How to Approach Debt Funding

What's Needed, What's Affordable, and Making It Happen

As a small business owner, you know that funding is essential to growing your business—whether you're opening a new location, hiring more employees, buying new equipment, launching new products/services, or expanding to a new market.

This overarching need for funding leads to some important questions:

- How much money do you need?
- What can your business afford?
- And, what can you do to pursue this funding?

In this exercise, you'll explore the answers to these questions.

How Much Do You Need?

Knowing how much money you need to support your business growth is important. The amount you need is directly tied to how you plan to use it. Businesses that seek debt funding with the mindset that one can never ask for too much may run into situations where they either can't get a loan because of the high amount they're seeking, or they manage to get a loan but are overburdened with debt that they struggle to pay off.[1] On the other hand, businesses that seek smaller amounts than they need might struggle to successfully implement their growth plans.

So, what can you do to find out how much money you need to support your growth plans?

- Determine the uses of the money—the more specific you are, the better.
- Based on your plan of how you'll use the money, develop **financial projections** using your company's history (past balance sheets and income statements) and your most informed prediction. Use these projections to estimate your expenses and the revenue you'll generate by taking out a business loan.[2]
    - For more on this, check out Financial Projections.
- Perform a break-even analysis to determine how long the business loan will need to support the growth before your company becomes profitable or can at least avoid a negative balance.[3]
    - Check out the break-even analysis **template** from SCORE.

How Much Can You Afford?

To figure out the loan amount you can afford, calculate your debt service coverage ratio (DSCR). This ratio shows how much cash you have available to pay off your debt.

DSCR Equation:
DSCR = Net Operating Income / Debt Obligations[4]

Tip: Your net operating income is usually represented by your EBITDA: earnings before interest, taxes, depreciation and amortization.

Let's look at an example. Let's say the annual net operating income for a business is $420,000, and its annual debt obligation is $325,000.

Therefore, based on the formula DSCR = net operating income / debt obligations, their DSCR is 420,000/325,000 = **1.29**.

Now, what can you tell from this DSCR?

Based on a DSCR of 1.29, the business in this example is in decent shape to pay off its debt with the cash flow they have.

This DSCR shows that the business has 29 percent more income than they need to pay off their debt.

The higher the DSCR, the better. Here are some handy guidelines:

DSCR Value	What does it mean?
Below 1	You have negative cash flow and will not be able to pay off your debt with your current cash flow.
1	You have the exact cash flow on hand to pay off your debt.[5]
Below 1.15	Lenders might consider your loan as high risk, as there isn't much room for unexpected expenses that might seep in.[6]

A low DSCR makes your loan risky.[7] This means that, most likely, you won't receive as many loan offers, and that the ones that are offered to you will charge more in interest because you are perceived as a riskier loan. As a result, your total loan cost could be much higher.

Action Plan

Once you have an idea of how much funding you need to grow your business and know if you can afford that level of funding, start preparing to pursue the business loan.

The checklist below can help you pursue the funding you need.

MY ACTION PLAN CHECKLIST FOR PURSUING DEBT FUNDING

☐ Check my credit score.

Your personal credit score will influence your lending options. Why? Because how you handle your personal finances will give lenders a peek into how you may handle your business payments.

Lenders will typically view credit scores above 720 as very healthy, which means that you'll likely have several lending options. Credit scores below 630 are problematic and could mean that you won't qualify for the best interest rates and will have fewer options.[8]

If your credit score isn't desirable, you can take steps to raise it. Check out **12 tips** to improve your credit score.

Need your credit report? Get it from the three major credit reporting bureaus—Experian, TransUnion and Equifax—who are required by law to give you a free report once a year.[9]

For more on this action item, check out *Checking and Monitoring Your Credit*.

☐ Organize my documents.

In *Preparing for Loan Underwriting and Examining Your Loan Agreement* you may have taken the opportunity to explore the documents and financial statements you'll need to gather to pursue a business loan.

Here's a quick recap of the documents:

- Statement of purpose/uses
- Business plan, including:
  - Cash flow statement
  - Balance sheet
  - Income statement
  - Personal finance statement

☐ Explore funding options.

In *Explore Your Debt Funding Options* you may have taken the opportunity to review the many funding options you have—their pros and cons, and other details—as you begin shopping for business loans.

Here’s a quick recap of the potential funding sources:

- Family and friends
- Traditional bank
- Online bank
- Credit union
- Credit cards
- Trade credits
- Finance companies
- SBA-backed loans

☐ Prepare questions for potential lenders.

By doing some early research, you can narrow down your list of lender options to ones that better fit your needs.

Consider checking the following items to get a grasp on potential lenders’ criteria for assessing your loan request and the extent of their offers:

- Their minimum requirements in terms of annual revenue, average bank balance and time in business
- Their requirement for personal guarantee and/or collateral
- The average loan amount they offer
- How quickly they can provide the loan
- The types of fees they charge—closing fee, prepayment penalty, etc.

For some of the above items, a lender may not be able to give you clear and detailed information until you apply for a loan with them, but getting some idea about these items will still be helpful.

☐ Build relationships with potential lenders.

It’s never too early to start building a relationship with your lenders. Even before you formally apply for a loan, visit your local bank, for example, and spend time with your banker—share financial information about your business, tell them about your growth plans, and ask them for advice. When you share information and seek advice, you’ll help build trust between you and your banker. They’ll feel invested in your success and will share information that can help you make better and timely choices—for example, which type of and how much loan to take out.

For more on this action item, check out *Building a Banking Relationship*.

Resources

- Review this **article** with detailed examples and a three-step process on how to calculate the capital needed to grow your business.
- Demonstrate your ability to pay back a loan. Here's a handy **article** from the SBA on projecting and managing the basic numbers for your business.
- Visit this **site** to find out how SBA's funding programs may help finance your growth plans for your business.
- Contact your local **SCORE** and **Small Business Development Center** counselors for free and confidential assistance.

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[1] *How to Determine How Much Money You Need When Getting a Business Loan*, Barry Moltz (Dec. 10, 2018), https://www.americanexpress.com/en-us/business/trends-and-insights/articles/how-to-determine-how-much-money-you-need-when-getting-a-business-loan/, (accessed May 3, 2019).
[2] Ibid.
[3] Jared Hecht, Financing for Business Expansion: The 4 Best Steps, https://www.inc.com/jared-hecht/financing-for-business-expansion-the-4-best-steps.html, (accessed May 3, 2019).
[4] Robert Schmidt, How to Calculate The Debt Service Coverage Ratio (DSCR) (February 17, 2016), https://www.propertymetrics.com/blog/2016/02/17/how-to-calculate-the-debt-service-coverage-ratio-dscr/, (accessed May 3, 2019).
[5] Dale Van Eckhout, Capacity and Credit, https://www.sba.gov/offices/district/nd/fargo/resources/capacity-and-credit, (accessed May 3, 2019).
[6] Ibid.
[7] Bill Fay, How to Raise Your Credit Score, https://www.debt.org/credit/improving-your-score/ (accessed May 3, 2019).
[8] Ibid.
[9] Ibid.