

## Credit for Growth

05/08/06

I think I'm going to need some financing this summer, to help me grow. I've gotten a few larger contracts, and I know that the clients are good. There are progress payments, but I may have to juggle payroll in between payments from the client, and I don't want to get caught short. What advice can you give me?

This question comes from the owner of a small, growing service company. They have a good offer, are facing a good opportunity to expand. The owner is smart to think ahead, to how she will handle gaps in cash flow, as she absorbs the new business. Let's take a look at how credit works, and what this owner will need to be prepared for, if she does decide to apply.

Credit lines allow you to borrow repeatedly, up to an established amount, which is good if you have swings in your cash flow throughout the year. There are several uses for credit lines. The most common use is as an account you can draw upon, to deposit money into your main checking account, to cover bills during a cash flow gap. This is probably what this owner will want to set up, to protect against shortfall as she ramps up her new contracts.

When the owner applies, and is approved for the line, she will probably get a book of "checks" that she can use to draw on the line of credit when she needs the

funds. At the point in time that she needs funds, she can write a check and deposit it in her checking account. Or she can use the checks to pay off a large bill.

One thing to keep in mind is that most banks have a limit of the number of checks that can be written on a credit line each month. In that case, it usually makes sense to plan out how much you will need. Then transfer the money from the credit line to your checking account, where you can write many more checks.

At some banks, you may be able to have your credit line attached to your checking account. This can help to protect the business from overdraft charges. If checks that you've written come in for payment, and the funds you have deposited in your account haven't actually cleared, the credit line acts as backup, to cover the shortfall. This type of backup is preferable to incurring significant charges and hassles that go along with bounced checks. In this situation the credit line helps to insure that your business operates responsibly, by helping you to cover the checks that you write against deposited, but not yet cleared, funds.

Do remember that credit lines are usually considered to be temporary loans. Many banks require you to pay off the credit line fully, at least once during a year. Ask your banker what terms

they require on their lines of credit, and be sure that you can meet those terms before you start to use the money. Plan out how your contracts and invoices will flow during the year. As cash comes in from the contracts, remember to set aside funds to pay down the credit line, to meet your bank's terms and to remain credit worthy.

Some business owners have found it challenging to stay on top of their open balances. They open the line of credit, use it, and then find they need more money. If this happens to you, you want to first figure out why.

There can be several causes for a continued or increasing cash shortfall. Ask yourself these questions.

- Are you making enough money to be profitable? Don't forget you have to cover the cost of delivering on your contracts, as well as the cost of overhead. If you aren't making enough profit, don't let the credit line be a band-aid that gets you into worse trouble. Go back to your customer and re-negotiate terms, or figure out how to limit the services you deliver to something that is more profitable.
- Are you getting invoices out on time? Sometimes owners find that the availability of money from a credit line means they get distracted from timely invoicing. Check

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that you are invoicing regularly, and as soon as allowed by your contracts.

- Are you collecting on your invoices in a timely fashion? Even if you do get invoices out on time, you still have to keep after your clients to pay their invoices. For a short while, it may seem easier to draw on the credit line than it is to call and hassle a customer to pay up, but that isn't healthy for either your or your customers. Check on your outstanding accounts receivable, and call everyone who is over 30 days past due. Make notes on when they promise to pay you, and follow up if their payment doesn't come in as planned.
- Did you accurately forecast your growth needs? Sometimes owners will pick a best case scenario when planning how much credit they will need. Or, the bank will limit how much the business owner can get in terms of credit. In either case, figure out how to operate with the credit you've been given, with a plan to eliminate debt as you go forward.

Whatever the reason for increased credit, be careful not to exceed your credit limits. Know how much credit your business can comfortably handle, and stick within that limit. You don't want to take on more risk than your business can afford, even if it means turning down, or delaying,

an opportunity. Remember that growth can be a 2 edged sword – opportunity and risk. Be prepared to learn as you move forward with your new contracts, keeping a watchful eye on profitability throughout. Be ready to act quickly to make changes if profits drop below forecast.

Once you draw down on your credit line, write out your plan for paying it back down to zero. Then stick to the plan. If your plan includes making a monthly payment to the bank, schedule it as a monthly bill, so you don't overlook the obligation. If your plan is to use a portion of incoming money from clients, be sure to write the check to the bank as soon as the money comes in.

It can be easy to let the credit line float up to its maximum amount. And then hard to get that credit line back down to zero. If you find yourself going more than a couple months only paying the minimum on your credit line, be careful. This may be a symptom that you need to re-work your contracts, or operating model. Paying only the minimum is an indication that you are not making enough money to cover your obligations. Fix the problem before it gets worse. If you can't figure out how to fix the problem, ask for help. Talk to your banker, business advisor, accountant, or anyone else whose advice you respect.

Keep in mind that if a credit line remains open for a long time, paying it off may also get tougher because of tax implications. In the year you incur the expenses, and use the credit line to cover short fall, you probably take tax deductions for those expenses. That might give you a very low tax bill that year, but you still have the credit line to pay off. In later years, you have to pay taxes on the money you earn to pay that line off, since you took the tax benefit of the expenses in the previous year. Plus, you've incurred interest charges throughout the year. All of that can add up, making it harder and harder to get your credit line down to zero over time.

If your credit line remains open for more than a year, you may want to talk to your bank about converting it to a term loan. Term loans are typically for 3-7 years, sometimes shorter, sometimes longer. They are usually used to purchase new equipment, increase working capital, fund expansion, or finance receivables or term out an existing obligation such as a credit line. A term loan is a schedule of payments, usually monthly, over a number of years.

Each payment on a term loan typically includes both interest and principal. The result is a zero balance on the loan at the end of the term. Often term loans are offered at a lower interest rate than lines of credit. Having a

## Credit for Growth

05/08/06

monthly bill to pay to the bank can help enforce your commitment to getting the credit balance to zero.

If you do need to apply for a loan, come prepared. Be specific as to amount, terms, purpose. Provide financial statements, prepared with the help of your accountant. Be aware the bank will likely ask for personal guarantees – you are their last line of defense, if your business fails to do a good job at managing the money they loan to it. Provide a thorough, well thought out business plan. Plan conservatively, and ask for enough money to get the job done. Whatever you're borrowing for, be sure that your loan can be paid off, even if several things go wrong with your plan. List things that could go wrong with your business and how you would deal with them – give your account manager ammunition when presenting your loan for approval. Be ready to negotiate.

Here is some of what banks look for, when evaluating loans. Liquidity: shows how effective you can be at handling cash flow. Leverage: the ratio of debt to worth shows how much you rely on the borrowed money. Remember, the less you need the money, the more likely you will be to get what you want. Inventory turnover tells the bank how well you monitor and manage your inventory. Accounts receivables and collections are important to the bank. They want to know you

have a good credit and collection policy. Your average collection period should be very similar to your payables schedule.

Never confuse debt with assets, and don't expect the bank to do you a favor or bail you out. Use credit, or leverage, based on your company's profitability and demonstrated ability to put cash in the bank. Keep control of your business by operating profitably, and using credit appropriately, to fund growth. Only use credit to fund gaps when you know the cash will be coming in to pay off the money you borrow. Build a fiscally strong company.

Looking for a good book? Try *Streetwise Financing The Small Business: Raise Money For Your Business At Any Stage*, by Charles H. Green.

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