Capital Ideas

Business Financing in a Rising-interest-rate Environment

By GARY G. BRETON, Esq.

What should small business owners be aware of in seeking to obtain new or alternative financing in a rising-interest-rate environment?

Traditionally, you may generally require three possible financing vehicles for the operation of your business. The first is a revolving working capital line of credit facility, which assists in funding the day-to-day operations of your business. The second is a term loan facility, which may be used to purchase capital equipment, or perhaps fund certain leasehold improvements. And the third is a commercial mortgage loan to fund the acquisition of the real property where your business is operated.

Each of these facilities generally will bear interest at different rates that may be tied to different indexes. And it is critically important that you evaluate the various interest rate options that might be available, with an eye toward the volatility of a particular interest rate mechanism and its potential impact on your company's projected cash flow, and consequently, profitability.

For example, a revolving line of credit is generally tied to a fluctuating index, usually the specific lender's base rate, which may or may not be reflective of the national prime rate as published *Wall Street Journal*. Additionally, it should be noted that the applicable interest rate on this type of credit facility also contains a 'spread' that is added to the index, typically .5% to 2%. Such a rate will be 'floating' and will increase or decrease with any upward or downward movement in the lender's base/prime rate.

Considering that the national prime rate has increased 16 times since June of 2003, from a low of 4% to a current rate of 8%, you should seek to have your lender agree to a maximum interest rate cap. While a lender who agrees to such a cap may also insist on a floor, the existence of a cap allows for better strategic business financial planning, as its allows you to accurately determine the maximum amount that would be required to fund this debt, presuming that the cap was met.

In both the term loan credit and mortgage loan credit facilities, you should be sensitive to a number of factors that may make a particular credit facility more or less attractive.

In recent years, most term and mortgage credit facilities, while providing for a 15- to 25-year amortization of the specific debt, contain either a specified review date or dates, (i.e. every five years,) at which time the lender may modify, extend, or terminate the credit facility, or a maturity date, (when the loan balance is due and payable in full,) that is shorter than the stated amortization period. Lenders generally may also be willing to extend both a specified review date and/or maturity date based on your agreement to accept an initial higher rate of interest at the inception of the credit facility as opposed to a lower interest rate that might be quoted for shorter-term money.

A second area of concern to consider, resulting from the credit facility's shorter review or maturity date, is that each such credit feature will result in a balloon payment being due if either the loan is called at the review date or the loan matures. In both instances you will have been making loan payments based upon an amortization schedule that would only pay out the loan if payments were made over the entire amortization period.

Therefore, you must pay particular attention to such dates and begin the necessary negotiations for an extension of such financing, or perhaps arrange for alternative financing four to six months prior to any such review or maturity date. This is particularly important in a period where interest rates are on the rise. Consider the possible detrimental impact a dramatic increase in interest rates may have on your business' operations and profitability.

A third area of concern is that of the pre-payment penalty or premium. Many term or mortgage credit facilities may offer what appears to be an extremely favorable fixed interest rate, but may also contain a pre-payment penalty that requires you to pay a fee equal to a percentage of the outstanding principal balance of the loan at the time such a pre-payment is made. Generally, such a penalty is not intended to be punitive, but rather seeks to provide the lender with a yield that would not be realized if the debt were paid off during the early years of the loan term.

When discussing the prospective loan terms with your lender, be sure that the imposition of such a penalty will not occur if a pre-payment is made from the normal cash flow of your company or if refinanced with the same lender, but only if you elect to move the credit facility to another third-party lender.

Another possible area you may wish to consider in an attempt to facilitate your company's cash flow while servicing your outstanding debt obligations is that of seasonally adjusted loan payments.

For example, a company that operates a landscaping/garden center or swimming pool installation company might seek to have its regular monthly principal and interest payments required only during traditionally busy months, (i.e. April through September,) when cash flow is strongest, with a reversion to interest-only payments during the late fall, winter, and early spring months, when business volume is understandably down and there is a corresponding reduction in available cash flow.

While it can be somewhat disconcerting to watch the slow and steady rise in short-term, and in some instances, long-term interest rates, there are a number of ways you can seek to mitigate the potential volatility of such rate changes.❖

Gary Breton, a shareholder with Bacon & Wilson, P.C., is a member of the Banking and Finance Department, whose major emphasis of practice includes representation of financial lending institutions, as well as both individual and business borrowers. He also represents numerous business clients in the startup, purchase and sale of businesses; (413) 781-0560; gbreton@bacon-wilson.com