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Ron Siegle, Vice President
Business Development Officer
Wells Fargo Bank - Business Banking
303-441-0286
ron.siegle@wellsfargo.com





“Conventional” bank financing for closely held businesses

Used to finance business assets (not expenses), which assets also serve to collateralize the loan.

Sometimes “outside” collateral (i.e. home equity) can also be taken as collateral.

Seldom are business loans less than 100% backed by “discounted” collateral.

Maximum advance rates of 80% of accounts receivable, 60% of inventory, 100% of new equipment cost, 75% of used equipment cost, and 80% of real estate appraisal value.

Higher advance rates against assets the bank could realistically liquidate to repay loans.

Short-term assets secure short-term borrowing, long-term assets secure longer-term loans.

Seldom are business loans not guaranteed by business owners.

20%+ ownership.

Management control of the business and its finances.

Also, operating company typically will guaranty loans to affiliated entities.



“Conventional” loan types:

Revolving line of credit

Short-term working capital- timing of cash collected from sales versus timing of expense outlays.

Collateral support is accounts receivable and inventory.

“Borrowing Base” formula may be applied to ensure loan balance fluctuates commensurate with collateral fluctuations.

Worth special note- contractors “progress billings” accounts receivable and “work in process” (or “underbillings”).

Amortizing “Term Loans”

Equipment purchases.

Real Estate purchases.

Sometime used to amortize “permanent working capital”.

Collateral = equity in equipment or real estate, and/or base of accounts and inventory.



Business Qualifications for “conventional” bank financing

Established businesses- generally minimum two full years of operations, more realistically 3+ years.

Profitable and retained earnings are growing.

Profits are used to repay all “term loans”.

Must have adequate owner’s equity.

Debt ratio (total liabilities/owners equity) of 3:1 or less (outside of real estate ownership/mortgages).

Owner equity in the business must be sufficient to make down payment/carry the non-financed portion.

Must have adequate “working capital”

Net working capital (current assets minus current liabilities), current ratio (current assets/current liabilities) are measures.

Special notes for contractor businesses:

Are you using contractor accounting methodology? Bank will want to evaluate past job performance.

Are you getting CPA-Reviewed financial statements?

Seasonality, cyclical, job size/volumes, and occasional job losses are variables your banker must understand and be willing/able to deal with. Carefully select your banker and bank with that in mind.

Banker and bank expertise is worth paying for.

Bank reliance on adequate profits historically, good history of contract performance, owners equity, and working capital are increased since “progress billings” accounts receivables are not realistically high quality collateral.



Business Plan/Financial Projections

A business plan is prepared for the benefit of owners/management.

Having prepared one, it is then an extremely useful communication tool.

Remember that “conventional” bank loans are for financing of assets. So financial projections need to include the balance sheet.

Historical versus projected profits- be prepared to explain the trends you are projecting.

Historical results and trends are the basis for making forecasts believable.

Best case, expected case, and worst case scenarios- why prepare more than one projection?

Cashflow and cash available to repay loans will vary with not only level of profits, but also with level of assets.

Rapid growth or periods of high job volume can outstrip cash resources unless planned for.

Projecting “worst case” shows that you have plans that can be implemented if need be.



Side notes:

Leveraging home equity, credit cards

Outside income

Personal credit score

Personal liquidity

Personal leverage

Do you have material equity in your personal assets?

Personal debt is, in fact, debt the business needs to repay.