Business Financing

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Even in these challenging economic times, businesses still have a need to grow and to obtain capital for either ongoing operations or to finance assets. There are two general ways that a business will acquire capital. One is to obtain outside investors to acquire an ownership interest in the business, such as through the sale of stock for a corporation. The other is to obtain financing on an arms' length basis from a Bank or other Lender. Most businesses prefer this vehicle for raising money since the proprietors of the business do not have to dilute their ownership interest in the business. Also, obtaining financing from a lending institution is simpler since there exists an established market for obtaining funding from Banks and other financial institutions. This article will concentrate on obtaining funding from a Bank and will also address some governmental programs available to businesses.

While Banks have reacted to the current economic environment by being more conservative with respect to making loans, they are certainly in the business of making loans to an acceptable Borrower. Bankers talk about the five "C's" when reviewing a Borrower's credit-worthiness:

1. **Capacity**. This deals with the prospective Borrower's ability to repay the loan. It is the most critical factor in a Lender's determination to go forward with the transaction. The Lender will consider the cash flow generated by the business (with respect to the timing of payments and the likelihood that repayment can be achieved). Also, the Lender will review the payment history of the Borrower as an indicator of future performance. When reviewing a loan request, the Lender

is primarily concerned about repayment. To help determine this, loan underwriters will order a credit report from one of the credit-reporting agencies (i.e., Equifax, Experian, TransUnion). These agencies render a credit score which the underwriter uses as a benchmark on a Borrower's ability to repay a loan. It is very important to know your credit score and work with the credit reporting agencies to present an accurate financial picture.

2. **Capital**. This means that the prospective Borrower has money to invest in the business. Lenders generally want the prospective Borrower to have contributed its own assets to the contemplated transaction.

3. **Collateral**. In most loan transactions the Lender will want a security interest in the assets of the business and the assets that will be financed with loan proceeds. They will want these assets available as a potential source of repayment in the event that the Borrower cannot make payments out of the cash flow of the business. Keep in mind that collateral may also include the assets of the proprietors of the business by virtue of a requirement for a personal guaranty with respect to the transaction.

4. **Conditions**. Lenders will review the general economic climate at the time of the loan and also the particular industry of the Borrower. The general conditions and the economy are reviewed by the Lender in making its evaluation as to the likely performance of a loan. As we are currently in a tight credit or restrictive lending environment, many lenders will look for assistance or credit enhancements offered by governmental agencies, discussed below.

5. **Character**. Lenders review the character of the individuals running the business. Such items as educational background and business experience are clearly reviewed with respect to the contemplated transaction. Additionally, the person's integrity and, of course, performance are also reviewed in analyzing a loan transaction as well as an existing or prior relationship with a lender and references from professionals who have reviewed business proposals (lawyers, accountants, business advisors and the like).

Subsequent to this review, the Bank will review various other components such as loan pricing, terms and other aspects of the transaction with the Borrower.

Keep in mind that borrowing money from a Bank is essentially a transaction and both the Bank and the Borrower are free to negotiate and arrange terms that are comfortable to both parties. Aside from discussing the elements of a Bank transaction, the Borrower should also remember that there are various state and federal governmental programs designed to help small to medium-sized businesses obtain capital. Frequently, the introduction of the Borrower to a Lender is based upon the loan package prepared by the Borrower for the Lender's review. Consequently, the Borrower should be able to demonstrate to the Lender that it has adequate cash flow or other sources of funds available to assure the Lender that the loan will be repaid. The Borrower should also demonstrate that it given some thought into its request for additional monies. That is to say, the Borrower should provide historical financial statements that will show the Lender the successful history of the enterprise and, in most instances, there should be pro-forma statements furnished to demonstrate to the Lender that the applicant has made a determination that it can handle the additional debt service requirements of the new monies to be advanced. In some cases a narrative should be provided to the Lender so that the Lender can better understand the Borrower's future needs to justify the financing.

Aside from historical financial statements and pro-forma statements, Banks will generally conduct a background check of the owners of the business to satisfy themselves that the individuals have the integrity to react properly to the Lender. Consequently, Lenders also require (and should be furnished with) resumes of the management of the business. Additionally, the Lender will often review the credit history of the individuals running the business (even if such individuals are not the Bank's customers) to satisfy itself that such individuals have acted properly in the past.

Banks will also look at general economic conditions in making a determination of the loan's viability. For example, in the event that a retail automotive store selling tires and the like request financing from a Bank, the Bank would probably review the general economic conditions and the conditions unique to the automobile industry and its after-market in making a decision about the loan irrespective of the financial condition of the specific applicant.

Banks will also look to collateral, whenever possible, to secure loans made to a business. It is obviously easier to obtain financing when a Bank is offered a secured position in hard collateral that can be reduced to cash in the event that all else fails and the business defaults on its loan. In addition to looking at the business, Banks will commonly look to the personal assets of any equity owners of the business in making a loan. It is very common for a Bank to require guaranties of the principals of the enterprise in considering a transaction. In fact, many bankers believe that, particularly with respect to closely held companies, the principals of the business need to guaranty the loan to demonstrate their commitment to the business.

With respect to the repayment of any loan obligation, there are basically two components in each loan payment. One is the repayment of a portion of the principal that was borrowed and the other is the interest payment charged by the Lender for the loan proceeds. Generally, the interest rate is determined by the Lender by taking into account the risk of repayment, additional business (such as account balances) created by the Borrower (resulting in additional earnings to the Lender), and a "spread" representing the Lender's gross profits. Many Banks price loans by determining a spread over a specific index. The index used most often is a function of the term of the loan. For example, the interest rate quoted for a ten year loan might be 2% above the Ten Year Treasury Bill rate. On the other hand, a working capital line might have an interest rate based on a short-term index such as the London Interbank Offered Rate ("LIBOR") (a daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale money market or interbank market) or the Lender's publicly announced prime rate.

As noted above, the interest rate charged to a particular Borrower is negotiable between the Borrower and the Lender. Some Banks have flexibility with respect to the pricing of their loans based upon the factors noted above and other Lenders are "more rigid" with respect to their pricing of a particular loan. Similarly, there are secondary Lenders for Borrowers that might not otherwise meet traditional banking institutions' criteria and therefore, such Borrowers pay higher fees and interest to such secondary lenders.

Another component of each loan is the term of repayment. The term of repayment is generally the length of time required by the Lender to complete repayment of the loan. In the case of a line of credit, working capital loan or account receivable loans, most Lenders anticipate such loans being repaid over a period of approximately one year, even if the expectation of the parties is that the credit facility will be renewed. Long-term business loans have maturities greater than one year but usually less than seven years. Real estate and equipment loans may have maturities of up to 25 years. Long-term loans are used for major business expenses such as purchasing real estate and facilities, construction, durable components, furniture, fixtures and vehicles. For example, a loan for a new building would typically be repaid over a period of 20-25 years because the nature of the collateral provided in conjunction with such a loan. The importance of a term to a Borrower is that the longer the term, the lower the required monthly principal payment. Obviously, it requires less cash flow (on an annual basis) to service a $100,000 loan which is repayable over ten years than for the same principal repayment requirement during a one year period.

One way to mitigate the cash flow issue in such instances is to have a loan payable over a longer period of time (for example, twenty years) with a shorter maturity date (for example, ten years). This "balloon" structure provides for a smaller (and perhaps more affordable) monthly payment to the Borrower and results in a balloon payment due to the Lender at the maturity date. In this instance, the Borrower and the Lender have an expectation that the collateral provided to secure the loan will have adequate value at the maturity date so that the parties can either refinance the transaction or the Borrower will be able to utilize the collateral in some fashion to repay the principal balance of the loan. Remember that interest is paid on the outstanding balance of the loan, so a longer amortization period results in greater interest expense to the Borrower.

Even for credit-worthy Borrowers, Lenders are generally looking for some equity injection into a particular transaction. For example, if a Borrower wishes to purchase real estate, the Lender would normally require a 20% to 30% down payment from the Borrower so that some equity cushion is provided with respect to the transaction. Sometimes a Borrower can mitigate the down payment requirement by either providing "side collateral" to the Lender or guaranties of the principals of the business.

As noted earlier, the collateral provided for a loan is often a direct result of the loan proceeds. With respect to a real estate transaction, the Lender will normally require a mortgage on the premises, an assignment of leases and a security interest in the fixtures. The mortgage documents basically provide the Lender with a lien position on the property which is being financed. Upon a default, the mortgage allows the Lender to exercise certain remedies against the property including the right to foreclose upon the property and to sell the property at a public auction. An assignment of leases basically allows the Lender to collect the rents and to maintain the property upon an event of default. With respect to such an assignment, the Lender normally requests an acknowledgement by the tenants at the premises (if any) that they are paying rent and that they will continue to pay rent to the Lender in the event it succeeds to the Borrower's position in the premises. Fixtures are generally secured by UCC financing statements giving notice that all of the fixtures (equipment and building systems attached to the premises) are secured by the Lender as they are an integral part of the premises.

In the event that a loan is used to acquire equipment, the Lender will normally require a security interest in the financed equipment. Such a loan is secured by a security agreement and UCC financing statements. The UCC financing statements are recorded with the secretary of state in the state of incorporation of the entity. The term of a loan for equipment generally tracks the useful life of the equipment. That is to say, in the event that the equipment has an anticipated useful life (prior to obsolescence) of ten years, the Lender would require a seven to ten year amortization, depending upon the loan, so that the loan is fully retired by the time that the equipment becomes obsolete.

Similarly, it is possible for the Lender to make a loan for leasehold improvements. In this instance, the Lender would require that the loan is amortized by the end of the lease term. Additionally, with such a loan, the Lender may want certain assurances from the landlord that the Lender would either have the right to remove the leasehold improvements from the premises (upon an event of default) or be allowed to cure any defaults under the Borrower's lease so as to be able to maintain the premises.

Businesses often borrow money for working capital needs, inventory and the like. Such loans and credit lines are generally short term in maturity (generally, one year) and may track certain business cycles. Such loans are collateralized by the general credit worthiness of the business and any "hard assets" available to the Lender. Frequently, the Lender will have a "clean-up" period requiring that the loan must be repaid before it is reinstated. This concept allows the Lender to satisfy itself that the business has the ability to operate without the benefit of the Lender's monies. With respect to inventory or receivable lines of credit, loans are often provided for a percentage of the business's inventory or receivables so that the Lender can assure itself that there is a cushion with respect to the payment of such loans (allowing for obsolescence and doubtful accounts).

In almost all instances, closely held companies are required to provide the personal guaranties of the owners of the business with respect to a loan transaction. Lenders view this as very important since it indicates a willingness and confidence of the owners of the business to stand behind their business and provide assurances that the loan will be repaid. In some instances, such guaranties may be reduced over time based upon the achievement of financial benchmarks or "burn-off" with the passage of time. In some instances, the business is so strong that it can stand alone and the Lender may waive the requirement for personal guaranties when it believes that the same may not be necessary or when it believes that it may need to do so in order to accommodate the request of a strong customer.

Lenders may in fact require that personal guaranties be "backed up" by the assets of the guarantors. For example, it is not uncommon to require the pledging of a guarantor's personal residence in a loan transaction. But keep in mind that in such instances, the spouse of the guarantor may need to pledge his or her equity interest in the residence in order for the Lender to perfect the lien with respect to the residence. In other instances, the Lender may require that the principals pledge stock or bank accounts as collateral to provide assurances for their guaranties. Again, it is not uncommon for such collateral to be released over a certain period of time or when certain financial benchmarks are achieved.

The most common sources of financing are banks (including savings banks, savings and loans, and commercial banks), credit unions, commercial finance companies, small business investment companies, and private lenders. There are also direct loan programs, including Small Business Administration (SBA) as well as programs running through the SBA's federal guaranty which provides credit enhancements to a lender that allow it to consider making a loan to a business whose credit criteria may fall outside a lender's normal requirements. State and local governments have developed many programs over the years to encourage the growth of businesses and spur economic development. For example, the New Jersey Economic Development Authority (NJEDA) has several programs which serve these goals.

Some lenders are unwilling to make loans to start-ups or businesses that are defined as small businesses. One source to find a small business-friendly bank is to go to a state-by-state directory from the SBA. All the banks that are listed are participants in SBA's Preferred Lender or Certified Lender programs which are designed to assist "small businesses" to fund under their programs. SBA loan programs are generally intended to encourage longer-term small business financing but actual loan maturities are based upon the ability to repay, the purpose of the loan proceeds, and the useful life of the assets financed. Other SBA programs with long-term loan maturities are available, including loans allowing for 25 year maturities for real estate and up to 10 year maturities for equipment (depending upon the useful life of the equipment) and, generally, up to 10 years for working capital needs. Short-term loans are also available through the SBA to help small businesses meet their short term and cyclical working capital needs.

Currently we are facing difficult economic times where the general availability of credit has been curtailed. Many lenders are looking for the credit enhancements offered by the SBA loan programs which provide them with additional security backed by the full faith and credit of a federal government. Accordingly, lenders who participate in these programs are more receptive to small business loan proposals. The SBA offers numerous loan programs to assist small businesses. The SBA defines what a "small business" is from industry to industry as established in a table of size standards (found at www.sba.gov/size) either by the average number of employees in a business or average annual receipts. For example, a horse farming operation is considered a small business if it has annual receipts of less than $750,000. Alternatively, a pasta manufacturing operation is considered a small business if it has less than 500 employees. It is important to note that the SBA is primarily a guarantor. Loans are made by banks and certain non-bank lenders.

The primary SBA loan programs for businesses are:

1. **7A Loan Guaranty Program**. This program serves as the SBA's primary business loan program to help qualified small businesses obtain financing when they may not be eligible for business loans through conventional lending channels. This is the SBA's most flexible business loan program since financing under this program can be guaranteed for a variety of business purposes. Loan proceeds can be used for business purposes including working capital, machinery and equipment, furniture and fixtures, land and buildings (including purchase, renovation and new construction), leasehold improvements, and debt refinancing (under special conditions). As noted previously, loan maturities are up to ten years for working capital loans and generally up to twenty-five years for fixed assets loans. This

program is delivered primarily through commercial lending institutions including banks and non-bank lenders who participate in the program.

2. **504 Program**. This program provides long-term, fixed rate financing to small businesses to acquire real estate or machinery and equipment for expansion or modernization. Typically, the funding components of a 504 loan include a loan secured by a private bank lender with a first lien position, a loan secured from a certified development company (funded by a 100% SBA guaranteed debenture) with a second lien covering up to 40% of the costs of the project, and an equity contribution of at least 10% equity from the Borrower. This program is delivered primarily through certified development companies which are private non-profit corporations set up to contribute to the economic development of their communities or region. These loans are made in conjunction with a private sector lender such as banks.

3. **Micro Loan Programs**. This program provides short-term loans of up to $35,000 to small businesses and not-for-profit child care centers for working capital or the purchase of inventory, supplies, furniture, fixtures, machinery and/or equipment. Loan proceeds can be used to pay existing debts or to purchase existing real estate. The SBA makes or guaranties a loan to an intermediary, who in turn makes the Micro Loan to an applicant. These organizations provide management and technical assistance to the applicant. These loans are not guaranteed by the SBA. The Micro Loan Program is available for selected transactions in most states.

A source of funding that should not be overlooked is assistance from the New Jersey Economic Development Authority ("NJEDA"). The NJEDA was created to facilitate and stimulate business within New Jersey. With respect to fixed asset of financing, the NJEDA has the ability to issue industrial development bonds. Such bonds are tax exempt and therefore the interest rates paid on such bonds are significantly lower than the interest charged by a lender for similar projects that are financed conventionally. Aside from the lower interest rate, the lending provisions are similar to those of a conventional loan.

In addition to the tax exempt bond program, the NJEDA has loans available to finance business expansion. Loans are generally available up to approximately $3,000,000 for transactions and have very attractive interest rates. The NJEDA has a local development financing fund program for municipalities considered as needing additional stimulation, with such loans having interest at the rates of approximately 3% per annum.

Many of the NJEDA's programs are designed to provide subordinate financing with respect to a transaction. Consequently, Borrowers for such transactions can provide the primary lender (typically a bank) with a first lien position with the NJEDA assuming a second lien position. The loan-to-value ratio for the lender in this instance provides the lender with additional confidence so that it may make a loan which it might otherwise reject. The NJEDA's requirements for such loans track the provisions of the prime lender and also offer below-market interest rates. In addition to such programs, the NJEDA has programs where it guarantees the loans made by conventional lenders (generally up to $3,000,000.00).

At some point in time almost every business requires financing. When seeking financing, it is important to investigate the options available before going in a particular direction. The positives and negatives of each type of financing should be listed in the decision process. A Borrower should be prepared to address the issues and questions posed by a Lender in securing a loan. Proper preparation will increase the chances of loan approval under the requested terms. Knowing the basic elements that lenders are looking for will greatly assist a potential borrower in achieving the goal of a loan approval and, ultimately, a loan closing.