Getting Credit for What You Do:

How and When to Borrow Money

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For many nonprofits, the scene is all-too-familiar: There's a payroll to meet and the county's check has been delayed. Or perhaps the photocopier is on its last leg, or the agency needs additional space. Surprising as it may seem to some nonprofit managers, these are all valid reasons to borrow money.

Under the right circumstances, a loan will stabilize cash flow so your services are not jeopardized during cash-poor times. The ability to borrow money is often just what is needed to bring financial equilibrium to a nonprofit at the mercy of unpredictable income streams, growing service demands, or old equipment.

Borrowing Myths

Before we look at how, when, and why to borrow money, let's first clear up some of the most common myths that cause many nonprofits to shy away from taking out a loan.

"Borrowing puts us in debt."

For some nonprofits, the term "borrow" is synonymous with debt, and since childhood we've learned that debt must be avoided. Stripped of its emotional baggage, however, debt is nothing more than a financial obligation. It is temporary money--money borrowed for a purpose and later repaid.

Every day, businesses, homeowners, car buyers, students, and nonprofits in need of immediate cash assume the obligation of debt, which they will later repay. True, some borrowers take on larger loans than they can handle and later find themselves in the type of "debt" that we would all do well to avoid. But prudent and responsible money managers quickly see the difference between using debt as a strategy and debt as a state of being.

"No, not me!"

For some nonprofit managers, taking out a loan is a negative reflection on their money management skills. Yet many of the same people freely use credit cards--which are just another form of borrowing. Every time they charge a purchase, they enter into a debt transaction with the same interest and repayment obligations as a bank loan. Credit cards are nothing more than a convenient, user-friendly (and usually more costly!) source of borrowed cash.

"Nonprofits can't afford interest."

Nonprofits frequently view loans as an expensive source of capital. But the carrying costs on a loan--be it for $10,000 or $100,000--are usually much less costly than the salary and expense it takes to generate the same dollar amount from foundation grants or government contracts.

Although nonprofits may wonder how they can afford the accompanying interest, there are actually several ways to cover the interest on a loan. For instance, you can build interest costs into the budget of a specific contract or into your fee structures. You can also use compensating bank deposits to lessen your interest rates, or you could obtain interest write down assistance from an understanding funder. (From the funder's perspective, it is less costly to pay interest on a loan than to make a grant in place of the loan.)

Nobody likes to pay interest. We all try hard to avoid or minimize it. Nevertheless, in many situations, it may prove more costly to spend all of your organization's hard-earned cash up front than to use an installment alternative.

"Borrowing puts nonprofits at risk."

Borrowing money creates a financial obligation. In this way, taking out a loan does put a nonprofit at risk. However, any time your organization accepts a foundation grant or government contract, you also enter into an obligation that you must strictly honor. The only difference between the two obligations is that borrowed money is money that has to be repaid.

The loan process creates a certain specificity that requires a borrower to anticipate the organization's financial activities over the life of the loan. The more specific you can be about future financial activities, the less risk you and the lender will incur.

Does this mean that any nonprofit that is able to project its financial future is an ideal candidate for a loan? Certainly not. Like any source of income, borrowed funds come with their share of strings attached. Be assured, however, that as much as banks and non-traditional lenders want to make loans, they'll never knowingly enter into a lending situation that puts them or you in financial jeopardy.

When a borrower defaults on a loan, the bank loses too. It gets back neither its original money nor the interest on the loan. And since bankers' salaries are paid in part from this interest, they literally have a vested interest in each borrower's success. The bank can't afford to knowingly put your organization at risk.

Knowing When to Borrow

Borrowing money is not a suitable option for every nonprofit. But under the right circumstances, and when viewed without myth or stigma, financing nonprofits' activities can be as viable as funding them.

- **Borrowing to stabilize cash flow.** Many nonprofits have felt the effect of the shift of federal and state dollars away from their programs. Some have been the recipients of start-up grant funding and now need stabilizing income to bridge the gap between the start-up phase of their project and the ongoing programmatic revenues.

  Still other nonprofits, although they are appropriate grant candidates, have cash needs that do not coincide with a funder's grant timetable. Other nonprofits apply for loans when the timing of a grant payment puts a strain on their organization's cash flow. Nonprofits providing contractual services often need a line of credit, or a steady source of cash, to stabilize cash flow between billing and collection.

- **Borrowing for capital purchases.** Nonprofits that need a new building, leasehold improvements, a new computer, phone system, or copy machine often struggle over where the purchase money will come from. Most look first to their own resources. But few nonprofit managers, even those with reserve funds, relish the prospect of depleting funds that have taken so long to build.

  One option is to apply for a grant. Frequently, however, the timing and the cost involved in writing and waiting is more than the nonprofit can afford. The need exists now for a source of cash to make the capital purchase.

Many nonprofits find a loan to be just the right income source to handle these big-ticket items. Borrowing money for capital purchases provides an immediate source of cash which can then be repaid over time, usually with the flexibility of installment or lump-sum payments.

- **Borrowing to take advantage of an opportunity.** "No finance, no romance!" This was the answer one social service agency gave when asked why it needed a loan. The agency had an opportunity to expand to another part of the state, a move that would diversify the organization's income and more than triple its budget. The board of directors saw this as an opportunity of a lifetime, one that fit within the agency's strategic mission.

  There was only one hitch: Although the new venture would eventually provide a stable source of income, it required up-front money to get off the ground. Moreover, the agency needed several months' working capital until prior months' services could be billed and collected. There was no time for grant proposals and the agency did not have enough savings to go ahead on its own. Financing made this opportunity possible.

- **Borrowing for certain emergencies.** Unforeseen problems happen to the best of us. Grant proposals aren't funded, insurance or energy bills skyrocket unpredictably, boilers break, roofs leak, staff crises arise--all of which call for a quick source of cash. Nonprofits can sometimes use loans to handle these unanticipated situations.

  Again, there's a hitch, one that applies to all borrowing: Every time you borrow money, you must know how, when, and from what source it will be repaid. This is the cardinal rule of borrowing. It presupposes your ability to project with accuracy the amount and timing of your organization's income and expenses, allowing enough room on the expense side to cover the agreed-upon loan repayment.

  Does this sound impossible? Not if you know how to forecast cash flow. Many nonprofit managers have discovered that the better their ability to project their organization's income and expenses, the fewer emergency situations in which they will find themselves.

Determining the Type of Loan You Need

Although there are many types of loan products on the market, experience suggests that nonprofits borrow money for six specific purposes. These purposes dictate the type of loan that will best suit their financing needs. The following descriptions present a variety of loan types, along with the appropriate use and attendant risk for each.

- **Cash-flow and bridge loans.** As the name suggests, cash-flow loans bridge the gap between an immediate need for cash and a pending source of income. Cash-flow and bridge loans always have a connected receivable, generally pledged as collateral for the loan. When the receivable is paid, the loan is repaid.

  Cash flow and bridge loans are particularly useful for nonprofits without their own cash reserve funds. When county contract payments or foundation grants are delayed, when client fees are slow to be collected, or when income flows in an uneven pattern throughout the year, a bridge loan may be the best way to stabilize cash flow.

  Cash flow and bridge loans are generally short-term and almost always repaid with 12 months. These type of loans are a good place to start the borrowing process because, in general, they pose the least risk both to the borrower and to the lender. The source of repayment is clearly identified. Often, even the timing of payments can be predetermined. Yet even these loans are not without risk.

  Every lender has made at least one loan in which the borrower's sure income unexpectedly dries up, taking with it not only the repayment source but also the collateral for the loan. That is why lenders often ask for an alternative source of repayment with a cash flow loan, in the event the "sure" receivable does not materialize.

- **Equipment financing.** Rather than spend hard-earned cash for a new copy machine, computer, phone system, or the like, many nonprofits choose instead to finance these purchases over a period of several months. Usually, the loan period for equipment financing will match or be somewhat less than the useful life of the asset.

  Equipment financing is typically secured by the item being purchased. From a collateral perspective, this is ideal. The financed equipment provides a tangible piece of property that the bank can reclaim in the event of the borrower's default. But equipment purchases contribute new costs to the organization, usually without corresponding income. Thus, equipment financing carries the risk that debt service on the loan may not be repayable from the organization's monthly cash flow. Still, when it comes to equipment loans, good cash flow projections, along with collateral, usually put a lender's mind at ease.

- **Capital improvement financing.** Changing times often require nonprofits to remodel or make physical improvements to their leased or owned facility. If your organization does not have cash reserves to handle these expenses, a loan may be a good alternative.

  As with most other loans, a lender will first want to see cash flow information that demonstrates the ability of your organization to include the cost of these renovations in your operating budget over the life of the loan. Because most banks require collateral other than the improvements themselves, be prepared to pledge either cash or fixed assets when seeking a capital improvement loan.

- **Construction loans and mortgages.** Banks make construction loans to erect new buildings or to add on to an existing structure. Construction loans carry a good deal of risk, the greatest of which is estimating how much the actual project will cost. Cost overruns are a fact of life in construction. First-time construction managers are often ill-equipped to make appropriate estimates and so fail to borrow enough money to pay contractors.

  As with capital improvement financing, the loan officer will want to see cash flow projections for both the construction project itself and the operation of your organization. Loans made for new construction frequently are replaced or "taken out" by a mortgage. Mortgages are long-term loans made to acquire real property, using the property itself as collateral.

- **Working capital loans.** Many nonprofits--especially those experiencing rapid growth, significant inventory, or unpaid receivables--often find themselves short of cash. Their assets are not converting to cash quickly enough to meet current obligations. When this is true, the result is negative cash flow. Nonprofits can use working capital loans as a temporary solution to this type of problem.

Working capital loans take into account the full income potential of your organization. They are based on the entire working operations of your nonprofit. Cash flow loans, on the other hand, are tied to a specific receivable which can generally be identified and verified. Because cash flow loans are more specific and time limited, they are less risky than working capital loans.

Working capital loans are repaid from the general income stream of your organization. This presumes an overall positive financial condition, as well as some understanding of the cash flow history and projected trends of your agency.

Some working capital loans are made as lines of credit to cover seasonal or ongoing cash shortfalls. For example, a nonprofit art center may receive three quarters of its operating income in the last six months of the year. A line of credit--a loan approved up to a maximum amount to be drawn upon as needed--gives the organization the flexibility to borrow just what is needed to cover its monthly obligations. Interest is paid only on the portion of the line which is actually borrowed.

Lines of credit generally carry an annual retirement phase, a date upon which the loan needs to be repaid before renewing it for another year. This gives both the lender and the borrower some sense of security that the loan will not become an "evergreen credit," the term that bankers use to describe a line of credit that rolls over every time it is due because the borrower's financial condition has not yet allowed for repayment.

Working capital loans require both the borrower and the lender to have a good understanding of the nonprofit's current and future financial condition. Determining this takes time and patience on the part of both parties. But in these days of declining general operating support grants, working capital loans promise to play a much larger part in future income stabilization for many more nonprofits.

- **Start-up financing.** Start-up financing, or seed capital, is the money that must be invested in a new nonprofit or (or nonprofit program) in order to move it from idea to reality. Start-up funding usually takes the form of equity investments, contributions from foundations or private parties to get a new entity off the ground.

Sometimes, organizations unable to obtain start-up grants or support turn to the bank. Cases do exist where a start-up loan may be appropriate. However, without a track record or a secure income stream, it is difficult to obtain a loan for start-up capital. The primary risk for the lender is that the venture will never materialize, making the loan virtually unrecoverable. This ultimately would jeopardize the creditworthiness of the borrower, and obtaining future financing would become difficult.

First-time borrowers, brand new organizations, and those generally unfamiliar with cash flow should not attempt to borrow money for seed capital. However, under the right circumstances, nonprofits with long and steady track records and experienced management may be appropriate candidates for start-up financing.

Getting the Loan

By the time most nonprofits get around to borrowing money, they have already become skilled at securing foundation grants, government contracts, and private contributions. They legitimately wonder if the approach that has made them successful fundraisers will serve them well in obtaining a loan.

Getting a loan doesn't require any more time or any more skill than writing a grant or contract proposal. In fact, in most situations, the process of applying for and obtaining a loan takes far less time than that involved in traditional funding. You just need to know the rules and demonstrate your ability to repay.

The five tips outlined below offer a short course in securing bank financing for would-be nonprofit borrowers.

1. Know when to apply.

As the old saying goes, "The only ones who can get a loan are those who don't need it!" Nonetheless, when applying for a loan, there is a substantial difference between those who have a critical business need and those who are desperate. Desperation carries an added risk for both the borrower and the lender, a risk that neither should take.

Seasoned borrowers know that the time to visit the bank is when they're in their best cash position. This demonstrates their ability to anticipate upcoming cash flow needs and gives both the borrower and the loan officer adequate time to fully understand and process the loan request.

Yet there are times when cash flow problems or the need for quick cash sneak up on even the most diligent managers. In these circumstances, nonprofits with a firm understanding of their financial situation have a much better chance to negotiate a loan from a position of strength.

2. Bring the right financial information.

Nonprofits funded by foundations and government sources have traditionally operated with the budget as their primary financial document. Although the loan process does consider your organization's budget, it also requires close examination of several other financial documents that are not always analyzed in the grant process.

A balance sheet describes your organization's overall financial position at a given date in time and lists your organization's assets, liabilities, and net assets. Although nonprofits have often worried that a positive net asset position (fund balance) might undermine their ability to obtain a grant, the opposite is true for borrowing. Loan officers want to see a positive fund balance--in other words, that your organization's assets exceed its liabilities. It is important that the balance sheet you present is current, and when unaudited, that it is accurate.

The income statement, or statement of activities, for the prior year and most recent period tell a lender whether your nonprofit has lived within its means. These statements will be analyzed even more critically when current cash shortfalls might be attributed to last year's deficit.

Cash flow projections showing anticipated income and expenses are also essential to the loan review process. They indicate how much money is needed over what period of time and how best the loan should be structured. They also forecast your organization's ability to have enough cash after the loan is repaid to carry on effectively.

3. Educate the lender.

The loan officer is interested in more than just the financial condition of your organization. Your organization's mission and programs provide a necessary context within which the lender can judge the importance of the loan to your agency's purpose and stability. Be prepared to discuss the number of staff you employ, the market demand for your program, and how the community benefits from your services. Being able to explain these economic issues shows that you understand the relationship between your organization and the community or marketplace in which it exists.

By themselves, enthusiasm and dedication to the mission of your organization will not persuade the bank to make the loan. However, they do add credibility to your presentation and may even tip the scale positively in a marginal approval situation.

4. Demonstrate management capacity.

Financial statements and cash forecasts lend themselves to an objective analysis. Assessing your management capacity--or "character," as the banking industry calls it--is much more subjective. You can make the job easier if you understand that the banker needs to make a judgment not only about your organization's ability to repay, but also about the likelihood that you, the manager, will repay.

Judging management strength is one of the most difficult functions a lender has to perform. Your knowledge of your organization's financial situation gives both you and the bank confidence in your presentation. Remember that your own attitude and demeanor play a major part in the lender's confidence in your application.

5. Know what to present.

The amount and purpose of the loan determines how extensive the financial application process will be. A complicated real-estate venture, a complex new program, or a project that has multiple partners will require a much more extensive review than a short-term cash flow loan. But in general, be prepared to address the following six points:

> **1.** Amount to be borrowed. Note that this is the first thing the loan officer will want to know. It pays to do both good budgeting and cash forecasting before going to the bank.
>
> **2.** Date the loan is needed. Advanced planning goes a long way toward enhancing your management credibility. It also gives the

loan officer the necessary time to get the loan approved, prepare loan documents, get the check signed, and close the loan.

3. Use of the loan. The loan officer will want to know the purpose of the loan.

4. Suggested repayment schedule. There are many ways a loan can be structured for repayment. These include one lump-sum payment at the end of the loan period, interest only for a period of time, or monthly installment payments. Although some rules of thumb do exist, most banks will make every attempt to match the repayment schedule with an organization's cash flow. This is the surest way to guarantee that the loan will be repaid as promised.

5. Repayment source. The more explicit and reliable the source of repayment, the more likely you are to get a loan. This is doubly true if you have an alternative source of repayment to offer in the event that the first falls through.

6. Collateral or guarantee. Banks are under obligation with regulators to place safeguards, such as collateral, on loans. To protect their interests in the event of default, lenders usually expect you to pledge collateral in excess of the value of the loan.

Dealing With Denial

The reality of loan denial is all too common in the nonprofit sector. Often, nonprofits approach the bank in the same way they have learned to approach a government contract or foundation officer--with a need but with no carefully thought-through method for repayment.

Here are some of the reasons why your loan may be denied:

- Weak balance sheet. If the liabilities side of your balance sheet exceeds your assets, you have what the bank will consider a "weak" balance sheet. Poor financial health is one of the most common reasons for loan denial.

- Poor credit report. If your loan is denied because of a credit report, the bank is required by law to advise you of the credit bureau from which report was obtained. Request copies of the report from the credit bureau and check it carefully for inaccuracies. If you do find an error, write immediately to correct it. The Fair Credit Reporting Act gives you the right to insert a statement of up to 100 words in your report to explain credit problems. Be sure to keep copies for your files.

- Insufficient collateral. Even with good credit references and positive assets, your loan may still be denied due to insufficient collateral. Although in limited circumstances a bank may choose to make an unsecured loan, more often then not the bank will require security equal to or greater than the value of the loan. Nonprofits with government contracts, non-renewable foundation grants, and limited fixed assets are often unable to produce sufficient collateral to pledge as security on a bank loan.

Although nonprofit managers have become much more financially astute over the last several years, the financial challenges they face have never been greater. Nonprofits eager to continue quality programs and services must seek new financial options to enhance traditional funding. Borrowing money is one such option.
Borrowing, however, is not for everyone. Like any source of income, loans come with strings attached--they must be repaid, with interest. Still, even with the carrying costs, many nonprofits find loans to be a reliable, economical source of working capital as they strive to achieve financial stability.

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