
UNDERSTANDING COMMERCIAL LENDING:

THE QUESTION-AND-ANSWER GUIDE



Illinois Small Business Development Centers

"Experts, networks, and tools to transform your business"

Illinois Small Business Development Centers (SBDC) provide information, confidential business guidance, training and other resources to early stage and existing small businesses.

Illinois International Trade Centers (ITC) provide information, counseling and training to existing, new to-export companies interested in pursuing international trade opportunities.

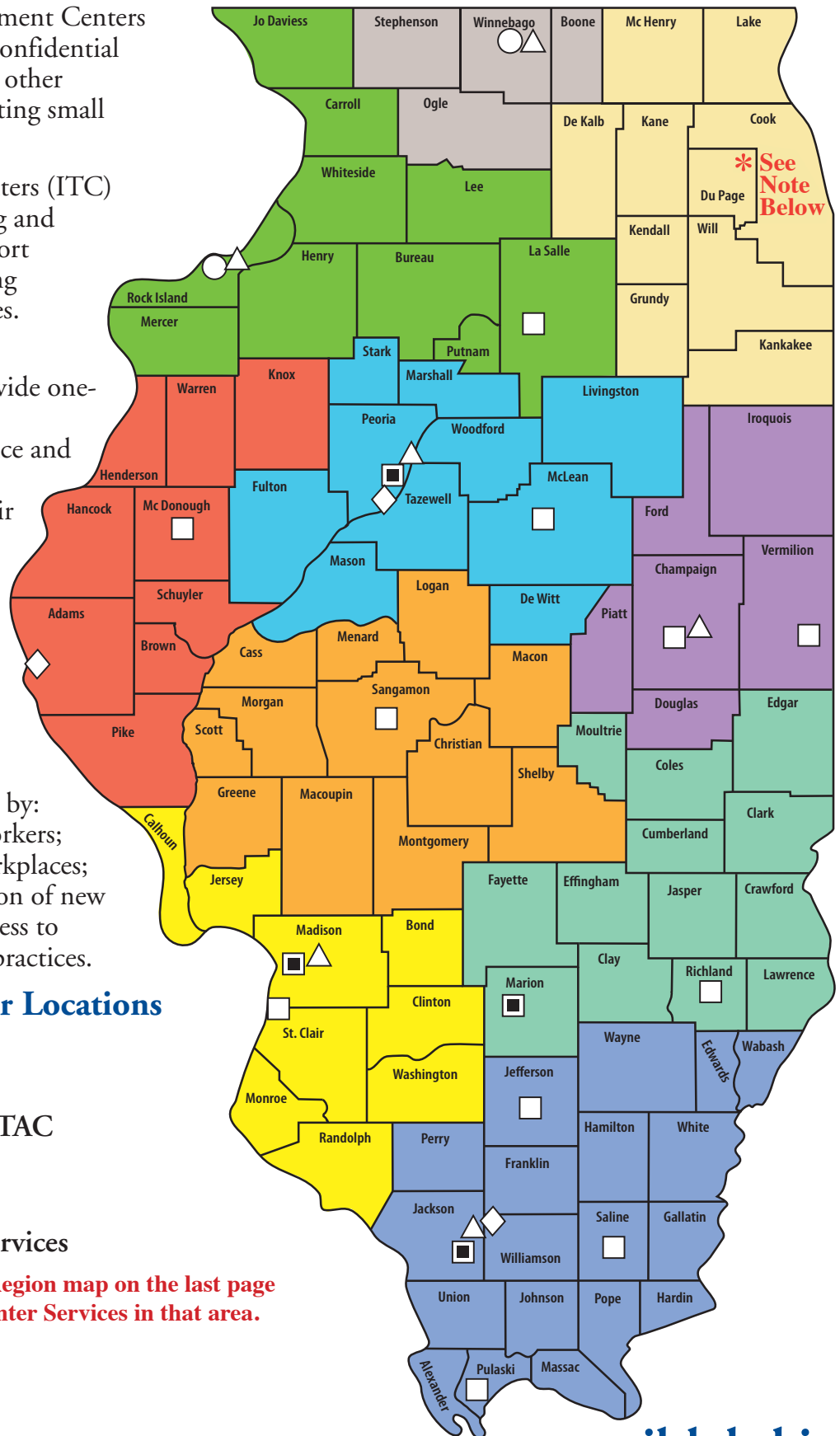
Illinois Procurement Technical Assistance Centers (PTAC) provide one-on-one counseling, technical information, marketing assistance and training to existing businesses that are interested in selling their products and/or services to local, state, or federal government agencies.

Technology, Innovation and Entrepreneurship Specialty (TIES) ten SBDC locations help Illinois businesses, entrepreneurs and citizens to succeed in a changing economy by: developing the skills of their workers; promoting safe and healthy workplaces; assisting in the commercialization of new technologies; and providing access to modernizing technologies and practices.

Business Center Locations

- SBDC
- SBDC/ITC
- SBDC/ITC/PTAC
- SBDC/PTAC
- ◇ PTAC
- △ Technology Services

***See the Northeast Region map on the last page for the Business Center Services in that area.**



A Partner in Your Success

Choosing a lender and developing a relationship is an important business goal. Feel more confident making financial decisions by gaining a better understanding of commercial lending.

Lenders will help you choose which financial products and services are best for your business.

Lenders also provide advice, support, and insights about opportunities in your industry. Lenders want you to be successful because it is their goal to have a portfolio of strong, profitable businesses.

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QUESTION 1 What are the first steps in contacting a lender?

ANSWER First Steps

- Contact a lender's commercial loan or small business loan department online or at a branch location.
- Determine if the lender makes loans of your size and type (Note: Not all lenders work with new startup companies, so be sure to ask.)
- Get a loan application.
- Gather and develop documents requested by the lender.
- Develop a Business Plan. See Question 9.

Basic Questions

- How much money do you need?
- How will the loan be used? See Question 5.
- How long do you need to repay the loan? See Question 3.
- What collateral do you have to offer? See Question 14.
- How much are you (and any other owners) investing in the business? See Question 7.

QUESTION 2 How do I prepare for a meeting with a business lender?

- Bring your Business Plan (see Question 9), a completed loan application, and any other requested materials.
- Your presentation should take less than 25 minutes.
- Invite the lender to your business location. If you are expanding or remodeling, explain your plans.
- Answer all negative questions with positive answers. Back up your answers.
- Ask when you can expect feedback and a loan decision.

Pay attention to the "Seven Cs"

- 1 **Credit:** Must be good and any problems must be explained. See Question 6.
- 2 **Capacity:** The business must be able to pay debts/expenses and be profitable.

- 3 **Capital:** Money you (and any investors) are putting into the new business or equity you already have in an existing business.
- 4 **Collateral:** The value of assets that secure a loan. See Question 14.
- 5 **Character of the borrowers:** You need to be confident, persistent, and passionate about your business.
- 6 **Conditions:** The economy, industry trends, or anything that could affect your business.
- 7 **Commitment:** Your ability to succeed, which involves guaranteeing the business debt personally, even if the business cannot pay.

QUESTION 3 What kind of business loan do I need?

ANSWER It depends on how the money will be used and how long you need for repayment.

- **Lines of Credit (LOC)** provide money when needed, which is then repaid (like a credit card). An LOC has a predetermined loan limit.
- **Short-term loans** (under two years) are used for inventory, expenses, machinery, equipment, furniture, leasehold improvements (enhancing your location), and buying a business. You get a sum of money upfront and then repay it over time.
- **Long-term loans** are used for buying or refinancing commercial real estate, making major improvements or additions to real estate, and purchasing major equipment

QUESTION 4 What is the Small Business Administration (SBA)?

ANSWER The SBA was created in 1953 to strengthen and promote the economy by helping small businesses. The SBA does not offer loans to businesses directly, but they do partner with lenders to help increase small business access to loans.

The SBA 7(a) loan is federally guaranteed and used to finance working capital (accessible cash

to operate the business), buy a business, refinance debt, and purchase equipment. The SBA provides a guarantee to the lender if a business defaults on the loan, from 75% to 85%. For example, if a \$300,000 loan is approved with a 75% SBA guarantee, the maximum loss (by the lender) is 25% or \$75,000. If a business owner defaults on the loan, 75% of the outstanding loan balance is guaranteed/paid by the SBA. However, business owners are still responsible for the loan balance, even if the SBA returns money to the lender. The SBA 504 Loan provides financing to buy larger business assets, including real estate.

The SBA includes organizations nationwide that help entrepreneurs including Small Business Development Centers (SBDCs), Service Corps of Retired Executives (SCORE), Veterans Business Outreach Center (VBOC), and Women's Business Centers (WBC). Check the site at www.sba.gov.

QUESTION 5 Do I need to show how the loan will be used?

ANSWER Yes. Give amounts and totals for the Loan Request, Use of Funds, Collateral Offered, and Repayment

Loan Request:

Amount Requested	\$140,000*
Owner's Investment	\$30,000
Other Investors	\$20,000
Total	\$190,000

Use of Funds:

Working Capital	\$25,000
Equipment and Machinery	\$110,000
Furniture & Fixtures	\$25,000
Office Equipment	\$30,000
Total	\$190,000

Collateral Offered:

New equipment & machinery	\$100,000
Old furniture & fixtures	\$25,000
New office equipment & computers	\$30,000
Equity in real estate	\$70,000
Total	\$225,000

Repayment:

- Term: \$140,000* for 5 years
- Rate: Prime + 2%
- Monthly payment (principal and Interest): \$3027
- Repayment source: Cash flow from business

QUESTION 6 Does my personal credit history affect business loan decisions?

ANSWER Your credit information impacts financial decisions, from the loan size to the interest rate. Lenders assume there is a direct relationship between your personal credit history and the business' credit history. If a lender feels secure about the business owner, the more likely there will be a loan approval.

Review your personal credit report that includes credit cards, mortgages, and loan payment history. Three credit reporting agencies (Equifax, TransUnion, and Experian) provide your information to lenders so it's a good idea to review all the available information. Your "credit score" comes from the Fair Isaac Company who condenses your credit information into one number or score that range from 500 to over 800. Lower scores affect your ability to get a loan and lower interest rates. Minimum credit scores are required for some loans (including the SBA- see Question 4).

QUESTION 7 How much of my own money must I invest in the business?

ANSWER 20-50% of your money must be invested in the business, but it depends on factors like your collateral, the loan purpose, and your repayment ability. For fixed business assets (machinery, equipment, furniture, and fixtures), business owners typically put 25% down toward the purchase price. Ask your lender about municipal, state or SBA programs that require smaller amounts of your own money to be invested (5%-10%).

QUESTION 8 Does my legal status impact my business loan?

ANSWER Lenders consider a business' legal description because it can provide alternate sources of repayment for a loan

- **A Sole Proprietorship** is owned by one person. If the business gets into financial trouble, the individual does too. There is little liability protection, so losing both business and personal assets could happen if a business loan needs to be repaid.
- **Partnerships** have several owners who can supply money to repay a business loan. However, personal assets of general partners can still be at risk if a loan goes into default.
- Legal status that **limit liability**: Several legal statuses provide business owners with limited liability so personal assets are not at risk for business debts/liabilities. This applies to:
 - **Corporations**: Treated as separate, legal entities. Shares can be issued to owners, employees, and investors. Owners are taxed twice: 1) at the corporate level, and 2) as shareholders on income received.
 - **Limited Liability Companies (LLCs)**: Hybrid between a partnership and a corporation that can be managed by the owners or a designated manager. LLCs can have multiple classes of ownership with no shareholder restrictions. LLCs can be taxed as a corporation or a "pass-through" entity (business income and deductions "pass through" to the shareholders' personal tax returns so they are taxed on the company's profits instead of twice, as a company and as shareholders).
 - **Subchapter S Corporations**: Business profits are passed through to the shareholders' personal tax returns. This form of business has requirements like holding meetings with a board of directors/officers and a maximum number of shareholders.

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QUESTION 9 What should my Business Plan include?

ANSWER A **Business Plan** provides an overview of your company and shows how a loan will be used and repaid. Financial statements (projections for a new business) and sales/marketing plans are included. Business Plans are also developed when an existing business makes a major change in operations. Consultants and accountants can help, but the actual Business Plan should be based on your input.

Your Business Plan should include:

- A cover letter with the legal business name and owner(s) names.
- A summary of how much money is requested and what collateral is offered (see Question 14).
- Executive Summary (description of owners).
- Professional team information (attorney, accountant, insurance agent, realtor, consultant, etc.).
- Management and employees.
- Marketing plan including a competitive analysis
- Business location.
- Operations.
- Financial Statements: Balance Sheet, Income Statement, and Cash Flow Statement (see Questions 11 and 12).
- Personal financial statements and tax returns.
- An Appendix with details (resumes, inventory quotes, marketing plans, site address, etc.).

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QUESTION 10 What are accrual and cash accounting methods?

ANSWER Business accounting is handled in two ways: **Accrual** or **Cash**. The **Cash** method means a sale is recorded when collected, and an expense is recorded when paid. Lenders want the **Accrual** method that creates:

- **Accounts Receivable**: Sales are made and recorded, but payments are collected in the future.
- **Accounts Payable**: Purchases and expenses are recorded but paid later.

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QUESTION
11
ANSWER

What financial statements does my lender want?

Prepare and provide lenders with these financial statement for the past three years:

- **Balance Sheet:** This is a snapshot of your business, a moment frozen in time. Your numbers will change.
- **Income Statement** (or Profit and Loss Statement): A business' "report card." Expenses are subtracted from income, which reveals the net profit.
- **Cash Flow Statement:** Shows money that comes in and out of the business. See Question 12.
- **Personal Financial Statement:** Provide personal assets and liabilities and tax returns.
- **New businesses:** Provide projected (estimated) financial statements including:
 - **Projected Income Statement:** Monthly for the first year, quarterly for the second year, and annually for the third year.
 - **Projected Cash Flow Statement:** Monthly for the first year, quarterly for the second year, and annually for the third year.
 - **Projected Balance Sheet:** Monthly for one year.

QUESTION
12
ANSWER

Is my Cash Flow Statement important?

Yes, because profits do not guarantee positive cash flow. This statement shows money that comes in and out of your business, every month and calculates the cash surplus or deficit (negative balance). Surpluses provide your company's ability to pay debts on time and have working capital (money available for day-to-day activities). Deficits must be covered with a loan, owners' investments, or by reducing expenses. This is especially important with a new business since negative balances are common, so you need to show how they will be covered.

Cash Flow Statement FYI:

- Differs from the **Income Statement** (see Question 11) because you record when cash is received and paid.
- Increased sales are good but could cause a

drain on your working capital since supplies and labor expenses as well as Accounts Payable increase too.

QUESTION
13
ANSWER

Should I understand financial statements done by my accountant?

Input from your accountant or business' financial manager is valuable, but don't be dependent on them. Educate yourself. You should thoroughly understand your company's finances and statements. You will need to explain your financial statements, provide details, and prove your numbers to a lender when requesting a loan.

QUESTION
14
ANSWER

How much collateral must I offer?

Collateral is assets that would be liquidated (turned into cash) by the lender if your loan is not repaid. It is the secondary source for loan payments since the first source is your business' cash flow (profits). Business assets may include receivables, inventory, equipment, and real estate. Personal assets include savings, stocks, and real estate.

Lenders discount (reduce) the value of your collateral, so the total discounted amount must be equal to (or more) than the loan request amount. Formulas for discounting collateral vary. Lender A may discount a \$5000 piece of equipment by 30% so its discounted value is \$3500 while Lender B may discount it by 50% with a discounted value of \$2500.

If using your real estate as collateral, ask the lender:

- What type of real estate do you accept?
- What percentage of the real estate value are you willing to lend?
- What are the loan rates, terms, and conditions?
- Is a first mortgage required or is a second mortgage allowed?
- What would disqualify the real estate from financing (location, systems, design)?

- What is the appraised value? Lenders order appraisals of commercial real estate and select the appraiser, which are paid for by the borrower.

Lenders usually want commercial real estate appraisals less than six months old, so older appraisals must be updated.

QUESTION 15 Will a lender review the lease for my business location?

ANSWER Yes, lenders examine leases so review it with your attorney and accountant.

Ask these questions about the lease:

- Duration? Lenders want the lease terms (duration) to match the loan terms or want the lease to be extendible to the loan maturity (end) date.
- What is the cost per square foot?
- What is your total monthly payment?
- Who pays taxes, insurance, maintenance, and other expenses?
- How much is the security deposit?
- What are the terms and conditions?
- Can you transfer or terminate the lease early?
- What are the plans and costs for leasehold improvements (customizing)?
- Is there an option to buy? If so, can some of the lease payments be applied toward the down payment?

QUESTION 16 Should I lease or buy equipment?

ANSWER Buying is usually cheaper over the life of the equipment and allows you to alter and sell it. Leases are an advantage if you have bad credit or need to lower your expenses since they require less cash up front. Leasing prevents keeping outdated equipment since it is easier to upgrade and replace. Some leases come with an “option to buy” for a reduced amount at the end of the lease. A mix of leasing and buying new and used equipment is also an option.

QUESTION 17 Will lenders review my vendors and suppliers?

ANSWER Yes, since suppliers are critical to your business. Suppliers have flexible payment terms and offer help with their products and services. Lenders will check the suppliers’ financial condition and ability to supply you. It is smart to have multiple suppliers since one or a limited number of suppliers could cause problems if they cannot provide their products and services.

QUESTION 18 What questions should I ask when buying a business?

Ask the seller these questions:

- Who started the business?
- Why is the business for sale?
- What is the price and how was it determined?
- What am I buying (building, inventory, equipment, Accounts Receivable, etc.)?
- What is the amount of goodwill (premium amount buyer pays in addition to the market value of the assets)? Will the seller finance the goodwill?
- Are there any patents or trademarks?
- Who are the competitors?
- How is the business industry?
- What are current sales and trends?
- How much debt does the business have?
- What is the age and value of the inventory?
- Is the machinery in good condition? If not, what is the cost of fixing or replacing?

Sellers need to provide buyers with:

- Audited financial statements (see Question 11) signed by the seller.
- Signed tax returns.
- Purchase-and-sales agreement (see Question 20).
- Pictures of the operation/location.
- Appraisals on all assets.

QUESTION
19
Can I get a loan to buy a business that doesn't claim some of its income?

ANSWER Never believe income is unreported on financial statements. It usually means the seller is inflating the income to increase the selling price. Lenders do not finance goodwill, so you need to decide how much (over the value of the assets) you are willing to pay. Will the seller finance some or all the goodwill?

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QUESTION
20
What should a purchase-and-sale agreement include?

ANSWER A purchase-and-sales agreement (PSA) shows you agree to purchase a business and the current owner agrees to sell it to you. The selling price determines how the business will be financed and what programs the lender has available. A "good faith" deposit is usually required and should be refunded if you cannot gain financing. Your attorney and accountant need to review the agreement to ensure you are legally protected.

A PSA should include:

- a list of what is being bought (machinery, equipment, furniture, fixtures, etc.).
 - actions required by the seller (like repairs).
 - actions required by the buyer (like financing a certain amount).
 - a time limit for both parties (to get appraisals, information, legal advice, etc.).
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QUESTION
21
What is a franchise?

ANSWER A franchise is a legal business relationship between a franchiser (Subway, for example) and the franchisee (you). The franchiser owns the right to the business name and sells that right to you. In return, you sell products and services supplied by the franchiser.

Risks are reduced since franchises provide an established business model and products/supplies.

You also get support services like site selection, training, and advertising/marketing plans. Does the franchisee offer financing? Check with your lender to be sure they will finance the franchise.

Franchises are required to provide prospective buyers with a Disclosure Document that explains how business between you and the franchiser will be conducted. Read it carefully because it includes their audited financial statements and other locations as well as start-up costs, ongoing costs, and fees. Determine your Return On Investment (ROI) by developing financial statements (see Question 11). Your attorney should review it too.

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QUESTION
22
How long will my loan decision take?

ANSWER It varies. The decision will be delayed if your Business Plan (see Question 9), financial statements projections (see Question 11), and Cash Flow Statement (see Question 12) have incomplete information. If lenders review your loan request and find missing information, they request it. The information then comes back to the lender, over a period, which is time consuming. A complete Business Plan speeds up the loan decision.

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QUESTION
23
What should I expect from a lender?

ANSWER Lenders want you to be successful. Value is added when a lender is on your business "team" since they help determine which financial products best meet your needs. A lender can also provide advice, support, and insight into your industry by sharing growth opportunities and how you can take advantage of them.

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QUESTION **What does a lender expect from me?**

24
ANSWER

Treat lenders like any other businessperson. Make sure your loan is repaid on time, which is the most important responsibility. Your lender might ask you to submit documents annually (or more frequently) including tax returns and financial statements. It's a good idea to contact your lender several times a year to share your successes and ask loan-related questions.

QUESTION **What should I do if my loan is rejected?**

25
ANSWER

Ask the lender these questions:

- Why was I rejected? FYI: Lenders vary their portfolio of small businesses so your business may not be a good addition, or they might have minimum/maximum loan sizes. Some lenders do not invest in certain industries or new businesses.
- Am I turned down permanently, or can I correct issues and resubmit the loan request?
- Should I go to another lender or seek alternative financing?

QUESTION **What are common financial problems?**

26
ANSWER

- **Little or no financial management** Keep good financial records for you, the Internal Revenue Service (taxes), and your lender. You need to understand your financial statements and cash management needs.
- **Failure to seek outside help:** Consult with your accountant and lender for advice and ideas.
- **Running out of money:** You cannot run your business with little or dwindling cash. Money must be available, or you need ways to access it (like a LOC - See Question 3). Calculate how much money is needed via your Cash Flow Statement (see Question 12).
- **Lack of collateral and assets:** The value of the collateral must be sufficient to cover the loan if

it is not repaid (See Question 14).

- **Bad credit:** Lenders will review your personal credit history and score to determine your business loan eligibility. Some lenders will accept lower credit scores while others do not have a minimum requirement. Lower credit scores mean higher interest rates on loans.

QUESTION **What should I do if I develop financial problems?**

27
ANSWER

Do not wait. Try to correct the problem quickly, before you get into bigger financial trouble. Analyze your accounts and financial statements and consult with your accountant and/or financial manager to determine what is causing the problem. Once the source is found, the solution might be getting a loan to correct the problem. Keep your lender updated. You may be tempted to limit communication when there are problems, but a lender's positive concern is preferable to a negative reaction from withheld information.

QUESTION **My business is changing and expanding. Can I get another loan?**

28
ANSWER

Yes, you can get another loan for:

- Purchasing inventory if it generates enough sales to pay for the loans.
- Expanding marketing plans and staff/labor to gain new clients or offer more to existing clients.
- Buying or leasing equipment and locations.
- Buying out business partners.

QUESTION
29
ANSWER

How do I fit another loan in my Business Plan?

Your Business Plan needs updating if you need another loan to fund growth and development. Updated financial statements must show your business income and cash flow will cover two loans. The same collateral used for your first loan cannot be used for a second loan, so you need to provide different collateral (see Page 14). If a new loan fits within lending guidelines, you may have several SBA loans (see Question 4).

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QUESTION
30
ANSWER

Will another loan be approved?

Lenders need to be sure you can repay the existing loan and a new loan, so they will evaluate your revised Business Plan and review your business credit history as well as personal credit (see Question 6).

Make sure:

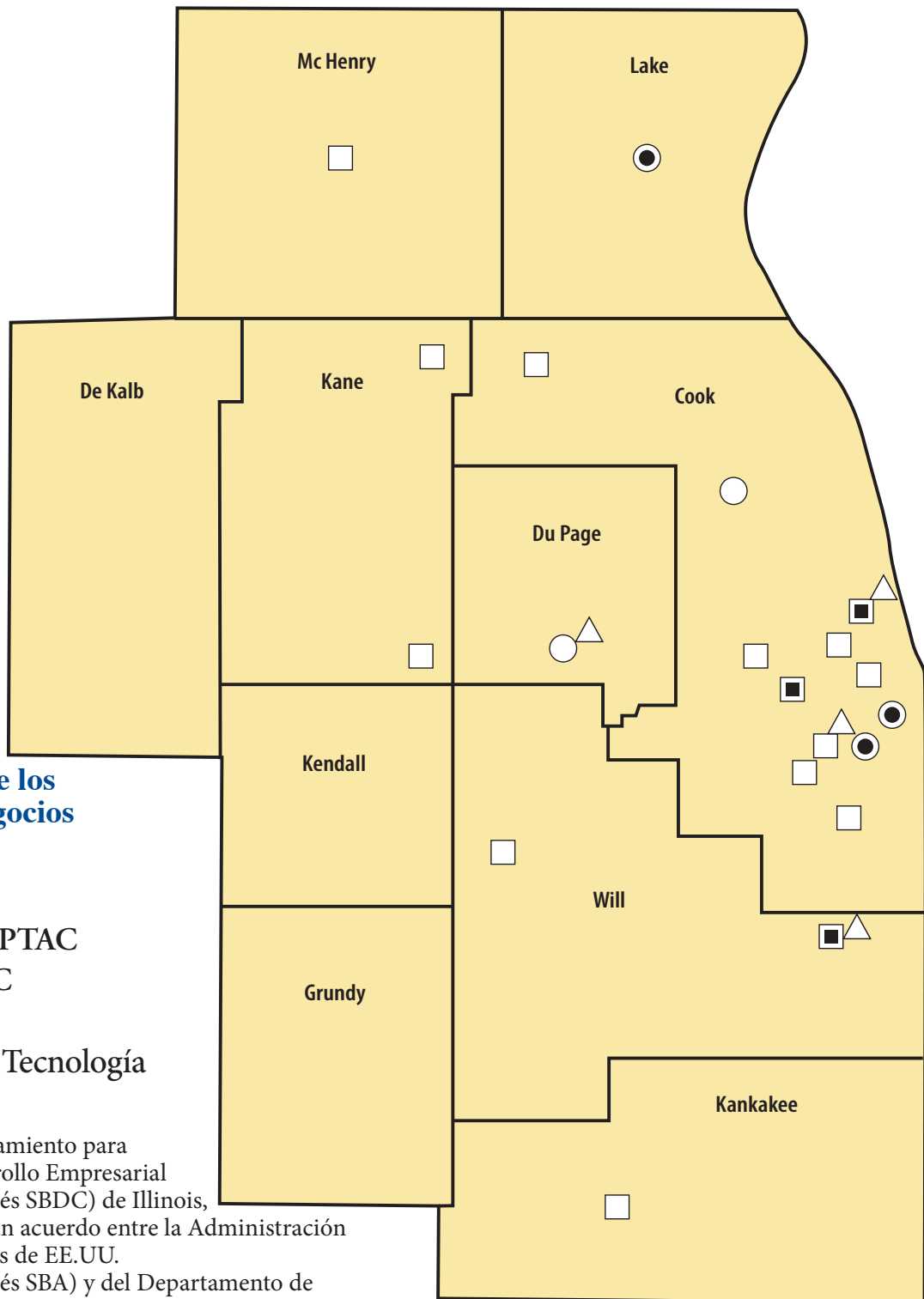
- Enough working capital is available to pay both loans and operate your business.
- No loan payments have been missed with the original loan.
- Your credit is good.
- Collateral is available for the new loan (See Question 14).

Gather:

- Personal tax returns.
 - Business tax returns.
 - Business financial statements.
 - Contracts (to show income).
 - Accounts Receivable (See Question 10).
 - Accounts Payable (See Question 10).
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Región Noreste

"Chicagoland"



Localización de los Centros de Negocios

- SBDC
- SBDC/ITC
- SBDC/ITC/PTAC
- SBDC/PTAC
- ◇ PTAC
- △ Servicios de Tecnología

Una parte del financiamiento para los Centros de Desarrollo Empresarial (por sus siglas en inglés SBDC) de Illinois, es hecho a través de un acuerdo entre la Administración de Pequeños Negocios de EE.UU. (por sus siglas en inglés SBA) y del Departamento de Comercio y Oportunidad Económica de Illinois (por sus siglas en inglés DCEO).

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