

COMMERCIAL LOAN REPAYMENT ABILITY

Report #157 from George Heaslip

In all SBA loan scenarios, the borrowers cash injection must be between 10%, if real estate is involved, to 20% for lease deals.

The historical earnings from the business for sale, a profit and loss statement from an accountant and cash flow projections for the next three years (assuming loan receipt) are the best basis upon which to determine the applicants repayment ability.

Cash flow projections, if backed by a rock-solid business plan, are considered the basis for determining repayment when there is a change in the circumstances affecting the business (adding an additional product line, improving a restaurant's menu, adding more service offerings at a gas station/convenience store, adding more legal services at a lawyer's office, significantly expanding the workforce, etc.).

Where there is no historical financial data, as with a startup business, the loan application is actually a projection and must be supported by a very convincing business plan. Start-ups require at least 20% down at closing, unless proof of a comparable cash injection to date can be provided.

Regardless of whether the historical or projected performance is the basis for repayment, all expenses (e.g., gross sales, operating expenses, owners withdrawals, salaries, dividends, loan payments, utilities, taxes etc.) are considered when evaluating repayment ability.

(1) Historical Cash Flow

The best evidence of repayment ability is having sufficient cash flow from prior operations to cover anticipated annual fixed obligations of the business under new ownership. The rule is simple; the ratio of net monthly profit per month, divided by the loan payment per month, must be 1.25 or higher.

(2) Interim Financial Statements - A word of caution!

These are generally not reliable since the seller will generally provide them for the good months, like for December through February for a restaurant in Florida, which is packed each night with snowbirds from the north. Interim statements for seasonal businesses are a slick accounting trick, and are especially misleading.

(3) Projected Cash Flow

If historical cash flow does not demonstrate repayment ability, a realistic projection of future earnings is mandatory, and must be backed by a formal business plan that the bank or lender will trust. The projections must be tested against industry averages and historical operations to assess feasibility.

Startups and New Businesses in operation for less than two years.

The applicant must provide sufficient information to show that he or she understands the nature of the industry through the submission of a business plan.

The loan officer at the bank will analyze the borrower's proposal as to whether it is a reasonable and appropriate undertaking for the business. The loan specialist must also assess the management ability of the buyer and key employees he or she is bringing into the project.

What Does The Loan Officer Look For?

The ability to repay a loan from the cash flow of the business is the most important consideration in the SBA's or conventional loan making process.

Here are the key elements:

> Existing Debt:

The pro forma schedule of annual fixed obligations (debt) is a key element in analyzing the ability to repay. Annual fixed obligations, including the proposed loan payments, are generally shown as the total principal obligation of term debt.

> Compensation of Owners/Principals:

The loan officer also considers the effect that owner compensation may have on repayment ability. Therefore, a global cash flow analysis is almost always used to determine the repayment ability of the small business. Global cash flow analysis includes:

- (1) What personal obligations and expenses does each owner have? (Credit card payments, rents, car loans, personal home loan payments, etc.)
- (2) How much compensation, including bonuses, perks (like a car and insurance), and benefits, is the business really paying each owner?
- (3) Are company "assets" benefiting the company or any owner?
- (4) How do these goodies impact the cash flow and repayment ability?
- (5) Do the balance sheets show increases in "Loan(s) Receivable-Officer(s) or Partner(s)" accounts?

Increases in these accounts usually indicate funds are being paid to the officers/partners in addition to their normal compensation listed on the income statement for that year. This conceals the impact on net profits and net worth and causes the traditional rule of thumb cash flow calculation to be inflated.

(6) Source of the Cash Flow:

The presence of a positive actual cash flow is not necessarily an indication of repayment ability. If the source of the cash flow is mostly or entirely from the occurrence of debt, equity injection or sale of company assets, repayment ability may not exist.

If the business does not demonstrate sufficient repayment ability, but the project appears to have substantial collateral, can a SBA loan be granted to the small business?

No. All SBA loans must be of such sound value or so secured as to reasonably assure repayment. Sound value contemplates such factors as good character, earnings, collateral, management

ability and financial condition. The object is not to obtain sufficient collateral to completely liquidate loans under future conditions.

Banks and lenders do not make loans based upon the liquidation value of collateral. This would be a disservice to the borrower. If there is not sufficient evidence indicating that the firm can repay the loan from the cash flow of its operations, the loan application will be declined.

For further information contact:

George B. Heaslip
East Coast Loan Services
110 Bent Tree Drive
Palm Gardens, FL 33418
Tel: 561-626-9599
Cell: 561-329-1315
Fax: 561-799-5801
Email: gbh11704@aol.com