrow money."

The amount of money you will need varies according to the type of transaction. For example, any loan that does not include real estate you can expect a requirement of at least 10% down payment and usually a 20% down payment. However, an equipment lease can require as little as a security deposit equaling one or two payments and will usually demand significantly less upfront cash than what is required for a loan. The down payment requirement for real estate loans can vary as well. Traditional commercial real estate lenders generally look for 20% down payment or more, depending on the type of property. But SBA programs can lower the down payment requirements to 10%. There are also some other, more aggressive programs out there where you can get as little as 3% required down payment, but those programs are at a higher interest rate and are difficult to qualify for. So, no matter what you need money for, be prepared to provide some of your own funds, no matter the amount of collateral you may have.

## CAPACITY

Your Profit and Loss Statement, Balance Sheet and business tax returns will all speak to the business's ability to pay back any new debt. If these financial documents are not strong enough to demonstrate the business's CAPACITY for repayment, then in order to give a level of comfort to the lender, the company will have to demonstrate new revenue in the form of projections or a Pro Forma. If the borrower is using the money to purchase equipment, he/she will have to demonstrate how the added equipment will generate more revenue for the company. The same holds true when adding on to your building or moving to a larger facility. But what if you are restructuring existing debt? In this case you are

not adding new revenue, yet have to demonstrate the ability to pay back the loan. If your existing financial documents are not strong enough to carry the new debt load, the Pro Forma becomes critical once again. In every industry there are natural business cycles, usually based on the calendar year. But in the CAC industry, specifically gymnastics, there is a four year cycle as well. For example, most clubs can expect a boost in revenues in the year following the Olympics. A Pro Forma showing the increased business, backed up by historical financial documents showing similar increases for past Olympic years might be enough to satisfy a lender, even if your financial documents do not show the company has the current ability to repay the loan and no new revenue streams are expected from the use of the loan proceeds. This scenario would be strengthened by a strong credit score for both the business and the borrower, as well as healthy reserves. In any case, even if your credit and credibility are perfect and you have healthy reserves, you will still have to prove your ability to pay back all funds borrowed.

## COLLATERAL

For any loan request you have, the first question from the lender is always about your credit and the second is about COLLATERAL. Obviously if you are buying a building for your company then the building is your collateral. Similarly, equipment is the collateral for loans or leases used for that purpose. But what if you want to buy a building and need money for the build out? Most buildings are not suited for CAC use without renovations. And if there is not enough equity in the building for you to borrow more than the purchase price, then there could be some potential problems in getting the financing you want. On equipment loans and leases you may need as much as a two to one ratio of collateral to debt in some cases, especially if the



**Continued p. 45**

## Continued from p. 8

borrower is weak in the other areas. In almost every situation other than some SBA loans, 100% collateralization is the minimum. Therefore in order to satisfy the lender, additional sources of collateral must be available. In fact, even on loans backed with an SBA guarantee you can expect the lender to ask to attach to all assets of the business (equipment, etc.) and will in many situations put a lien on your home for even more protection. This lien should not alarm you, but you definitely need to be aware of it. It can prevent you from getting home equity loans or otherwise use your home's equity. SBA loans may be easier to qualify for, but are not right for every borrower. The process is very time consuming and can easily tie up all of your business and personal assets (collateral) for the foreseeable future. However, SBA loans often have a longer term making the debt more manageable for the cash flow of a business, especially in the early years.

Almost every business will have opportunity or need for financing at some point. If you are not prepared for this possibility you could find yourself either not able to get financing or not prepared, which could lead to a tremendous amount of work and stress, ultimately affecting your desired timeline. Borrowing money for your business should be thoroughly thought out and planned well in advance. By having a plan to borrow, you can help make the process run more smoothly. If you pay attention to the five areas I have outlined, you will be contributing to the

overall health and success of your business. And when the time comes for financing, you will be prepared.

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