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Obtaining a Business Loan:
A Step-By-Step Guide for Businesses

This five-step guide will walk you through the process of obtaining a loan and help you prepare to confidently engage loan officers and the application process.




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Introduction:

Business owners often see opportunities to grow or upgrade their business; rather than spend all of their company's capital, they consider using financing of real estate or equipment to make their aspirations a reality.

But what goes into obtaining a business loan from a banking institution?

This five-step guide will walk you through the process of obtaining a loan and help you prepare to confidently engage loan officers and the application process.

Step 1: Why Do You Need Funding?

To engage a lender about financing, your starting place will be the type of purchase, investment, or expansion that financing will support.

Here are several common scenarios:

Equipment Purchase: This funding type is designed for acquiring business equipment, such as machinery, trucks, vehicles, or office furniture. Often these loans are "secured" by the equipment itself, meaning they are the collateral a lender may seize if payments were not made. A downpayment will likely be required.

Real estate purchase, renovation, or expansion: As businesses grow, they often need to acquire or expand into new, larger spaces. These loans also are secured by the real estate. A downpayment of 10-25% will be required, depending on if the loan is conventional or an SBA loan.

Small-dollar loans: For loans under $50,000 to established businesses with an operational history of over two years, small business loans are available and based on profitable operations and good personal credit. For businesses with less than two years of operational history, consider applying for a microloan through the U.S. Small Business Administration's (SBA) microloan program. These loans are obtained from Community Development Financial Institutions (CDFI) and some banks.

Start-up loans for a new business: If you are not yet a business owner and want to learn about business loans to start or acquire a business, read our "Financing for New Businesses" resource.

Securing a start-up loan can be challenging due to most lenders' requiring an SBA loan for any start-up business, as well as requiring industry experience. To no longer be considered a start-up, businesses must have two years of operational history and be profitable at year-end.

For new businesses, friends, and family, applying for a microloan or a business credit card may be more feasible. Business credit cards also can be easier to qualify for as approval is typically based on personal credit scores.

Loans to cover day-to-day operations: Working capital loans, which are short-term loans normally with maturities no greater than twelve months, are used for shortfalls in cash flow. These are ideal for managing daily expenses such as rent and payroll. They help address temporary cash flow issues that may arise from timing differences resulting from making or delivering goods or services and receiving payment. Borrowers usually offer assets the business owns, such as accounts receivable and inventory. In special cases, equipment and real estate can be used as collateral. Borrowers may also pledge personal assets, such as equity in their homes. A rule of thumb is that a line of credit should not be more than 10% of the revenue over 12 months.

Borrow on an as-needed basis: Other loan structures may be structured to fit a particular need. A business line of credit is a flexible option when you require variable borrowing amounts. Once approved, you can withdraw funds up to a predetermined limit, utilizing them as necessary. The expectation is to pay these down as cash comes in and borrow again for shortfalls. Interest is only charged on the amount borrowed. These loans are secured by assets of the business.

Step 2: Master the Loan Request

With your financing need defined, it's time to talk with a lender. Good loan officers will want to understand you and your business needs. They'll also ask about your goals for the business if and when you obtain funding.

To prepare for a conversation, organize key information about your plans and needs, then use that to draft your request. Here are five questions you should be prepared to answer:

- **Why are you seeking financing?**

  Businesses commonly finance equipment, offices or new locations, office equipment, vehicles, or any other asset used to provide the business's product or service.

- **How much do you need?**

  Knowing how much you need to borrow in detail demonstrates that you have thoroughly planned your financial requirements and are prepared to use the funds responsibly. By calculating your needs, you can avoid unnecessary interest expenses and only borrow what is required. See the examples below.

- **What is the useful lifespan of the asset financed?**

  Determine how long the business will use the equipment or real estate. Some equipment, such as construction equipment, is usually useful for ten years or less. Real estate can be useful for decades; there may be a time when the real estate is no longer used to support your business and is used as an investment.

  For example, you may run the business out of a building, but at some time, you may sell or move the business and rent the building. Letting your loan officer know how long you plan to use each asset helps them prepare your loan package for your benefit.

- **How will it be repaid?**

  Often businesses pay back loans with existing cash flow, cash flow from growth, or cost savings. Your loan officer will want to know all loan repayment sources you plan to use.

- **What is collateral?**

  Depending on the amount of financing needed and the business's financial status, a business can pledge a "purchase money security interest" in the equipment, meaning the lender will be listed on the title or deed. A business can pledge additional assets, or all of the business's assets, depending on the situation.

  Lenders typically ask for some form of collateral to protect the money lent in a business loan. Collateral can be any asset of value, though lenders use only certain types of assets, which tend to be tangible and marketable should it become necessary for the collateral to be seized and sold to pay off the balance of the loan.

  Collateral requirements can vary depending on the type and amount of the loan, as well as the policies of the lender. Collateral examples include real estate, business assets like cash accounts, equipment, vehicles, inventory, or personal assets like equity in your home.

Here are two loan request email examples from a construction company owner and an auto mechanic shop owner. Use these examples to start a conversation with a lender or email a lender directly.

Construction business financing request email to loan officer:

Hello Mike,

We are a construction company based in Blaine. We're looking for about $800,000 for four pieces of construction equipment to expand home construction over the next two years.

The equipment will be in use for 10-12 years; we'd look to pay off the financing in eight years. We'd like information from you on loan terms and rates. We have the existing cash flow to cover payments but expect cash flow growth to quickly handle the repayment.

Your institution would provide purchase money and retain a security interest in the equipment.

Could we set a time to talk?

Auto mechanic financing request email to loan officer:

Hello Susan,

Our shop in Alabaster has been serving local car owners for 11 years, and we are ready to move out of our rental space to a facility we own. There is an open lot a mile down the frontage road where we can continue to serve dedicated customers conveniently while eliminating rental expenses.

We want to use anticipated savings from rent to acquire the lot and build a new facility of about 16,000 square feet. That size would double our capacity.

The rent savings and/or our cash flow would more than cover the loan payments.

Could we talk by phone next week?

When a loan officer reviews your request with this background information, they get started knowing much more about your business and the exciting growth offered by obtaining financing. They can now ask better questions and position the request for underwriting and approval.

Step 3: Submit Financial Information

A lender will review your business's financial information to learn about the strength of your business and assess the financial institution's ability to provide you with the financing you've requested.

Lending is a two-way street. Like a mortgage or a car loan, lenders gather information to gauge and validate your business's capacity to repay the loan you've requested. You know you would like financing from them; now they must decide if they can reasonably lend to you.

But it is not all numbers. Loan officers also want to know the story of the business and gauge character because they will need to stand behind a loan and tell your story to the institution's ownership or loan committee.

Some information you may be requested to provide for a credit application request:

- **Business and personal tax returns from the last three years, including all Schedules and K-1's.**

  Tax returns provide an important gauge of your business's capacity to repay a loan. Other financial information such as company-prepared financials, accounts receivable and payable agings, schedule of current debt repayments, as well as other information may be requested.

  Generally, net income, capital and liquidity, interest, and depreciation are important to lenders as they seek to understand your business. But no business's history is the same; Context and transparency can be important to establishing personal trust between you and your loan officer; it is just as important for a lender's credit decision.

  This is your opportunity to provide additional information on any financial items, positive or negative. Most credit reviews are extensive and thorough. It is far better to take the opportunity to discuss known negative items candidly than to let the lender discover them on their own. A positive example would be one-time events like selling equipment or real estate or, on the other hand, a major customer charge-off should proactively be disclosed.

While tax returns provide a look back, the most current income statement and balance sheet show the status of the business today. Again, the information here can be negative, but it also can be positive; this is your opportunity to provide context.

The past is determined, but the future is uncertain, which applies to business as much as everyday life. A business that thrived last year may struggle this year based on market dynamics or a change in customer needs. Remember, the lender's goal is to understand your business's financial condition and its ability to repay a loan.

- **Financial statements of owners and guarantors**

  Profit and Loss, Balance Sheets, Accounts Receivable Aging, and Accounts Payable Aging from the last three years at year-end, as well as year-to-date information, are collected. Business leaders and owners commonly ask why lenders request this information for a business loan. Owners and guarantors provide the business additional financial strength. No one knows what the future holds for the economy or for your business's industry. Should the business face hardship, the lender wants to know owners (or principals) and loan guarantors can weather the unexpected.

  Owners also often provide a personal guaranty on a business loan. The lender must ensure their financial condition provides support for the loan.

  Loan officers will want to know the following:

  - Are sales growing or changing? Did you bring on or lose a large customer?
  - What other assets does the business have - equipment or real estate, for example - not pledged as collateral to other lenders?

- **Concentrations in sales, accounts receivable, and accounts payable**

  How much of the company's sales come from one, or a handful, of customers? If more than 10% of gross sales - or account receivables - are concentrated in a few customers, lenders will want to understand the standing of those customers.

  For concentrations, lenders often will look at amounts owed closely during the underwriting process. It's best to prepare information on accounts receivable and accounts payable, especially for these substantial customers.

- **Purchase agreements**

  When purchasing equipment, for example, the purchase agreement or invoice tells the lender what you're buying, the terms of the seller, and the asset's original cost. Real estate transactions also utilize these types of agreements.

  These are important because they provide a true total amount that includes the price, fees, commission, taxes, additional services agreed upon, and any other amount charged in connection with the sale.

  All this information together allows the lender to ask some final clarificationquestions, such as:

    - How much of the total purchase price does the business intend to pay with cash?
    - How much of the assets' value at purchase will be financed?
    - What dealer or organization is selling the equipment?

Gathering this information can take some time initially, but it will save time in the loan process. It also provides the first impression to lenders that you are prepared for each element of the loan request.

Step 4: Underwriting

Lenders determine if they will provide a business with funding through an analysis process called underwriting. During this step, they take all the information gathered in the financial information step and combine it with what they learned from meetings and follow-up communication with the business.

Lenders have three goals in this step:

1. Verify information accuracy
2. Assess the risk of making the loan
3. Determine if and how to provide funding

Loan officers often have a general sense of a decision timeframe, and they may follow up with questions as underwriting progresses. While they are not advisors, lenders' deep analysis of your business can also allow them to ask insightful questions about your business. They can even provide you with referrals to companies with services you might use, help you network with other business leaders, and share how they observe other organizations overcome business challenges similar to those of your business.

What are the financial metrics analyzed by lenders? Here are the basics:

- Earnings Before Taxes, Interest, Depreciation & Amortization (EBITDA) / Debt Service Payments
- Debt Service Coverage; for every dollar you owe in a payment there is an additional 25 cents available. A normal ratio is 1.25 Debt Service Coverage
- Net Cash after Operations / (Current Portion of Debt + Interest Expense)
- Current assets / current liabilities
- (Cash and equivalents + marketable securities + accounts receivable) / current liabilities
- Net Income without Distributions or Dividends
- Revenue growth
- Loan amount / discounted asset value
- Industry averages for net income and debt compared to net worth for organizations of similar size

Step 5: Loan Structures and Decision

Many loan officers are lending experts, and not just on determining if they should provide your business funding. Often loan structure, funding source, and other parameters can provide different funding options to borrowers.

This is where an experienced loan officer really shines. When opportune to complete a funding request, they can recommend additional funding sources beyond their institution, such as the SBA or local economic development programs. Look for lenders who will provide a thoughtful proposal to accomplish your goals.

Here are the loan options you can expect to consider:

- **Line of Credit**

  A business line of credit is best for funding where you want to borrow as needed to buy inventory or even out cash flow. Some businesses use lines of credit during seasonal cash flow gaps or for activities where timely access is required.

  Credit lines have a 12-month term, are interest-only, and based on a variable rate. They are typically backed by collateral, primarily accounts receivable or inventory. In specific cases, collateral can include equipment or real estate.

- **Term Loan**

  Term loans are another common type of business financing. They are for long-term capital improvements in the business for fixed assets, investing in tenant improvements, acquiring businesses, investing in new technology, and many other investments.

  For term loans, you pay monthly principal and interest payments over a specific time period at a fixed or variable interest rate.

- **SBA Loans**

  The U.S. Small Business Administration (the "SBA") partners with banks and other financing entities to offer a variety of loan programs available to the vast majority of U.S. businesses. The SBA is not a direct lender.

  Eligible businesses must:

  - Operate for profit
  - Be engaged in, or propose to do business in, the U.S. or its territories
  - Have reasonable owner equity to invest
  - Provide all available collateral in an amount sufficient to collateralize the loan
  - Use alternative financial resources, including personal assets, before seeking financial assistance
  - Not be eligible for traditional financing without an SBA guarantee

There are two primary programs:

SBA 7(a) Loans

Businesses often use the 7(a) program to finance working capital, business acquisition, partner buyout, equipment, start a business, export financing, refinance existing debt, or build, improve, or purchase owner-occupied commercial real estate.

7(a) loans can range from $20,000 and up to $5,000,000. They have a rate based on the prime rate with terms from 3 up to 25 years fully amortized. Down payments can be as low as 10%.

SBA guidelines require that for real estate purchases, your business maintain at least 51% occupancy to be considered owner-occupied by the borrower/guarantor, a determination the lender makes during underwriting.

Your business must be a for-profit company in the United States and have (subject to change by the SBA):

- A tangible net worth of less than $15 million
- An average net income of less than $5 million after federal income taxes for the two years preceding your application

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SBA 504 Loans

Businesses use 504 loans to finance equipment or to build, improve, refinance, or purchase owner-occupied commercial real estate. SBA requires that funding be used to purchase a range of assets that promote business growth and job creation, including:

- Existing buildings or land
- New facilities
- Long-term machinery and equipment

Or the improvement or modernization of:

- Land, streets, utilities, parking lots, and landscaping
- Existing facilities

They cannot be used for:

- Working capital or inventory
- Speculation or investment in rental real estate
- Non-owner-occupied real estate

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- **Business Real Estate Loan**

  Investing in real estate, or building a location for your business, is generally accomplished with a business real estate loan.

  Because borrowers buy real estate, while others build and some renovate it, the loan structure utilized can vary. Term loans often are used for purchasing real estate. Purchase-related financing is often structured with regular fixed monthly payments over a period of time, often five years, then a re-price would happen with a balloon payment due at maturity.

  The maximum loan term is typically ten years, although with SBA lending, the term can go to 25 years. The bank may lend up to 75% or, with an SBA loan up to 90% of the real estate value. SBA loan structures include an SBA 7(a) option, or an SBA 504 debenture, and both allow for a higher advance rate.

  Construction loans are disbursed over the course of evidenced construction using monthly draw requests with supporting documentation to determine the loan amount to be advanced. They can be one loan with a construction to permanent loan or sometimes be refinanced into a long-term mortgage loan after construction is completed.

Conclusion:

Securing a business loan may seem like a challenging and uncertain journey, but it can be a manageable process with the right approach. By completing the essential steps outlined in this guide, you can confidently navigate the loan application process and increase your chances of success.

Experienced loan officers also can be invaluable as you put your request together. It's not unwise to reach out to them to let them know you are writing a request; they can provide insightful advice early on for your specific goals.

To talk with a local banker at Coastal Community Bank, call us at 425.257.9000.

To see our full range of business banking solutions, visit coastalbank.com.