

# How to defy all odds and secure a bank loan

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## Abstract

One of the potential hurdles to overcome in becoming an owner in a veterinary practice can be securing a business loan. This presentation will discuss the factors involved with gaining an approval for a business loan, starting with understanding the lender's perspective and concerns, and then exploring how you can improve your chances for success. Successfully navigating this process can be viewed as a 3-legged stool with each leg required for the success of the overall process. The legs of the stool include bank factors, borrower factors and business factors. Each factor is explored in this presentation.

**Key words:** financing, lending, banks, loan, ownership

## Introduction

My veterinary career has been spent in a predominantly dairy practice in southeastern Pennsylvania. Over the course of my career, I have been involved in 7 buy-ins, 3 retirements, 1 small animal practice split off and 2 purchases of neighboring large animal divisions of business. In 2001, I obtained my MBA degree. For over 9 years I have been a member of the board of directors for a community bank with 15 current branches. It is from these perspectives that I present this material.

No matter what business you are involved in as an owner, there are capital needs that need to be met. These needs may be operating capital for the day-to-day operations of the business, vehicle and equipment needs of the business, inventories and supplies for the business, building and facility needs and even goodwill values when purchasing an ongoing business. As a general statement, it takes money to make money! Sources for this needed capital varies with the specifics of the business and the ownership. Sources for this cash may include personal savings or investment, family help, equipment and trade leases, vendor payment plans, internal lending within a business and various government grants and loans. Even with all these potential sources of funding, many businesses find it necessary and desirable to obtain funding from commercial lenders. Examples of commercial lenders include banks, savings and loans, credit unions and the farm credit system. The remainder of this presentation will focus on understanding the commercial lending process, hopefully leading to success using this process to secure a loan for your business needs.

## The 3-legged stool analogy for securing a bank loan

The 3-legged stool analogy is used to describe many situations in which success is required in 3 different factors for there to be success overall. This applies to securing a bank loan, as there are bank factors, borrower factors and business factors that must be considered to achieve overall success. Before we discuss the 3 factors involved, it is important to review what banks do, how they work and what they want.

Essentially, banks core function is to take deposits from customers, handle financial transactions efficiently and borrow that money out to other customers to help them meet their

goals, needs and desires. Many banks receive other income from various service fees and related businesses, but their primary source of income for their operations and profits are interest payments from their borrowers. This is all accomplished with their net margin, calculated as the difference between their cost of funds and their interest income. Any loans that do not pay as scheduled or ultimately loans that fail to be paid back adequately, even through collection methods, cut severely into this margin. Costs include loss of income, increased internal costs to meet regulations to track problem loans and ultimately lost principal in failed loans. Banking is a highly regulated industry, with regulators that oversees how banks make loans and the risks they take, as banks are responsible to handle community funds in a fiscally responsible way. It is important to understand that in many ways, the banking industry is really about risk management. Those that do this well, succeed, while those that don't, perform poorly and represent a risk for their shareholders and their communities.

## Bank factors

Because of the above, there are factors that banks look at when evaluating loan applications. There are also factors that borrowers should consider about selecting potential banks to work with, as not all banks are the same in various ways we will discuss.

## The 5 Cs of lending

Traditionally, banks look at 5 Cs when going through the loan approval process: character, capacity, capital, collateral and conditions. We will discuss each to help understand how to improve your chances of success in the loan approval process.

Character of the applicant is difficult to measure, especially if the lender has no, or very little, experience with them. It is important to note that evaluating character for lending reasons relates to their character in their management of bills, debts, business decisions, work ethic and relations with vendors and their community. Quantitative proxy measures include credit scores, historic business performance and measures of living within their means. Qualitative factors may include trade references, past histories with the bank and the overall performance of the applicant in face-to-face meetings with the lender. The applicant should put their best foot forward, showing they are serious and prepared with well-developed plans for their business moving forward.

Capacity refers to the applicant having the expected financial capacity to pay back the loan from the expected cash flows available. Neither you nor the bank wants you to become committed to payments that you can't make. A common measurement used for this purpose is the debt service coverage ratio. This is a ratio of the available cash flow after expenses other than debt is paid, divided by the scheduled debt payments. Available cash flows are calculated as net income + depreciation + interest expense - living expenses or draws of the owner. Many lenders may expect a 1.2:1 ratio or higher, to allow for unforeseen circumstances and variable market conditions. When

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applying, it is important to identify your expected draws or needs from the business and not just state all profits will be used up for your family living. Having a documented track record of your family living, or draw history, is helpful to back this up.

Capital is a measure of your balance sheet strength. Think of it as what you own versus what you owe to others. The difference is actually your equity. It is desirable if there is a cushion of capital for tough times or if projections prove to be overly optimistic. The bank wants to get paid back so they want to see you have some other options if you need more capital for working capital or upcoming improvements or changes as your business adapts and grows. If this is inadequate, a guarantor or co-signer may be required.

Collateral is what banks need to secure as a secondary source of repayment of the loan. It sounds harsh, but if you don't pay as agreed to, what do they take to repay the loan and make them whole. Remember that banks do not want to lose the principal on any loan. Collateral assures them they will get their principal back. They also realize it is not always easy to get full value for something in a stressed situation, so a cushion is needed to make sure they can secure a loan in a liquidation situation. Some assets are also easier to cash in. For example, real estate is something physical and marketable. Accounts receivable, drug inventories and old equipment are hard to value and find buyers for. If most of the collateral of a veterinary practice is of the latter type, banks may be shy to use it at high values as a repayment source.

Conditions is the final "C" looked at. Conditions can refer to 2 separate issues in regard to lending. First, conditions can refer to general economic or industry specific conditions that may affect or give more risk to the business moving forward into the future. Economic and industry trends, price outlooks, demographic changes or regulatory expectations can all have effects on businesses. It is important to recognize these issues to estimate the risks of the business in the future. The second meaning of conditions in the loan approval process refer to the conditions the lender may require of the borrower to move forward with the loan. These conditions might include limits on draws, small business administration (SBA) approval of a loan, insurance requirements and guarantors or co-signers. These are conditions that the lender may require to manage their risks for the repayment of the loan.

In summary, character, capacity and capital give the lender an idea about the stability, management and financial capabilities of the borrower to help them determine the collateral and conditions under which they will make the loan to the borrower and mitigate their risks related to loan repayment. If the lender does not feel they can mitigate these risks, they may not approve the loan.

## Other bank factors to consider when applying for a loan

When applying for loans to meet your business needs, it is important to realize that not all banks are the same. Banks vary by their risk profile, expertise and focus within various industries and aggressiveness toward new loans, depending on their capital situation. If loan/deposit rates are currently relatively high, a bank may be less aggressive than if this ratio is lower. If banks can achieve all of the loans they have capacity for with loans collateralized with real estate, they may not be interested

much in non-real estate based lending. Banks are held accountable by their regulators for understanding the industries they work in, so individual banks may be averse to working on certain types of loans. Conversely, if banks work in specific areas of business such as professional businesses, such as medical, dental or veterinary practices, they may have both the expertise and allocated capital dedicated to this type of loan. Many of these banks are also SBA approved lenders, allowing them to guarantee up to 95% of the loan amount with government backing. It is important to do some research on banks you may have access to, helping to determine a good fit as a lending partner for your business. Also, don't feel that if you get turned down for a loan from one bank, no bank will borrow you the money you need for your business.

## Borrower factors

Now that you have a better idea about what lenders consider in the loan approval process, we will consider what you can do to strengthen your position in the lending process. First and foremost, consider what your credit score is, if it's accurate and what it says about you. Credit scores look at how you have dealt with the financial obligations you have had in your life; can you live within your means and how much unused capacity you have within your current obligations. First in importance is to pay all your obligations by their due dates all the time, plain and simple. Do you pay your credit card balances off each month or just the minimum payments required? Have you taken on new credit cards with increased balances just to pay your current bills and purchases? Your credit score reflects these issues in a quantitative manner.

Other borrower factors that funnel into the evaluation process include the capital and collateral situations you have, stability in your employment or business life and your demonstrated management capabilities. For example, someone who has been employed for several years in their current job position, looking to buy into that business, may be looked upon more favorably than someone whom has worked in several short-term jobs over the last several years and is now trying to buy a different business they have no experience with. All of these factors are evaluated through the 5 Cs process. Anything you can do to strengthen them over time work in your favor. Try to take an honest look at your situation from the perspective of lenders, as we have outlined in this presentation, to figure out ways to improve your credit worthiness over time. Lenders are evaluated in-depth over their approval processes to make sure they do not discriminate for race, ethnic background, sex, sexual orientation, location and any other appropriate category. But it is the banks job to evaluate credit worthiness and unworthiness and make their decisions based on that. Do what you can to improve your credit worthiness through the eyes of the lender.

Finally, do your best to present yourself in positive ways in your interactions with your lender. This includes being prepared, presenting yourself positively and having appropriate documents to back up your plans. You will need a current personal financial statement and at least 3 years of tax returns, so be prepared for that. Have a good idea about what your family living costs are and be prepared to describe your long-term plans in your business and community. All of these things show maturity, stability and responsibility. Remember, banks want to manage their risk!

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## Business factors

The final leg in the 3-legged stool analogy is the business factors involved with your loan. Obviously, this is an extremely important factor in the loan approval process. Since this is a business loan, it is the proceeds from the business that will allow for repayment of the loan. The lender will be evaluating if this is a likely outcome or if it presents an unacceptable risk to them. To do that, they need to be able to understand your business. They learn about your business, your plans for the future and the expected financial performance of your business through your interactions and dialogue with them, through any descriptive documents describing your business and through financial documents related to your business. It is important to realize they make their decisions based on the information presented to them, not all the great things about your business that you don't tell them!

For established businesses, considerations that may be evaluated include the history, past performance and stability of the business. Management abilities in the past and plans for management in the future, including transition of management abilities to new owners, may be considered. Operating agreements will need to be in place and shared with the lender. A current balance sheet and income statement will be required, along with past business tax documents and projections for the future. The lender is looking for a successful business in the past that has a good prospect for being successful in the future.

For a start-up business, a good, sound business plan is required to expect them to finance your project. They need to assess that you have not only veterinary skills, but also business systems and proper expectations of cash flows, working capital, equipment and inventory needs and a functional accounting system in place. You will need cash flow projections that show a positive return and debt coverage ratio that is positive, at least. At start-up, you and your business are often times almost like one in the same, so your personal finances and family living draws need to be acceptable and planned. Since start-up businesses, by their nature, are considered of higher risk, collateral, guarantees, co-signers, insurance requirements and other conditions can be expected. Lenders like to help business start-ups, but are required to make sure they are covered in case the business doesn't work out as planned. Once again, remember, banks are all about managing risks.

## Learning from setbacks

Not all loan requests get approved. I've outlined many of the considerations in this presentation why that might happen. It is hard to cover every possible reason for setbacks in a short presentation. The important thing to remember about setbacks is that you should use them as a learning experience. Ask questions and learn from any setback you might have. I was turned down for my buy-in loan from the first bank I applied at. We re-adjusted the buy-in structure, discussed different lenders with other financial advisors and found a bank that was willing to work with us. We adjusted a couple of the legs on the stool to allow us to move forward. You may have to do the same.

Especially in start-ups, but also for buy-ins or purchases, remember that a rejected loan application may indicate that you should reevaluate your business plan, pricing of purchase, or other aspects of your business because the refusal may mean your plan just isn't feasible or is of high risk. Neither you nor the bank wants that! Go back and work on your business to help assure it will be successful in the future. In start-ups, you may have to throttle back a bit on what you think you need to get your business up and running. You may buy used instead of new, scale back facility costs or ramp up the proposed charges for services you had been contemplating. You also may have to start-up a scaled back business, getting a bit of a successful history under your belt, and apply later for a loan, once there is a successful track record to work from. You may need to line up some family financing for a short period of time. The lesson is to learn from setbacks and move forward with new ideas. This lesson will serve you well as you enter the business side of veterinary medicine, now and in the future.

## Conclusion

It is important to learn how to navigate the lending process for many different things that you may want to do in your personal and professional endeavors. Hopefully, this presentation helped you to understand the process and the perspective that the lending industry has, so you can better navigate the system successfully. Remember to think of the process from the factors related to the bank, the borrower and the business. They all must be acceptable for you to find success in securing a loan. If at first you don't succeed, learn from the process, try again with a better application to the proper lender and move forward with your plans for your future.

