Getting Inside Your Banker's Head

By Neal O'Hurley

"Why does the bank want all that information about my company and me?"
"That's history – it has nothing to do with what's going on today or tomorrow . . ."
"The bank just doesn't understand what I'm trying to do . . ."
"The bank will only lend me money when I don't need it . . ."
"Why did they reject my application? I thought banks wanted to lend money!"

Unfortunately, these words are spoken (and sometimes *screamed*) by frustrated business owners in their noble, yet quixotic attempts to obtain financing from banks. I have reviewed countless financing requests from business owners over the years and have observed two common themes that contribute to their aggravation:

- many business owners don't understand a bank's role in the financing spectrum
- lack of preparation for the presentation to the bank

Part of my responsibility as a commercial lender is to educate the business owner in these critical areas. Without a basic understanding of what a bank looks for (and why) in commercial financing and addressing these issues in the presentation package, the business owner is setting himself up to fail in the process.

Banker or Business Owner or Both?

Fortunately, in my professional career, I've had the opportunity to play both banker and business owner, which gives me a deep understanding of both perspectives. After 16 years as a commercial banker in New England, lending money to small and middle-market companies, I gave in to the mounting urge to own and operate a business for myself. So after more than a year of searching and evaluating potential targets, my wife and I found and acquired a small company based in Raleigh, North Carolina, in 1995. The business was engaged in the sales and service of hydraulic components, such as hydraulic pumps, motors, and cylinders for mobile and industrial applications. Frankly, I knew nothing about this industry.

The target company had reached a critical stage in its evolution where the founder/owner simply didn't know where to steer the business to continue its growth. This was clearly evident in the revenue line, as sales had stagnated for the prior two years. Nonetheless, the business was still profitable and our collective due diligence resulted in our decision that the risk was acceptable. So we bought the business.

Needless to say, the seven years of operating our business was full of all the ups and downs, wins and losses, and hope and despair that most business owners experience. But my wife and I both came away with a much deeper understanding of the daily challenges of running a small company, and a genuine appreciation for the never-ending issues small business owners struggle with.

Once the business was producing incremental revenues and cash flow from a new strategic initiative we implemented a few years earlier, and a continued upward trend was reasonably assured, we decided it was the right time to sell the business. We devoted much time during the next year to "dress up" the business so that it looked good in the initial presentation and would stand up to the rigorous test of a more thorough due diligence process expected of a company with a significantly higher price tag. Our offering memorandum was focused on what a buyer wanted to see, and it presented the business "on a silver platter." We then found a good buyer (meaning the right price, terms, and mostly cash) and moved back to the Boston area.

We believed that our business presentation was key to attracting the right buyer and maximizing the price they would pay. The long hours of preparation paid off. The leader of the buyer's due diligence team said he was actually impressed by the thoroughness and integrity of the information package and detailed organization of the administrative side of the business. We indeed presented the business and its future prospects on a silver platter, making it easy for the new owner to visualize himself running the company and to justify paying the price.

The same concept applies to the process of requesting money from a bank for a business. The presentation is critical and it reflects the owner's state of awareness and control over the business. It is also critical to understand the mindset of your audience – the bank.

It's Show Time!

All too often I see business owners contact the bank, either directly or through an introduction from their CPA or one of their advisors, with a rather lackluster request to borrow money. Don't sell your company short! You spend thousands of dollars on marketing materials, a new Website, and on various promotional initiatives, all in a valiant effort to position your product or service in the best possible light to maximize your chances of winning the bid or closing the sale. So why do many business owners fly by the seat of their pants when they meet with the banker to obtain additional money, the lifeblood of any business? I know from direct experience that a typical business owner simply wears too many hats and just doesn't find the necessary time to develop a strong presentation for the bank. But this will surely reduce the chances of obtaining the financing.

If the business owner can't devote the time to present the company's needs and background, they should ask their CPA or consultant to prepare the package. Although there is a cost for this service, it is relatively nominal considering the positive contribution the new money makes to the business.

Banks – What do they want?

Believe it or not, banks are not paid enough to take a significant amount of risk in their commercial lending activities. Saying this has most business owners, who have paid thousands of dollars in interest to banks, scratching their heads. Just as most companies focus heavily on the "gross profit margin," banks must do so as well. In banking this is called the "net interest margin." This is the amount of money left after the bank pays its depositors interest for the money they leave with the bank. Unfortunately (for banks), this margin has been declining, resulting in smaller dollars to pay for the operating costs of the bank. Furthermore, any loan charge-offs affect the bank significantly, so the bank adds to a reserve for potential loan charge-offs with every new loan (another "cost" in the P&L).

So why does a business owner need to know this? Simply put, the bank is not paid enough to take "equity" risk, which is what many business owners ask of the bank. Higher-risk loans produce higher charge-offs, which have a severe negative impact on the profitability (and stability) of a bank. A bank is regulated by the government for almost every activity it is engaged in, particularly in its core business activities, accepting deposits and making loans. Since the deposits are insured by government agencies, these agencies audit the bank to ensure lending activities don't become too aggressive.

Commercial Loan Approval – 101

Given the bank's relatively low tolerance for risk in commercial lending, it needs to identify at least two, and sometimes three sources of repayment for a new loan. The first and most critical test is operating cash flow. If a business has generated only operating losses, this is a difficult hurdle for a bank. Secondary repayment sources come from collateral pledged to secure the loan, and from the personal guaranty offered by the owner(s). In a loan request presentation, the business owner should highlight the various repayment sources to the banker. Bankers automatically focus on how the loan will be repaid, so don't forget to deliver this critical information to the banker on that "silver platter."

Another critical element in risk evaluation is the experience and competence of management. There should be a section that highlights not only the strengths and experience of management, but also explains any industry or operating problems that occurred in the past and how the management solved them. Almost anyone can operate a business when everything is going right, but only the most experienced management can keep the ship afloat during a storm. A business owner should not be afraid to admit past problems and show how they solved them.

Final Thoughts

The process of obtaining a commercial loan for your business can be difficult, and each lender will evaluate the application on his/her own particular merits. You can facilitate the loan application process, though, if you follow these basic steps:

- Prepare for your loan request! Your business deserves it.
- Present the company, its operations, and management with the banker's perspective in mind. Remember what the bank needs to see.
- Work with a banker who takes the time to understand your business and its operating risks. Show off your company and look for your banker to be a key part of your business advisory team.

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