

## READING

**BORROWING NEEDS BY BUSINESS TYPE OR INDUSTRY**

Businesses within the following types or industries tend to have similar functions, working asset needs, operating cycles, and capital requirements:

**Manufacturers** tend to have a large investment in fixed assets, including machinery and equipment necessary to make a product. This generates long-term financing needs for the fixed assets. A secondary financing need can arise with long-term financing for any permanent investment in accounts receivable and inventory. If the business is seasonal, short-term financing for temporary increases in accounts receivable and inventory may be necessary.

**Wholesalers** do not have such a strong need for fixed assets and related financing. Their primary assets tend to be accounts receivable and inventory. Accordingly, there is a limited need for long-term financing of fixed assets, but a greater need for long-term financing for permanent levels of accounts receivable and inventory. A wholesaler also is likely to need short-term financing for seasonal or other temporary build up in accounts receivable and inventory.

**Retailers** tend to have a large investment in inventory, followed by fixed assets if a store location is owned. As a result, long-term financing usually is needed for permanent levels of inventory, along with short-term financing for seasonal or other temporary build-up of inventory.

**Agricultural businesses** have fixed asset needs, primarily for equipment, as well as annual purchases of feed, seed and labor that start the cash cycle. This results in long-term financing needs for equipment, as well as short-term financing need for the start-up costs.

**Service businesses** generally do not carry inventory, so financing needs are primarily centered on accounts receivable. Long-term financing usually is needed for permanent levels of accounts receivable, along with short-term financing for seasonal or other temporary build-up of accounts receivable. Depending on the type of service provided, fixed asset investment may not be very prominent.

**Construction businesses** have cash needs for materials and labor. However, many subcontractors are not paid until a job is completed, resulting in long-term financing needs and short-term financing needs for the build up of accounts receivable, depending on the nature of the contracts involved. Some long-term financing may be needed for equipment, but this need is usually secondary to the financing for accounts receivable.

**General Borrowing Needs by All Businesses**

A business banker can anticipate the types of borrowing needs that many companies will have simply by understanding cash flow cycles of different industries and business types. Nevertheless, businesses of all types have some common borrowing needs.

**Borrowing cause vs. purpose (Use of funds)**

Borrowing cause relates to why the business has a cash shortfall, compared to how the funds are being used—usually the loan purpose. Depending on the situation, the cause and purpose may not be the same. One example may be the owner taking money out of the business to purchase an airplane for personal use, leaving the business unable to finance seasonal build-up of accounts receivable and inventory. Another example is a business using excess cash on hand to purchase machinery, leaving it unable to fund payroll on the following Friday. Both examples illustrate a “disconnect” between the borrowing cause and the use of funds.

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Because loan repayment most likely will come from events related to the borrowing cause (even an outright reversal of the borrowing cause), understanding the true borrowing cause is a key task for the business banker. Also important is recognizing other sources of repayment (such as additional capital contributions by the owners or sale of collateral) that can be used. In most cases, a business banker will identify a primary source of repayment that is closely related to the reversal of the borrowing cause. A secondary source of repayment will include items, such as sale of collateral or guarantor support.

Understanding why the business needs to borrow is a key part of the lending decision process and is a critical component for appropriately structuring the loan that the bank may approve.

**Primary borrowing causes**

- **Growth in business sales**
  - Permanent accounts receivable and permanent inventory
  - Temporary or seasonal build up
- Declining efficiency of working capital accounts (current assets and current liabilities)
  - Slower collection of accounts receivable due to increased dating terms granted to customers, or customers taking too long to pay invoices
  - Slower utilization of inventory due to length of manufacturing process or reduced demand for a product
  - Faster payment of suppliers due to reduced dating terms or taking discounts for more prompt payment
- **Fixed asset purchases**
  - Expansion of fixed asset base
  - Replacement of existing fixed assets
- **Other borrowing causes**
  - Restructuring of business liabilities
    - Pay off existing accounts payable or accruals
    - Refinance or pay off existing debt, both short-term and long-term
    - Conversion of short-term debt to long-term debt
  - Owner buyouts
  - Distributions or dividends to owners
  - Unprofitable business operations
  - Miscellaneous, one-time expenses such as litigation settlements and bulk or large-volume materials purchases

With an understanding of the business type, cash flow cycle, and the general types of borrowing needs of most businesses, the lender can now begin to identify possible lending arrangements.