Open a Line of Credit at Your Bank

by Robert A. Woods

Builders who have an open line of credit at their bank sleep better at night than builders who don't. A line of credit means you don't have to sweat bullets on the tenth of the month when you can't pay your bills because your clients haven't paid theirs. With a line of credit, one call to your bank and cash is automatically transferred into your checking account.

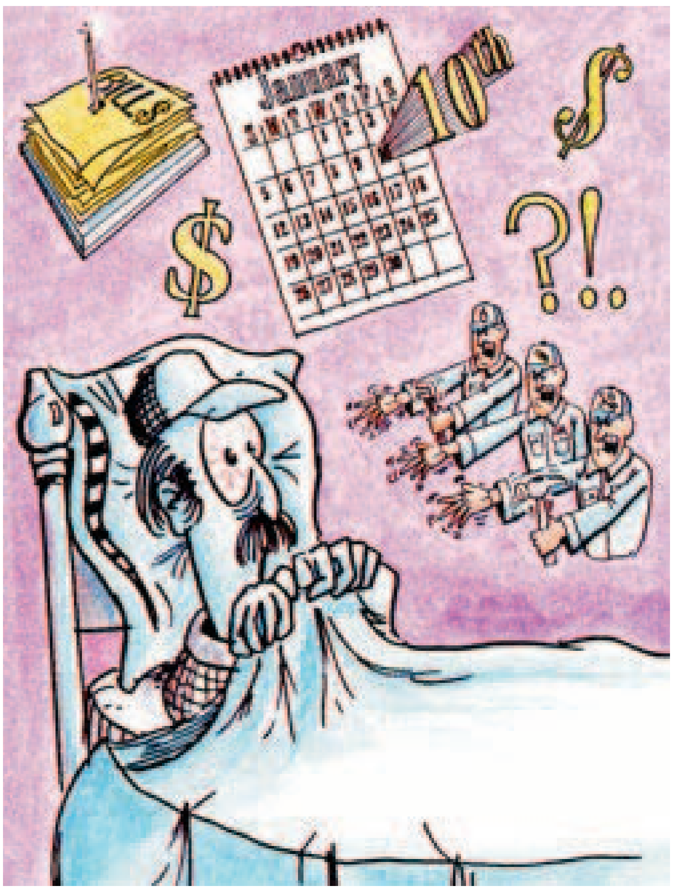
What Is a Line of Credit?

A line of credit is simply a specific amount of money the bank has set aside with your name on it. The money is yours to use to run your business as you see fit: You can draw the full amount of the line or any amount up to your credit limit with no questions from the bank.

This freedom from bank interference can, however, be a double-edged sword. The advantage, obviously, is that the money is yours to do with as you please. The downside is that if you don't handle your line properly, the bank will yank it when it expires (credit lines are usually renewed every 6 to 12 months).

A credit line is a type of short-term loan. Unlike other loans, however, the bank expects this loan to be paid back, either in full or partially, during the term of the loan and then borrowed again.

Here's an example. Many builders have cash-flow problems around the tenth of the month, because subcontractors and suppliers like to be paid by the tenth. Being able to pay these bills in a timely manner is not only good business practice, it gives you a lot of leverage over your subs and suppliers. When they know they will be paid like clockwork on the tenth, they are more likely to give your jobs priority over their other commitments. Also, most cash discounts apply only to payments made by the tenth.



But paying venders is often a problem if you haven't been paid yet by your clients. If you have, say, a $25,000 line of credit with your bank, you can use this money to pay bills due on the tenth. When the money comes in from your clients, you use that money to pay back the bank.

Use It, Don't Abuse It

Lines of credit are intended to go up and down. Your line may fluctuate between zero and $25,000 outstanding. A clear red flag to the bank would be if the line stayed at its limit, $25,000, and didn't budge. This would indicate that you were not using the money to finance your receivables as you told the bank you would; instead, you would be using the credit line as a conventional loan. If this is the case, the bank will be justifiably concerned about what you are using their money for and how the line will be paid back when the loan is due.

Don't apply for a line of credit when what you really need is a long-term loan. The balance outstanding on a line should always be going up and then coming back down, often to zero. Bankers are impressed with builders who have cash available in their lines. If you have a $25,000 line and all you ever used is $15,000, your bank will admire your financial performance and restraint. Don't use your line of credit to buy equipment or property; it's financial suicide to purchase long-term assets with short-term money.

Plan Ahead

Ten years ago bankers freely handed out lines of credit to builders. Today you can still obtain a line of credit, but the approval process is much more rigorous. This means you can't wait until you need a line of credit to ask for one. The time to hit up your bank is when your company is operating smoothly and your financial house is in order. Just as smart builders fix the roof before the rains start, you should line up credit before you need it.

Bankers are quick to sense panic on the part of borrowers, and nothing brings on rejection faster than a borrower who is desperate. If it's Thursday morning and you can't meet Friday's payroll, forget about talking to your bank about a line of credit. They are not interested. Bankers plan ahead and are very careful, meticulous people by nature. They have a hard time understanding why everyone else, especially a potential borrower, doesn't share these traits.

When opening a line of credit, your bank will want to know specifically why you need it and how you plan to use it. Bankers always lend money with a specific purpose in mind. Needing additional "working capital" is a catch-all for builders who are short of cash and is not sufficient reason for a bank to grant your loan.

No Collateral, No Loan

Because of the risks involved in granting lines of credit to builders, banks insist you put up collateral equal to or exceeding the amount of the line. In fact, the banking climate has changed so much that the traditional five "Cs" of evaluating a loan applicant — character, capacity, capital, conditions, and collateral — have come down to one: collateral. Banks don't lend on ideas, promises, forecasts, or predictions; they lend when they are assured of getting their money back. In most cases, this comes down to the value of the collateral behind the loan. All the good intentions in the world can't pay back a loan that has gone bad, but selling the collateral can.

Builders who have gone through the loan process know there is "easy" collateral to put up and "hard" collateral to put up. Easy collateral is your accounts receivable and construction tools and equipment. If your accounts receivable run $50,000 per month, for example, the bank may value it at 50¢ on the dollar and accept it as collateral for a $25,000 line of credit. Tools and equipment are often treated the same way.

Banks are not stupid, though, and they are not in the business of trying to collect money from your clients or trying to sell your used equipment. Banks prefer collateral that can be more easily converted into cash — like your house. It's an unfortunate fact of life for most business owners that the only significant asset they have, other than their companies, is their house. So banks often ask for a second mortgage as collateral. Banks are also aware that most people will go to great lengths to keep their houses, so the chances of your defaulting on the loan go down.

Joint guarantee. Personal guarantees are also a fact of life. Don't fight it, just do it. The tricky part is when the bank insists that your spouse also give his or her personal guarantee. Depending on the state of your marriage and the condition of your finances, this joint and several guarantee may or may not be a problem. Just remember: There are many ex-spouses out there today who wish they had not signed that piece of paper.

Interest. Expect to pay two points over the prime interest rate for the money you use from your line. Banks may also charge a one point setup or origination fee. (Make sure this fee is charged only when you set up your line and not each time you renew the line.) Banks like short renewals, but insist on at least six months as the initial term of the loan. After you've shown you can handle the line responsibly, the renewal period can be lengthened to a year.

Builders can often minimize use of their credit line — and the monthly interest charges that come with it — by having clients finance their own jobs. Before you start a job, ask for a substantial down payment. As the job progresses, design your payment schedule so the owner's cash keeps you going until your next draw. ■

Robert Woods is chairman of Woods Capital Corp. in Park City, Utah. He specializes in helping builders and contractors nationwide obtain financing.