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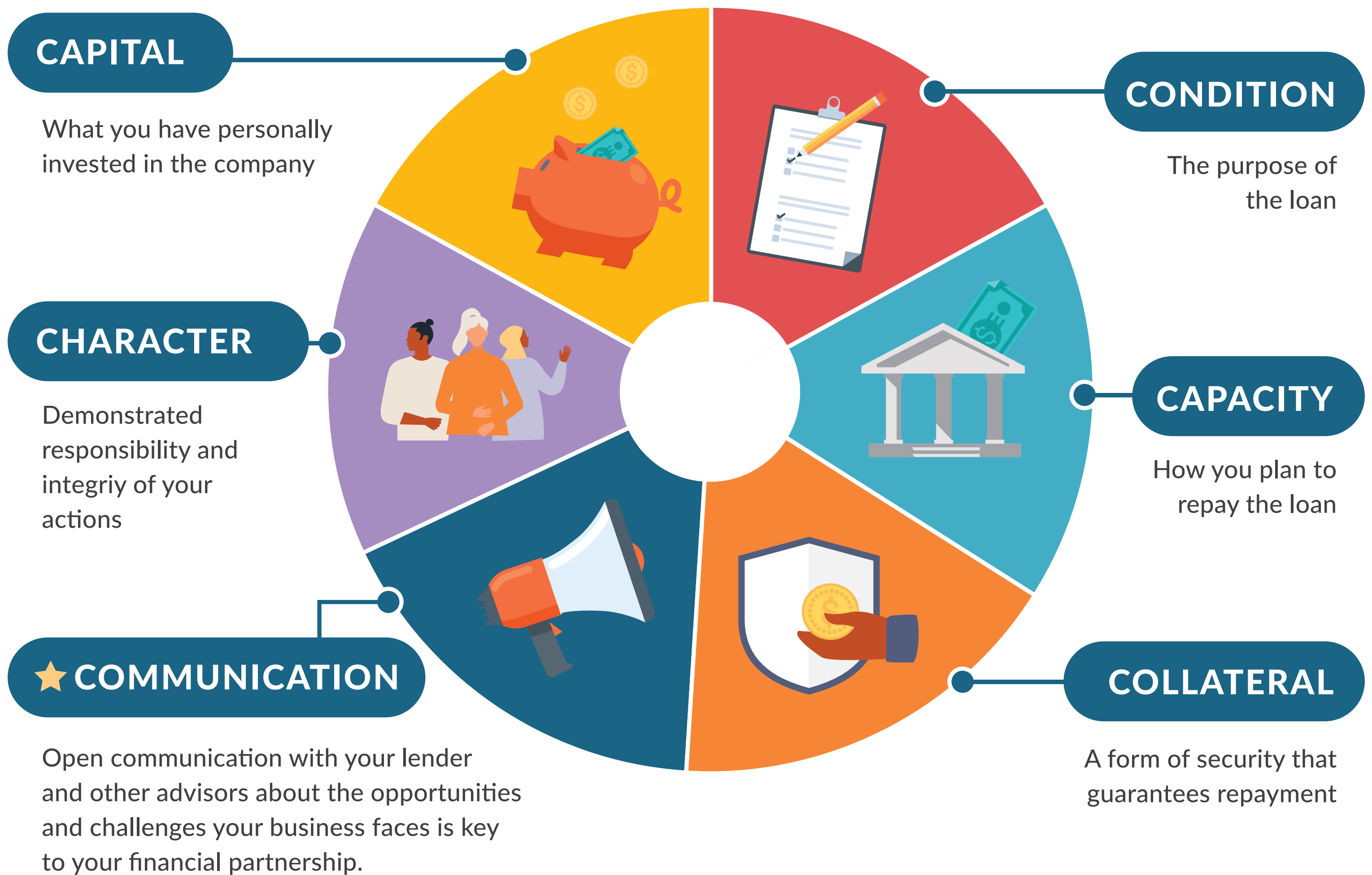
Applying for a Business Loan What Lenders Look For

Outline of the data to collect when applying for a small business loan and the factors your lender will review.



Approaching a lender about a loan is an important step for your business. Before you head in, take a look at the 5 C's of credit: the five key elements lenders look for when they're deciding whether they want to give you a loan. By evaluating the 5 C's yourself, you can get a better idea of what lenders are looking for and your chances of securing the loan you need to boost your business or get it started.

1. Character

As soon as you walk through the office door, lenders will start observing and considering your character. They want to know that you've got what it takes to launch and manage the business. They may consider:

- Whether you already have the necessary skills to manage the business
- If you have secured any licenses necessary to operate your business, from personal licenses necessary to operate in specific sectors to business licenses necessary to operate in your area
- Your credit report (and that of anyone else who owns 20% or more of the business)

The lender will also consider whether you have the experience, connections, and know-how necessary for the success of the business. Preparing a statement ahead of time can help you better present your capability to the lender.

How to improve:

- Before you walk into the lender's office, make sure you have the licenses necessary to launch your business.
- Request a free credit report and dispute anything that is incorrect. Check your credit score and know both what it is and your likelihood of securing a loan based on that score. If you have a low credit score, it may be worth waiting a couple of years to bring it up before you try to move forward with your business. One way to improve a low credit score is to pay your bills on time by setting up automatic online payments for your debts.
- Prepare to explain any gaps in payments, late payments, bankruptcy, foreclosure, or tax liens. In some cases, you may be able to show your loan officer how things have changed since those events. Keep in mind, however, that they could be a reason for loan denial.

You can also use a co-signer with good credit when applying for a loan.

2. Capacity

Your loan officer is going to calculate cash flow using your tax returns or your business plan projections. That's why it's important to have these items readily available. The goal is to find out if there is enough cash flow available to make your loan payments, based on reasonable expectations of your business projections. Your financial capacity may determine how much you can secure through a loan–or even if you can receive a loan.

How to improve:

- Put together all the paperwork the loan officer may want to access, including tax returns and business plan projections.
- Pay down any personal debts before applying for the loan, if possible, so that you can show clear ability to handle that capacity.
- Calculate your debt-to-income ratio by dividing your total monthly debt by your gross monthly income. What is your ratio? Typically, banks look for a debt-to-income ratio of less than 36% as an indicator that a borrower is responsible with credit.
- You should also be ready to answer any questions or point out unusual expenses that might not be recurring items. Sometimes, you can use this as evidence that you can afford to make payments on a higher loan than initially anticipated.

Your debt-to-income ratio compares how much you owe each month to how much you earn. It's an important factor to understand your probability of securing a loan.

3. Capital

The amount you, personally, invest in your business, or the amount you have on hand to get started, is considered your startup capital. Usually, this comes from:

- Personal savings
- Personal resources, including income from another job
- The contribution of paid-for high-cost equipment

Lenders look at the amount of start-up capital you will have. They are more willing to approve a loan when the business owner has invested some personal money in the business. It's unusual for a small business to get started with 100% borrowed money.

How to improve:

- Often, you can improve your available capital by saving up or investing before you start the business. You may need to take some time to build capital, purchase and pay off starting equipment, or make sure you have the resources on hand that you'll need to get started. For some business owners, this can make a huge difference in the loan they can secure.
- Try to stick to a budget and find ways to create an emergency fund before borrowing. If an unexpected event occurs, you'll want a nest egg to continue making timely payments on your loan.

If investing your own capital in your business is not possible, you'll need to rely more heavily on the other C's. If your character, capacity, collateral, and conditions are particularly strong, you might be able to offset the lack of capital.

4. Collateral

Almost every lender looks for some type of collateral when they make a business loan. In other words, on what can the bank file a lien or mortgage to secure the repayment of the loan?

Have an idea ahead of time what you will offer for collateral to the lender. You may want to consider:

- Business assets the lender can put a lien on
- Real estate assets that you can mortgage
- Personal assets, including vehicles, real estate, land, or CDs

Carefully consider what you're willing to offer as collateral. If you're just getting your business off the ground, you may need to use some personal assets to secure your collateral. It's important, however, to keep your personal assets separate from your business assets so that if your business fails, it does not cause as much personal strain for you financially.

How to improve:

You can use two strategies to produce a high standard of collateral for your business.

- First, you can choose to build up your physical business assets: high-value equipment, for example, or real estate assets associated with the business.
- Second, you can use personal assets to secure your loan. The greater the value of your collateral, whether personal or business, the more favorably the lender will usually look on your loan.

If you don't have collateral but still need to secure a loan, you might look for a co-signer. This is a person who has collateral to back the loan. Remember, using a co-signer is a big responsibility.

5. Conditions

In addition to direct factors related to you and your business, the lender will take a look at market conditions, your business's place in that market, and how those concerns relate to your likelihood of success. This could include:

- Current economic conditions
- Who your competitors are and how you plan to differentiate yourself from them
- Who your target market is and how potential customers will find you

Favorable market conditions can significantly increase your odds of securing the loan you need.

How to improve:

You may have little influence over the current market and economic conditions, but you can influence how the loan officer will perceive them.

- Produce a clear business plan that will help your loan officer understand how the market and economic conditions will support the success of your business.
- Present your target market, what sets your business apart, and how you plan to operate within that market to help the lender understand why betting on you is a great idea.

Just One More: Communication

In addition to the usual 5 C's, there is one more thing your lender will take into consideration: communication. Open communication with your lender and other advisors about the opportunities and challenges your business faces is key to your financial partnership. Your business isn't just about the numbers. There's a story behind it and behind you–and by communicating openly with your lender, you can increase the odds that they will look favorably on your loan request.