

What to Do When the Bank Pulls Your Line of Credit

Entrepreneur takes a close look at who's lending and when the cost is too high.

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Ryan Weber considered himself a prudent business owner. He borrowed \$6,000 from family members to start [Radiant Photography](#) in Las Vegas, and he paid them back--with interest--in three years. To cut expenses, he rented a studio when he needed it, instead of building his own. And when Advanta, a credit card company in Spring House, Penn., offered a business credit card with a \$7,500 line of credit, he accepted it.

"Having \$7,500 in reserve really helped," Weber says. "In case a check didn't go through from a client, it was there to rent studio lights or pay my cell phone bill."

Then last spring--a few months before declaring bankruptcy--Advanta pulled the credit lines of 1 million small-business customers, including Weber. It also capped their credit cards at the level of their outstanding balances, effectively cutting off their access to emergency cash.

"I was suddenly working without a safety net," he says. Like many small-business owners, he depends on timely payments from clients to pay his own bills. But in this economy, invoices are stretching to 60 days or longer. "My wife and I are paying the mortgage on our home and making payments on one car," Weber says, "and we have a 6-month-old daughter. Some months, I receive \$5,000 from a single commercial client; other months I'm lucky to get two checks from magazines for \$400 each. It's very stressful trying to meet our monthly costs with no backup funding."

Millions of small-business owners are suffering through the same predicament--and worse--as unprecedented numbers of banks pull back or cancel credit lines. In the first six months of last year, 38 percent of small businesses reported a decrease in their lines of credit or credit card limits, according to the National Small Business Association. More than 40 percent of small-business owners who had requested extensions of their credit lines were turned down, the National Federation of Independent Business reported, and many of those who received extensions were required to increase collateral, pay higher interest rates and/or agree to more stringent terms.

"A few years ago, losing a line of credit was a crisis--today, it's the new normal," says Marilyn Landis, a board member of the NSBA in Washington, D.C. "We business owners have burned through our personal savings, seen our credit card limits go down as our interest rates go up, and now our bankers are taking away our credit lines. But we still have customers who will pay us in 30 days and employees who expect to be paid every two weeks."

Losing credit suddenly can devastate a small operation. "Now I'm trying to keep my company running while I look for another bank to take on the \$160,000 I still owe," says a Colorado technology consultant who asked that his name not be used because he is afraid of jeopardizing his relationship with his bank--the same bank that had courted him three years earlier and offered him a \$250,000 line of credit, and pulled it entirely for 2010.

"It drives you crazy. I'm doing a good job, I'm still making money, and if I can't find a new bank to take on my credit line, I could be forced into bankruptcy," he says.

Even as the economy improves, the credit markets will remain tight through 2010. Forecasters predict that the home

mortgage crisis will be followed by a similar crash in commercial real estate. "Until this sorts itself out, banks are caught between a rock and a hard place," Landis says. "They want to support local business but know that state and federal regulators will come in to evaluate their loan portfolios. In the name of making banks better, they are being forced to turn down loans because of collateral or credit scores they would have accepted previously." Many economists predict little easing of business credit until sometime in 2011.

In the meantime, what's a small-business owner to do?

Entrepreneur talked to financial experts, borrowers and lenders to analyze the options and find ways to cover monthly shortages, pay employees and simply stay in business.

We looked beyond the troubled national banks, such as Citigroup and Bank of America, which have cut way back on business lending. (CIT Group, the institution most friendly to small business, declared bankruptcy in November.)

We discovered that money may be available from local community banks or, surprisingly, local credit unions. Less surprisingly, a variety of alternative lenders has stepped up to offer a mix of loans based on your outstanding bills, daily credit card receipts or future purchase orders. You can even use your retirement funds to pay your rent. Many of these products carry fees and most charge interest rates that, in pre-recession days, would have left you gasping.

"It's become the wild west of financing outside the traditional realm," Landis says. "Be really careful."

Community Banks

Many of the country's 8,000 community banks have managed to stay clear of the mortgage meltdown and still have money to lend. But they, too, are subject to regulator scrutiny and are struggling to diversify their portfolios. A bank with several outstanding loans to pizza restaurants, for example, will not take on a request from a similar business, no matter how strong the application. Banks are even trying to lessen their exposure to certain parts of town or specific shopping centers.

But if one bank turns you down, ask those loan officers what other local institutions are making loans to your industry or area. You can find independent banks in your area via the bank locator on the website of the [Independent Banks of America](#), or by just driving down Main Street.

John Blatz, vice president and senior client manager in the Shawnee, Kan., branch of Brotherhood Bank and Trust in Kansas City, says, "We are still issuing lines of credit to borrowers who are relatively local. Community banks want an intimate understanding of each customer and his or her industry before granting a credit line."

Unlike national or regional banks, where decision-makers grant credit according to strict underwriting standards, "We don't take a cookie-cutter approach," Blatz says. "If you've had a loss in the past one or two years, we want to understand why and see that you've made repairs to restore profitability."

Another piece of advice: Don't ask for a loan the first time you walk into a local bank. Community bankers want to get to know you first. "Go in and build a relationship," Blatz says. "Ask a loan officer how the bank feels about your type of business. What is the bank's sweet spot for credit lines? If you discover that they already have too many companies like yours in their portfolio, or that the credit line you want is too large, isn't it better to find that out in a casual conversation?"

Credit Unions

Your best bet for getting a new line of credit may not be a bank at all. During the banking crisis, thousands of credit unions quietly amassed billions of dollars from members' savings and interest from home and car loans. Many of them are moving into business lending and offering credit lines--if you can find them.

Mike Hales, a director of the National Association of Credit Union Service Organizations, a trade association in Newport Beach, Calif., calls credit unions the world's best-kept secret--"and that's not a compliment." The country has 7,800 credit unions, 2,000 of which make business loans to their members, Hales says.

And many credit unions are offering membership to the public. The Boeing Employees Credit Union, for example, is open to anyone who lives in Washington. You can find credit unions in your community on the website of the [National Credit Union Association](#). Call to ask if they make business loans and how to become a member if they do.

"Throughout the country, credit unions are increasing their small-business lending capacity," says William Beardsley, president of the Michigan Business Connection in Ann Arbor, an organization that manages commercial loan programs for Michigan credit unions. "In the last several years," Beardsley says, "30 cooperatives have formed around the country to manage business loans for hundreds of credit unions."

Alternative Sources

If you strike out at the bank or credit union, hundreds of alternative financing companies can provide you with short-term cash. But be warned: Many of the agents selling these financial instruments used to be mortgage brokers, and we know what happened there. Business-to-business lending is unregulated. Because usury laws don't apply and no industry group imposes standards, these products can carry extremely high fees and interest rates. Not unexpectedly, competition is fierce

and a spokesperson for one company defends annual interest rates of 36 percent by pointing to competitors that charge 80 percent.

"Ask lots of questions," Landis advises. "Check with your peers and industry groups and check out the competition."

When talking to the loan agent or broker, ask:

- What is the effective annual interest? Many salespeople quote interest rates by the month, without telling you how much a loan will cost if it extends beyond 30 days.
- Do you charge upfront fees? Less-scrupulous providers charge a loan origination fee whether they place your loan or not.
- What are the penalties for not making a payment on time? We've talked to companies whose charges sound reasonable, until they say that late fees begin at \$50 a day.
- Could I talk to some of your other borrowers? The agents who say no probably don't want you to hear what the borrowers might tell you.
- William Dunkelberg, Philadelphia-based chief economist of the NFIB, cautions: "Don't bet the house--or your retirement savings--until you weigh the real chances of your business making it. Are you in a declining market, where people are moving away? If so, you might be better off cutting your losses and closing down."

Borrowing Against Receivables

If you no longer have a credit line to tap into when your customers don't pay you on time, one painful alternative is to find a lender to advance money against your outstanding receivables. Companies that provide this service are efficient--loan requests are usually processed in less than a week--but they charge high fees and may trap you into using them far longer than expected.

At least 1,000 companies provide this service, called factoring: They buy up your receivables at a discount and are reimbursed when your customers pay them. Factoring provides you with immediate cash and allows you to pass on slow-paying clients to someone else for collections.

But it comes at a steep price: Factors quote interest rates by the month, so what sounds like only 3 percent can mean 36 percent for the entire year. Dan Effa, a Vancouver, British Columbia, franchisee of Liquid Capital, a factoring group with more than 65 franchises in the U.S. and Canada, charges his clients an effective interest rate of 36 percent or more a year.

"Last August," Effa says, "I had a call from the owners of a commercial printing company whose bank was closing down their \$1 million line of credit. The only way they could keep it going was to sell me receivables."

Factoring companies that serve restaurants, retailers, hair salons and even doctors get paid back through a percentage of MasterCard or Visa receipts.

Cathy Bass, a founder of Business Financial Services, headquartered in Raleigh, N.C., says her company can advance \$3,500 to \$500,000 if it is allowed to take over the processing of your credit card payments. Each day, Business Financial Services deposits about 80 percent of a company's credit card receipts into the client's accounts and keeps the rest until the advance is paid off.

"This is not cheap money," says Bass, who works from Aliso Viejo, California. "If you receive an advance of \$10,000 from us, you'll pay back \$12,500 to \$14,500, depending on the risk involved."

On Deck Capital in New York City adds yet another twist and will loan \$5,000 to \$100,000 to a high-volume, low-ticket business such as a plumber or restaurant, based on daily monitoring of financial data. Founder Mitch Jacobs says On Deck charges 18 percent to 36 percent annual interest and is paid back through daily debits from your business checking account.

Unsecured Lines of Credit

If you have a personal credit score of more than 700, you may be able to get working capital based on that alone. Underwriters for companies offering these lines have discovered that people with outstanding credit are a good risk, even if their businesses are losing money right now. If you have managed to keep your personal FICO score high, you will likely qualify.

Several companies, including Diamond Financial Services in Raleigh, N.C., arrange business credit lines ranging from about \$30,000 to \$100,000 through a network of financial institutions--at a high price. Diamond consultant Don Johnson, of Hazlet, N.J., says applicants pay a \$2,000 fee that is refunded if Diamond cannot find a bank to fund your credit line. Once the line is approved, you owe Diamond an additional 10 percent of the line's value, a bill you can pay with one of your new credit line checks. You'll then pay the bank annual interest of 5 percent to 9 percent.

Jack Salemmo arranged for a \$35,000 unsecured line of credit through Diamond when he opened Auto Image Services Inc., an automobile reconditioning business, in Holmes, Penn., late last year. This means that he paid out \$5,500 for the right to borrow \$35,000 at a conventional interest rate; that's more than 15 percent of the amount of the loan just to borrow the money.

"It was expensive," Salem says, "but I didn't have time to go shopping for financing."

Borrowing Against Purchase Orders

Here's a typical scenario for one of these loans: A California business owner could sell a large selection of cashmere shawls to Costco for \$400,000--if she had the money to pay the manufacturer in China. Enter PurchaseOrderFinancing.com, of Chicago, one of about 50 firms that will pay a manufacturer for goods you'll deliver to a credit-worthy buyer. Dan Casey, CEO of PurchaseOrderFinancing, says such transactions only work for deals with middle to high margins and cost 1 percent to 5 percent a month of the amount advanced.

The terms get more expensive the longer it takes for your goods to be manufactured and your invoice to be paid. If the time drags into months, you could end up paying out almost one-third of the total price of your goods for the loan itself.

Borrowing Against Your Future

For about \$5,000, in addition to an annual record-keeping fee of \$800, Guidant Financial in Bellevue, Wash., or a handful of other companies will help you invest part, or all, of your 401(k) or other retirement funds into your own business. Instead of investing that money into stocks, "you become the fiduciary of your own retirement fund," says Guidant co-founder David Nilssen. Using your retirement money for working capital means you'll have no debt and no monthly payments, but you'll also have nothing to live on later if your business fails.

"Do not use this as an alternative if you can't get a loan anywhere else," Nilssen says. You should invest your retirement fund into your company only if you feel it will grow safely there, not as a desperate way to keep a failing company alive for a few more months. Most Guidant customers use retirement funds to start new businesses or expand thriving ones.

Final Option: Go Cash

Weber, the Las Vegas photographer, decided to skip credit altogether and set up a business savings account, which he'll tap into only when necessary.

"I've set up a merchant account so clients can pay me by credit card, which is easing my cash flow problems," he says. "Otherwise, I plan to go debt free and run my business on a cash basis. Losing my credit line was much too stressful."

It almost goes without saying: If you find a lender willing to open a credit line for your business, you can't afford a misstep. Bankers prefer applicants who provide detailed financial information and who can talk easily about their business's financial situation. If you aren't confident explaining a recent sales decline, take along your accountant or lawyer. And prepare:

Put together a clean package of critical information. Include three years of financial statements and tax returns from your company, a personal financial statement and your personal tax filings--and include several copies. Collateral for your line of credit will be your inventory or receivables. If you own an inventory-rich business, include a detailed listing, with information about how often it turns, how you cull bad inventory and how subject it is to obsolescence. Otherwise, include a list of your customers, how you qualify their credit worthiness, their ordering and payment history and how you collect when they don't pay on time. "You want to make the bank confident they can lend money against your receivables," says John Blatz of Brotherhood Bank and Trust in Shawnee, Kan.

Make an appointment with a loan officer with expertise in your industry. Dress appropriately: That means no jeans, and also no Armani suits if you're in a laid-back community.

Give the lender a reason to make the loan. Tell a compelling story and invite the loan committee to visit your company and meet your management team. Ask about underwriting standards, so you won't be blindsided if the institution wants a personal guarantee, for example.

If the officer asks for more information, provide it quickly.

If you are turned down, ask the officer why and, if possible, make those changes. You can then reapply, or move on to another local institution.

Don't take rejection personally. "Lending is a process," says John Hamburger, president of Franchise Times Corp. in Minneapolis. "It just means that your credit line will not work with that lender at that time. Continue your relationship."