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A California Statewide Collaborative

Excerpt from the NEDLC
Family Child Care Financial Planning and Facilities Development Manual
(To learn more about the full Manual, which will be available in English and Spanish in July 2003 please contact Building Child Care at 888-411-3535)

UNDERSTANDING LOANS

A. Why use loans for facilities development projects?

The idea of incurring debt through loans is not one traditionally welcomed by the child care field for a variety of reasons. But, financing, if used wisely, is truly one of the most viable options for providers looking to build, purchase, renovate or expand a family child care home. The four points below explain the benefits of using loan financing to pay for family child care home development costs.

1. Meet Higher Costs; Serve Families Faster

- The supply of available loan capital is far greater than the supply of available grant funding. Another way of thinking about this is that loan funding is a revolving resource because all money that is lent has to return to the lender so she can lend it to someone else. Grant money on the other hand, is of one-time only use. Therefore, grants are part of a much smaller and more limited pool of money.
- Loan applications have a fast turn-around time, which allows a project to move forward swiftly. In the field of child care, where an interruption in services can be both financially straining and very difficult for clients, being able to complete a facility project quickly is crucial.
- Raising equity through grants, donations, savings and internal resources takes a long time.
- Grant funding for facility development projects is generally limited to nonprofit organizations and is not usually available to for-profit child care centers or family child care providers.
- Loan financing typically provides larger amounts of money than grant funding. Sometimes local grant funding is available for family child care providers to do small facility improvements and equipment purchases. However, such grant resources are rarely, if ever, large enough to cover the actual cost of a significant renovation or expansion project.
- The bottom line: financing allows a provider to raise greater amounts of money in less time, which means he/she can meet higher costs and serve families faster.

2. **Capital Efficiency**

- Financing allows a business to leverage other money (e.g. savings) and to make limited resources go farther. For example, a provider can use loan financing in combination with business savings and/or a small grant to pay for a renovation project instead of trying to do it through savings alone. With the additional funding available through a loan those savings can go farther and make more of an impact.
- Financing allows the business to pay for costs over time instead of all at once. With a loan a provider can pay for the cost of a facility project over the term of the loan rather than all up front at one time.
- It is quite common, and usually essential, to combine multiple funding streams in order to be able to make a facilities development project happen successfully. In other words, it is likely that to do renovations a provider will need to combine loan financing with personal or business savings.

3. **Business Skills**

- Community development and small business lenders often offer special technical assistance services to insure a high success rate on their loan products.
- These services foster the development of a provider's business and financial planning skills.
- Good lenders only make loans if they believe that the borrower is capable of repaying it on the designated terms. In other words, they do not want to invest in risky ventures that may result in both the borrower (you), and the lender (them), losing money.
- Financing is a good way to bring homeownership within reach, which allows a provider to: gain long-term tenure, customize the space for kids and staff, and build financial position and stability.

4. **Expand Early Care and Education (ECE) Stakeholders**

- Financing leverages interest in the ECE field from financial institutions and other economic entities such as local economic development corporations.
- By demonstrating their success as businesses, child care providers help to encourage the expansion of additional funding streams for the field.

B. The lender's perspective

In attempting to qualify for a loan, it is vital to understand the perspective of the lender, and to ask the question: What does a loan officer look for in a loan application? The bottom line of lending is **Repayment Capability**. In other words, lenders consider lending only if they are confident that a borrower is able to repay the loan on the designated terms. The 5C's of lending are the main criteria by which a lender will judge an application for a loan. They are:

1. **Cash flow (Capacity to Repay the loan)**

   - Lenders use cash flow to identify whether an agency is able to meet its monthly payments to repay a loan. (Note that cash flow does not always reflect profit. Lenders are concerned with a borrower's capacity to meet a monthly payment rather than its end-of-year profits).
   - Lenders look at projected versus historic cash flow. Most lenders have a minimum debt service coverage (DSC) ratio requirement.

2. **Character (Capacity to Execute the Project Successfully)**

   - Does the borrower have a sound vision and a clear business plan?
   - Is there leadership and technical capacity to execute the plan?
   - Lenders typically analyze business leadership and the experience of any consultants hired to help with the development process (e.g. architects, contractors, lawyers).

3. **Capital (Equity Investment in the Project)**

   - What money is the individual planning to invest?
   - What other equity sources are invested?
   - What percent of the total cost will be covered by the borrower's equity?
   - Lenders typically look for a significant investment by the individual applying for the loan. Many lenders view a business owner's capital investment as a measurement of the owner's commitment.
   - Some community lenders may be amenable to substituting cash equity with "sweat equity," an owner's work investment in the business. However, most lenders want to see some capital investment as well.

4. **Collateral**

   - What is the value of the property being pledged for repayment of the loan?
   - Lenders typically commission appraisals of property or other assets.
   - Internal collateral comes from the business itself, whereas external collateral uses assets outside the business.
   - Most lenders have policies regarding loan to value ratios. For example, they will only lend 80% of the project value.

5. **Credit History**

   - What is the credit history of the business, the borrower, and the guarantors, if any?
   - Lenders look at past performance carefully and evaluate the borrower on his/her potential for future bankruptcy.

It is important to note, in reading over the 5C's of lending, that if a borrower does not fit perfectly into each category, that does not mean that a lender will automatically turn down the application. It does, however, mean that other categories need to be strong enough to outweigh the weaknesses. For example, if the loan applicant has had bad credit in the past, but has been able to rebuild his credit in recent years and has solid collateral, significant capital investment, positive cash flow (or well-researched projected cash flow), and a clear and detailed plan for the project, then a lender will still be likely to consider the application.

C. What is the best way to apply for a loan?

The best way to apply for a loan to pay for renovating or expanding a family child care home is to provide the lender with a well thought-out, clear, concise and financially sound **business plan** that is developed with professional assistance. For more information about developing a strong child care business plan see Chapter Four of the *Family Child Care Financial Planning and Facilities Development Manual*.

In addition to the 5C's listed above, there are many other factors beyond the financial position of a business that a lender looks at when considering a loan application. For example, the lender is also interested in the strength of the current management of the program, knowledge of the industry, community reputation, and market research information articulated in a business plan.