



Having bank financing problems? Know the rules of the game!

Engine builders from coast to coast have experienced problems with financing their business from the traditional banks. They truly feel they have been *blackballed* from obtaining proper and fair financing from their banking institution. Many also have been forced to over secure what loans they do have which can “eat into” the business and personal equity position. This doesn’t have to be the way of doing business with the bank if one understands the rules of the game. This article will review the criteria business owners must be aware of and address in order to have a positive banking experience.

The first rule to clearly understand is that the average bank is not a risk lender. They are equity lenders. Banks want the “sure thing”, that is, loan the money out, get paid as agreed to on time, and collect interest. When you think of it that is a pretty simple game plan but in reality the company asking for the money must meet proper financial criteria to maximize its banking relationship. That is where the business owner has to study and understand the rules.

The following are the basic analysis that the bank will do on your business each time you hand them a Financial Statement. Do your own analysis before you hand the Statement to the bank and you will be able to determine what kind of reception you should expect from them.

1. Current Ratio

This ratio is sometimes called the ‘working capital’ ratio and it tells the banker how easily the shop can meet its current debts.

The banker will take the total of your **current assets** such as your cash in the bank (bank balance), the accounts receivable balance, inventory on hand, and short-term notes (i.e. 30 or 90 day term deposits), and **divide it by the current liabilities**.

Current liabilities are items payable within the next accounting cycle such as your trade payables, principal and interest on loans, and all taxes (payroll taxes, sales tax, corporate income tax). If you give the bank an annual Financial Statement, the current liabilities will be debts that are due within the next year. If you provide the bank with a quarterly Financial Statement, the current liabilities are debts due within the next quarter.

A strong current ratio above the generally accepted 2 to 1 (written 2:1), (or current assets twice that of current liabilities) will contribute a smile to your banker’s face.

If this ratio is declining from one year to the next, it could be a very strong sign to the bank the business is heading into trouble.

2. Debt to Tangible Net Worth (Retained Earnings)

This ratio is an indication of how much a business is borrowing in relation to the amount of equity invested in it. Note the word “tangible”.

This means if you have a number on your Balance Sheet in the Assets called “goodwill” – it is traditionally meaningless to a banker’s mind as they know they can’t collect “air” – so they take that number off the Balance Sheet all together which in essence reduces your Retained Earnings number. The bank wants to see genuine (concrete, obvious, solid) net worth (retained earnings). The lower this ratio goes the greater the cushion against losses to creditors.

In our industry, a debt to tangible net worth ratio of 2:1 is often cited as acceptable. **Total debt divided by net worth**. That means total borrowing (total of all debt, not just what you owe the bank) should amount to no more than two times the amount

BUSINESS NEWS

BY BOB GREENWOOD

of tangible net worth (retained earnings) in the business.

A ratio under two (for example a ratio of 1.53 to 1) would make the business appear to be in good shape. A ratio of .50 to 1 means you are in great shape.

Build credible assets and reduce your debt to within this criteria and I'm sure your banker will pay for your next lunch out together because he/she wants your business.

3. Gross Profit Percent

This is a key measure to a bank as it is often used to determine the health of a shop's sales transactions.

This percentage indicates proper execution of a businesses mark-up and pricing policies.

A falling gross profit percentage from one year to the next could indicate the shop is not increasing its prices in relation to its costs. Gross Profit percent is calculated by taking the **total gross profit dollars and divide it by the total sales dollars**. An engine building shop should realize a minimum total shop gross profit, including the labor component without the machinist wages factored in, of 70%.

We find the most common problem as to why a shop does not achieve 70% is due to ineffective labor billing practices. In other words labor not being billed out for the time spent and at the wrong rate in relation to the machinist wages paid.

4. Age of Receivables

This ratio needs to be looked at in relation to its selling terms with the customers. In our industry we work in 30 day terms, and the banks are clearly aware of that.

Most banks are not given the sales mix of the shop by the owner; for example 60%

of our total sales were a charge during the year and the rest were cash or credit card. Without that information the bank may assume 100% of the sales were a charge to begin with. They would calculate the age of your receivables by taking the **accounts receivable balance and divide it by total sales and multiply that answer by 365**.

Obviously when the ratio works out to 45 days, 60 days, 90 days or more, then the shop's credit policies and collection procedures definitely need some attention.

As well, the ratio must be compared to previous years to see if the collection period is lengthening. Total accounts receivable balance, in an independent engine rebuilding shop, should not exceed 20% of average monthly sales. Average monthly sales are calculated over the last 6 months. Accounts receivable are a credibility (shop to banker relationship) destroyer in our industry.

5. Age of Payables

This ratio shows the banker how long the shop is taking to pay its suppliers.

If a shop normally has 30 days to pay its bills and if the ratio works out to more than that — for example 63 days — the banker may assume that the shop will have a poor relationship with suppliers.

A poor relationship with suppliers is a risk factor the bank does not want to buy into.

To calculate the age of payables **take the total payables and divide it by the total purchases and multiply that answer by 365**.

It is extremely beneficial to pay in full by the 10th of the month following because suppliers usually offer an additional discount (2% net 10th is the norm). This discount would go directly to

the shop's bottom line.

However, when a shop cannot take advantage of discount opportunities, we have found that the shop usually has a problem with accounts receivable and/or the total shop gross profit percentage, as a trend in the business.

6. Tangible Retained Earnings Growth

In order for an engine building business to grow, it must be profitable "after tax". These after-tax profits increase the retained earnings number of the business. Plan your business to have a minimum retained earnings growth of 20% per year. Consider that with healthy retained earnings, Management will never be unemployed and competent staff will have job security for life.

Management should also properly plan the payment of dividends with the accountant, since this method of shareholder remuneration reduces the retained earnings number on the Financial Statement.

As you can appreciate, banks can also look at other criteria when evaluating your business, but you can be assured that when all of the above ratios and guidelines are met, that reception by your bank will be far more positive and constructive compared to the cooler reception many shop owners may otherwise experience. Slow down and do the math. Focus on building and following these guidelines in your business and I am very confident your business financial stress levels will come down substantially and your banking relationship will be better than it has ever been.■



Robert (Bob) Greenwood is President and C.E.O. of Automotive Aftermarket E-Learning Centre Ltd. (www.aaec.ca) providing shop business management resources and interactive education through the internet. He also delivers live industry specific business management courses. Bob writes monthly articles for Canadian Technician Magazine in Canada and Aftermarket Business Magazine and Engine Professional Magazine in the United States. He can be reached at 1-800-267-5497 or E-mail him greenwood@aaec.ca.