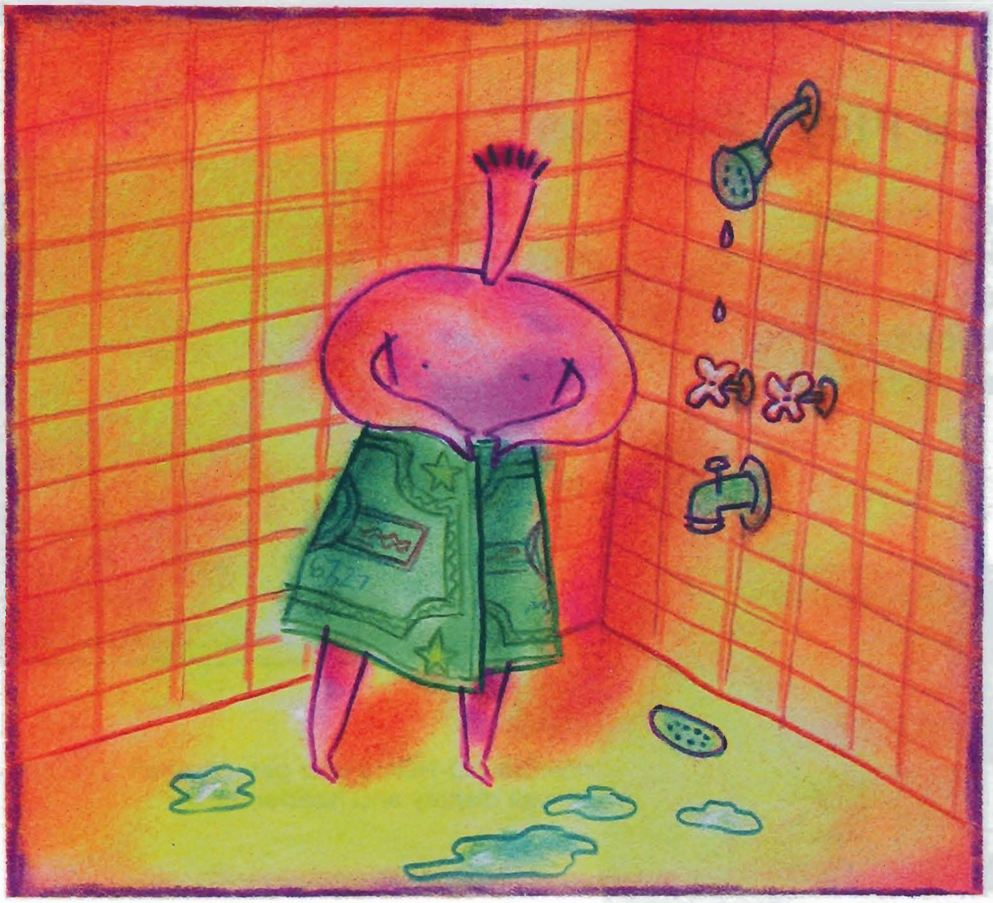


The Frog and the Princess Banker

A frog walks into a bank in search of a loan for his business. He approaches one of the bank's lending officers, Ms. Patricia Wack, and tells her that he needs a loan for his music store.

"Well, do you have any collateral?" asks Patricia Wack.

The frog extends his green little hand and drops one of those guitar-pin novelties that are frequently found at the front counter of music stores. After she examines the pin with noticeable contempt, Patricia Wack tells the frog that she must get the approval of the bank's president before she can approve the loan.

Patricia Wack marches down the hall and into the office of bank president Haywood Jalendmi, and smugly says, "Mr. Jalendmi, I have this frog in my office requesting a loan for his music store, and all he has for collateral is this stupid pin. I don't even know what it is, really. What do you want me to tell him?"

Jalendmi, a ripping guitar player with a cherry '62 Strat, modified Marshall stack and a vintage Tube Screamer (and a recent Weekend Warrior participant with his band of fellow bankers called "The Rockinfellas") examined the pin, stood up and told Patricia Wack, "Hey, it's a knickknack, Patty Wack; so give the frog a loan!"

Unfortunately, most music retailers don't experience banking fairy tales with such happy endings. Their fractured fables go something more like this.

A music retailer walks into his bank hoping to increase his line of credit from $100,000 to $300,000. He's escorted into the office of his newly assigned lending officer, Mr. Slim Chance.

"Before I can consider your loan request, I'm going to need copies of your business and personal income tax returns from last year, a review-level financial statement with appropriate disclosures from your CPA firm, interim year-to-date financial statements, detailed receivable and payable reports, an updated personal financial statement, a detailed business plan, financial projections and a statement showing the intended use of the borrowed funds you seek," says Slim Chance. "If I like what I see, I'll submit your loan request and supporting financial documents to our underwriting department. If it gets through underwriting, the loan request will then be submitted to the bank's loan committee for approval. It may take six to eight weeks to get this loan done, and we're going to need a lien on your house on top of your personal guarantee, there will be some hefty loan closing costs and we may end up having to take the SBA route. And by the way, I'm not sure I understand why you need this money. It appears to me that you'd be better off selling some of your excess inventory rather than borrowing more money."

Say what? It makes no sense. You've got substantial store assets and a long-standing relationship with the bank, but that doesn't seem to matter much to your banker. Why? Because bankers are ultimately assessing one factor when considering a small business loan—their risk. And there's no way a banker is going to sacrifice the bank's assets (and their job) on a loan that appears to be more than a minimal risk.

Is there anything you can do to greatly improve your chances of getting that loan? Yes, as long as you (a) understand the risks that your bank takes when lending you money, and (b) take measures to minimize those risks. Let's discuss.

Banking Basics

First, we need to understand how banks make their money. In its simplest terms, banks borrow money from their depositing customers by enticing them with interest earnings (these customer deposits are the bank's liabilities). The bank, in turn, lends this same money to their borrowing customers and charges them interest (these customer loans are the banks assets). How banks make their money is by simply charging their borrowing customers a higher rate of interest (let's say 9 percent) than the interest they pay to their depositing customers (let's say 4 percent). The difference between these two interest rates (5 percent) is called the "spread" and represents the bank's profit-before-operating expenses.

Easy money for the bank, right? Sure, as long as the loan doesn't go bad, become uncollectible and the bank get stiffed. It amazes me how much risk a bank takes to make such a small profit. For example, if a bank pays a customer 4 percent yearly on a $500,000 certificate of deposit (CD) and in turn lends you the same $500,000 at 9 percent per annum, the bank can make a potential profit of $25,000 ($500,000 x 5 percent) a year before operating expenses. A $500,000 risk for a $25,000 gross profit? Wow, big deal.

So how do successful banks make large loans, charge competitive interest rates, cover their operating expenses and return profits to shareholders? By managing their risk.

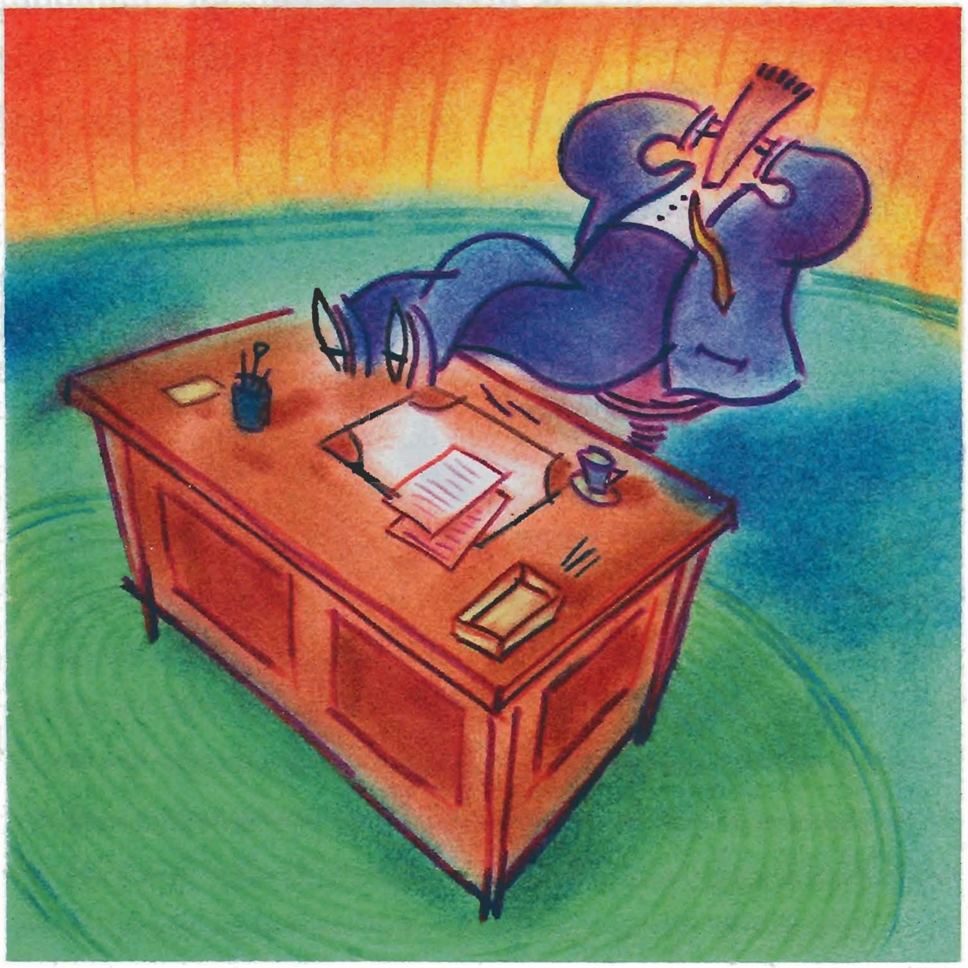
Risky Business

There's a variety of "things" bankers do to assess loan risks before making a business loan. The assessment process is often referred to as the "3 C's of Lending": Character, Credit and Collateral. Following are a few of the important tasks, commonly called "loan underwriting," that are performed by bank personnel during the assessment phase of a loan request.

Getting to Know You, Getting to Know All About You. Beyond a credit check, this step includes the time spent by your loan officer getting to know you as a person to see if they like you. Don't laugh. Their assessment of your intelligence, your ideas and your people skills has a direct bearing on their opinion of your ability to manage your business, make sales and attract customers.

Understanding Your Business. This step often includes your banker walking through your store, meeting key people in your organization, asking questions about your operations, your industry, your management style and your competition.

Analyzing Financial Data. This step includes gathering and analyzing financial statements, tax returns, detailed A/R and A/P aging reports and other financial reports to help determine how cash flows in and out of your business. This step is critical to properly structuring the repayment of your debt. A loan won't do you any good (and can do irreparable



harm) if it has to be paid back quicker than the cash to pay it is available. This event often occurs when retailers finance rental instruments with trade debt and short-term lines of credit.

Assessing the Achievability of Your Business Plans. This step includes testing the "reasonableness" of the assumptions that management has used in forecasting future revenues and expenses. It is essentially deciding whether a bank believes the owners have the managerial and fiscal abilities to successfully grow their business.

Yes, there's a lot of hoops you'll need to jump through to get the bank loan necessary to finance the growth and success of your business. So let's identify the steps that you can take to minimize your banker's risk, ease your pain during loan underwriting, improve your chances of getting that loan and create a streamlined process for future borrowings.

Money, It's a Hit

Here's what Pink Floyd provided their banker when they needed a loan for their "new cars, caviar, traveling set and new Lear Jet":

Good Credit. Good credit (a.k.a. "paying your bills on time") is extremely important to bankers because it demonstrates credibility. Sometimes good credit slips due to unexpected cash shortages (often the triggering event behind seeking the loan). But a blemished credit history won't automatically disqualify you from obtaining a bank loan. Be prepared to explain the cause of those shortages and how you're prepared to prevent them in the future.

Reliable Financial Statements. Financial statements are the most relied upon document by any banker for (a) assessing the profitability and liquidity of a business; (b) extracting key financial data related to cash flow, inventory levels and turns, and working capital; (c) properly structuring both old and new debt; and (d) forecasting growth trends and borrowing needs before they happen.

In that financial statements are submitted with every loan request, bankers can quickly appraise the reliability of these statements by assessing their format and presentation, as well as the expertise of the CPA firm that prepared them. Accordingly, it's imperative that a music store owner's CPA firm understand their business and industry. Plus, bankers love having another set of trained eyes focused on the financial condition of their loan customer.

Adequate Collateral. Be prepared to provide your bank with "tangible" assurances that you will repay their loan. The bank will undoubtedly want a security interest (a.k.a. "lien" or "UCC Filing") on your corporate assets (inventory, receivables, equipment, fixtures, etc), as well as the personal guarantee of repayment from the store's owners.

But bear this in mind: collateral is a banker's least desired means of loan repayment; it's viewed as a "when-all-else-fails" course of action.

Achievable Financial Forecasts. Just like financial statements, a properly assembled set of financial forecasts (a.k.a. "projections," see *Think Tank*, July '99) can illustrate the store owner's expectations for future revenues, expenses, cash flows and borrowing needs. These forecasts also create a baseline by which the business can measure its future financial results as they happen and take corrective action when needed. The bank often requires these statements be prepared by the store's CPA firm, in order to assure reasonableness and conformity of presentation for the business' financial statements.

NAMM's Cost of Doing Business Report. NAMM has a fabulous resource book called *The NAMM Cost of Doing Business Report*. This publication is the perfect tool for communicating the vital information and statistics about the music retailing industry to your banker. It contains industry ratios, trends and financial statistics organized by store type, sales volume and geographic region. The book is available at the NAMM Shows, or by calling NAMM at 800-767-6266.

The NAMM Cost of Doing Business Report is the perfect tool for communicating some of the vital information about the music retailing industry to your banker.

Some Final Thoughts

Don't be discouraged if your banker turns you down for a loan. It may simply mean he or she doesn't understand your business and, accordingly, isn't comfortable with the perceived risk.

If you are approved for a loan, make sure you have meaningful discussions with your banker about the appropriate loan facility and length of time for repayment. You don't want to have to "go back to the well" in six months because you didn't borrow enough or you're repaying the loan too quick.

Follow these borrowing guidelines and one day you'll kiss a frog who turns into a bodacious banker that is mesmerized by your financial statements, thus turned on by the size of your collateral, consenting to lending relations with you at prime only to fall in love with your projections. And you'll both borrow happily ever after.

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