<u>What do Banks look for when assessing a lending proposition?</u>

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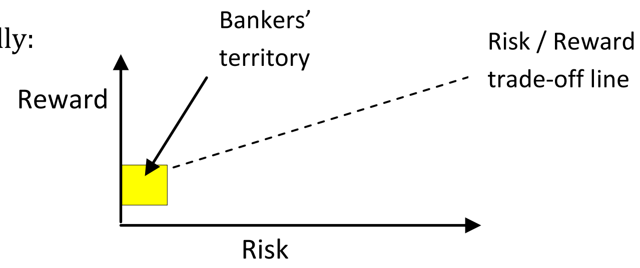
When making a lending decision a bank's first priority is to its shareholders not to you the (potential) customer. When lending money to any customer the bank's overriding concern is to ensure that the funds are at some time repaid, preferably in the way set out in a formal contract (facility letter) with the customer at the time the funds are lent.

In looking at any proposal a **bank is looking for repayment from an identifiable and credible source** be it by on-going trading / profits of the business or the financial fruits of a specific project. Then the bank will want some form of back up, **an alternative repayment source**, just in case the original plan does not work – view this as built in redundancy. For a large company the alternative source might be the strength of the overall business – its balance sheet but for many smaller businesses this inevitably means providing extra security – a personal house or other assets. If there is no additional security the bank may consider the option of an Enterprise Guarantee scheme loan. Speak to your bank / business adviser for more information. Is this fair? Well look at how the bank sees it.

- If a bank lends £100,000 on a 3% margin over base it takes over 20 years to double its money. An equity investor looks to double their money in 2 - 5 years.
- If the bank loses £100,000 to a bad debt they need to lend £3,333,333 for a full year at 3% over cost of funds to merely cover the loss.
- **Banks by necessity are risk averse** with a low risk threshold.

Shown graphically:



<u>Is your proposal a good risk?</u>
For most businesses the proposal that is put to a bank will be 'credit scored'. Standard information is input to the computer that is then compared to statistically significant traits based upon empirical records of business performance. The computer will then provide a guide to the decision maker as to whether to agree your proposal.

If the proposal is likely to trip up on the credit scoring you need to present sufficient information and reassurance to overcome any initial reluctance to support your presentation. The level of information that will satisfy their fundamental appraisal processes and fit with their principles of good lending – Canons of Lending, which are often made into a mnemonic, one such is 'CAMPARI' – see adjacent box. The information needs to be presented in a fashion that assists the manager make a recommendation to their credit committee to support you.

<u>CAMPARI – Canons of lending for bankers. Do you tick the boxes?</u>

- <u>Character</u> – Can you the customer be trusted, what is your track record, your historic actions will be considered here, have your previous projections been optimistic / conservative.
- <u>Ability</u> – What key skills does the organisation's management possess for the proposal presented. Are there areas of weakness in the management team?
- <u>Margin</u> – Set to match perceived level of risk; including commission, interest margin and fees.
- <u>Purpose</u> – Is bank prepared to lend for purpose stated, is it against bank policy, is it illegal or is the bank wary of the market sector? Could the bank consider that the proposal is too risky, development capital will often attract a premium margin when compared to normal working capital or owner occupied premises finance.
- <u>Amount</u> – Is the amount being asked for appropriate? Too much or too little, here the bank will look in detail at your projections, and challenge your assumptions. They will also be interested in the customer's stake in the presented proposal?
- <u>Repayment</u> – The crucial element, a source of repayment needs to be established at the outset – trading profits turned into cash-flow, trade sale, asset disposal, market quotation, whatever the source this needs to be set out for the bank. It must also be identifiable not merely a promise. This is their real risk assessment task and a major component is usually the assessment of the historic trading figures and the projections. Early stage companies with no or minimal sales and no chance to establish credibility in financial forecasts can have problems here.
- <u>Insurance</u> – In case something goes wrong the bank will normally seek some form of appropriate collateral – ideally something that is easy to take, value and if necessary realise.

Matching funding requirement to the appropriate type of funding

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When seeking funding it is sensible to seek to match the type of funding to the purpose of the funding request

a. FUNDING WORKING CAPITAL

Providing finance to cover a company's working capital requirement – the funding needed to turn stock / service activity into cash. It is a essentially a function of levels of stock holdings / terms of trade with debtors and creditors and direct labour costs. This is not constant over time and will often increase as a business grows.

Generic Bank Options

- Bank Overdraft
- Debtor finance
    - Invoice discounting / Factoring
    - Advance payment trading
- Stock finance
- Supplier credit
- Acceptance credits

b. FUNDING ASSET PURCHASES

To support the service / manufacturing operation a Business requires assets – office equipment, machinery, vehicles, buildings. These will be depreciated over their useful life say 3 years for office equipment and vans; 5 years for plant and trucks and 20 years plus for buildings. Companies need funding options that match the life of the asset.

Generic Bank Options

- Lease purchase (Finance lease)
- Rental lease (Operating lease)
- Hire purchase
- Contract Hire
- Standard Loans
    - Commercial mortgage
    - Business loans

c. FACILITATE INTERNATIONAL TRADE

When a business trades internationally in return for a new market opportunity new commercial risks are introduced into its trading cycle. These centre around currency risk, political risk and risks of trading across different legal jurisdictions. Companies require services / financial instruments that mitigate these risks.

Generic Bank Options

- Letters of Credit / Documentary Credits
- Bills of Exchange for Collection / Documentary collections / Forfaiting
- Credit insurance linked products
- Currency protection
    - Spot & Forward exchange
    - Currency Options
- VAT Deferral Bonds for importers

d. EARLY STAGE COMPANIES

No track record, minimal assets, limited sales but good ideas and energy. "Nobody talks about entrepreneurship as survival but that is exactly what it is and what nurtures creative thinking" *Anita Roddick.* When seeking debt finance the primary problem is overcoming a credibility deficit and you cannot get funding unless you are prepared to provide additional collateral or compromise control to secure equity funding. With equity funding the problem is finding the needle in the haystack - a partner who will invest in your business.

Central Government provides assistance through the Enterprise Finance Guarantee, which enables access to finance in banks (and other finance providers on the scheme) by providing a guarantee to the financial institution equivalent to 75% of the value of the finance, reducing the risk for the provider.

e. RAPID GROWTH / STEP CHANGE COMPANIES

High growth companies may have a track record but, if they have adverse terms of trade, can consume cash as they grow. Bank call this 'overtrading' as you are growing too quickly (riskily) for your capital base but if the customer base is spread an invoice discounter will look primarily at the risk of your customers not you. Recapitalising the business with new equity is also a way to de-risk the business from a finance provider's perspective.

Rapid growth brings not just straight forward funding issues but operational risks that challenge company organisational structures and systems, layering additional risks for those looking at providing finance for such companies. Structured finance (including equity and mezzanine) alongside traditional debt and some form of advisory service support may be a necessary.

f. BUSINESS RECOVERING FROM 'SHOCK'

Companies can fail / struggle for many reasons only one of which might be the condition of the underlying business. Where a company has failed by being over borrowed, having made a wrong investment decisions or because of poor management but where the business (or part of the business) is fundamentally sound then it is often a mistake to abandon the whole of the business through a liquidation process.

Where opportunities exist to retain employment, with the likelihood of sustaining the business in the future, special financing structures are often needed requiring speed in delivery and execution and a mix of managerial, legal and financial skills. Support for such businesses can be controversial as some creditors may lose money as a company implodes but if the money is already lost why fail to support a new enterprise, as a phoenix or turnaround of a failed company "Persistent people begin their success where others end in failures" *Edward Eggleston*