BUSINESS FORUM

How To Look Good To Your Banker

by Robert A. Woods

Banks have always provided the vast majority of financing for builders. But dealing with bankers can intimidate even the most experienced businessperson. Banks are much easier to deal with, however, when you understand their motivation and can speak their language. Here are some insights into how to persuade a bank to loan you money.

Numbers Speak Louder Than Words

The worst thing that can happen to a loan officer is for a customer to default on a loan. If this occurs more than a handful of times, that loan officer's career is over. So bankers are careful with the bank's money, and they can't understand why builders aren't just as careful.

To be successful when applying for a loan, you need to command as much information about your business as the banker commands about his. The banker knows his cost of funds, the spread he needs for a profitable loan, how many loans he needs to make this month, and many more details about what it takes to run a bank profitably. No banker is going to be sympathetic to a builder who doesn't know his own key numbers.

The most important number is your net profit. No matter what a banker may say, the first thing he or she looks at is your profit, and no amount of explaining can undo the damage a poor profit figure will do to your image as a successful builder.

Bankers are not risk takers, and it's risky to loan money to a company that is not making a reasonable profit. That's because bankers know that the only way a loan can be repaid, short of liquidating your company or your collateral, is out of excess cash generated from profitable operations. Since bankers use the past as a guide to the future, if you can show you've been profitable in the past, you're well on the way to convincing them that you will likely be profitable in the future.

Clean Up Your Numbers

Just as you would never show a house you just completed without first giving it a thorough cleaning, put your financial information in the best possible light before you meet with the bank.

There are two things you can legitimately do to help sell the bank on making your loan. The first is to "recast" your previous year's earnings. The second is to show exactly how you plan to use the bank's money, and how that use will result in additional profit for your company.

Recast earnings. Most builders claim their goal is to maximize profit, but that's only half an answer. Builders also want to minimize taxes, so their financial statements often don't show how much money their company really made. Recasting earnings means redoing your financial statements to show what your business *could* have earned — its maximum earning power.

Recasting typically involves adjusting all expenses that were not absolutely necessary to running the business. For example, the sponsorship of your child's Little League team and other charitable contributions represent earnings you chose to spend in a tax-deductible way, but you could have left the money in your company. Similarly, the bonuses you paid your employees boosted morale — and lowered your taxes — but were not required expenses.

In particular, look carefully at your own salary and that of any relatives on the payroll. As the owner, you can take as much cash as you want out of the company. But if the amount exceeds the average compensation for similarly sized construction companies in your area, your company is showing less profit than it is actually making. This may make sense personally, but it's not what you want to show your banker.

Better bottom line. Recasting earnings can have a dramatic effect on your bottom line. Imagine a hypothetical builder with $800,000 in annual revenue. His books might show a net profit of $19,000, or 2.4% of sales — not very good. The recast earnings in Table 1 at left show what this builder's company could have made by adjusting four areas: salary, employee bonuses, truck reimbursements, and charitable contributions.

The largest adjustment is for the owner's salary. Our builder pays himself $75,000 a year, but the average owner's salary for similar companies in his area is $50,000; the $25,000 difference reduces his profit. Similarly, the employee bonuses were really paid out of profit in the first place, so it's more meaningful and perfectly legitimate to show this $10,000 as profit rather than an expense. The $6,000 in car and insurance payments made by the company are not necessary or even typical. And the charitable contributions are well-intentioned, but also not necessary.

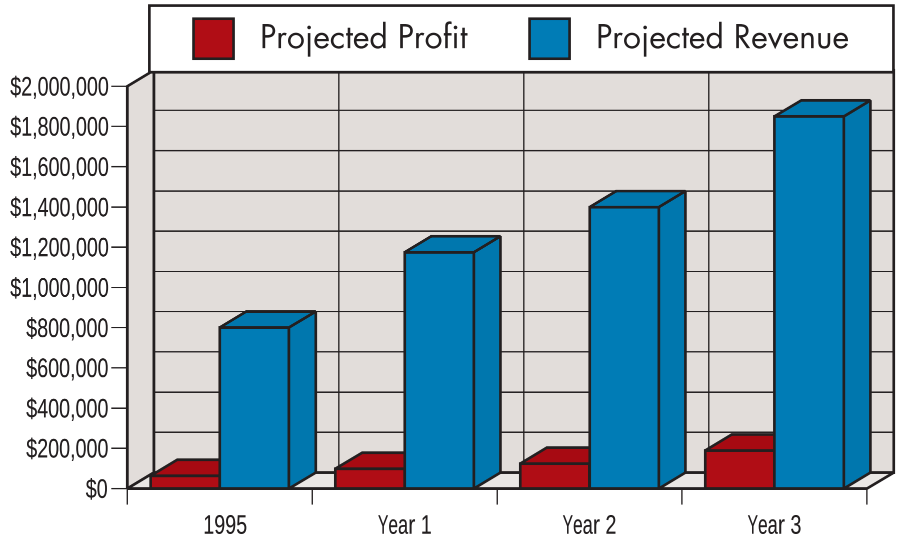
After these four adjustments, our

Table 1
Recast Earnings

Item	Actual	Adjusted	Net Gain
Owner's Salary	$75,000	$50,000	$25,000
Employee Bonuses	10,000	0	10,000
Car and Insurance	6,000	0	6,000
Charity	3,000	0	3,000
Total increase to Net Profit			$44,000

To improve net profit, adjust expenditures that are either higher than average, such as your salary, or that are not necessary to running the business, such as employee bonuses.

Table 2: Projected Revenue & Profit



	Revenue	Profit
1995	$800,000	$63,000
Year 1	1,175,000	99,000
Year 2	1,400,000	124,000
Year 3	1,850,000	189,000

To prove to the bank that you've done your homework, prepare a pro forma showing the projected increases in revenues and profit that will result from your company's use of loan money. Back up this data with a detailed income statement showing projected revenue and expense breakdown for the period of the loans.

builder shows a net profit of $63,000, or 7.9% of revenue. This profit is actually above average for builders of this size and will look better to the bank than the original $19,000 profit.

If all of this sounds suspiciously like keeping two sets of books, relax — it's perfectly legal, since all of your income is being reported. You are simply showing what happens if you move expenses around on paper. The point of recasting earnings is to show the amount of available cash you can draw on, if necessary, to meet your obligations. Recast earnings often show a more accurate picture of a company's true financial condition than the original financial statements, especially for small, owner-managed businesses.

Predicting the Future

Bankers want to know specifically what you are going to do with the loan funds. Here you have another opportunity to set yourself apart from the competition by showing the bank exactly how you are going to use their money.

Bankers loan money when they are persuaded that it will be put to good use, which to a banker always means money making more money. Unless you can demonstrate that the borrowed funds will sow the seeds of additional funds in the form of company profit, don't bother your banker with a loan request.

To show how your use of the borrowed money will add to your profit, you need to develop a set of projections showing your financial performance over the next few years. These projections — best guesses, really — are called *pro formas*, and they demonstrate what your financial statements will look like over the next two to five years, if your assumptions about the future are correct.

Let's go back to our builder with $800,000 in revenue and recast earnings of $63,000. Assuming he would like to grow, he needs capital to hire another supervisor and crew. He approaches a local bank and requests a $50,000 five-year loan. The bank naturally asks, "What are you going to do with the money?"

Our builder replies, "I'm glad you asked that question. Here are my figures showing the increased profit and revenue that will result from your $50,000 loan." And he lays down a pro forma like the one shown in Table 2, above.

As the banker looks over the numbers, our builder anticipates additional questions: "I already have the infrastructure in place to handle additional business," he explains, "and right now I'm turning work away. With the bank's money, I can take on that business. In two years, my profit will double, using the bank's money. Repayment of the loan will be out of operating profits. As collateral, I can pledge my trucks and equipment. And, of course, I will personally guarantee the full amount of the loan."

Don't fight this last point on personal guarantees. Builders *always* have to guarantee their business loans. (So does Donald Trump.)

Naturally, the bank will examine the assumptions behind your projections, taking a more pessimistic (or realistic?) view. What if there is a recession? What if interest rates rise another two points? Does the builder have the management skills to handle a larger company? Will the collateral really be there if the bank needs it?

A pro forma is no guarantee of a loan, but in preparing one you have shown the bank that you've done your homework. You've demonstrated that you think as carefully about your financial operations as you do about what goes on at the job site. The bank can't help but be impressed with your preparation, especially compared with the average borrower. Your loan request is going to get a fair hearing and careful consideration. And that's really all you can ask. ■

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