Financing: It's Not All About Interest Rates

There Are Many Factors that Determine if a Loan Package Works for You

By GARY BRETON and GARY FIALKY

Obtaining a commercial loan from a financial institution can be complicated, and it requires substantial consideration.

A bank traditionally proposes terms that are necessarily protective of its own best interests, so the borrower must be very careful to do the same. Unfortunately, many borrowers make their decision to sign on the dotted line by a sole factor, the interest rate.

Basing one's decision on this sole criterion can be a dangerous mistake. Many other factors should be carefully considered before a commitment letter is signed, sealed, and delivered, as many of the terms may be negotiable.

First and foremost should be a careful evaluation of the loan officer, who should be someone with whom you are comfortable and share an open and honest mutual respect. He or she must have the ability to understand and the desire to care about your business. The lines of communication must be strong between the two of you, and if you find that you are not comfortable with him or her during the loan application process, you may want to consider asking for another representative or, if necessary, consider another financial institution.

Collateral is also an important consideration when evaluating loan terms. Whenever possible, it is recommended that business assets be utilized before personal ones. In the event that business assets cannot substantiate the loan amount requested, personal assets may have to be pledged as additional security. Items such as equipment, furniture, fixtures, inventory, accounts receivable, and related real estate should be considered. It is also important to note that the definition of what constitutes eligible accounts receivable and eligible inventory can vary from one financial institution to another.

For example, one financial institution may look to a specific percentage of a business's inventory as eligible collateral, specifically excluding old or obsolete collateral. Accounts receivable can also be utilized as collateral, but again, what constitutes eligible accounts receivable must be defined. For example, must they be earned less than 30 days, 60, days or 90 days? These conditions vary among financial institutions, so it is paramount to clarify them at the onset of the agreement.

Another factor that may be negotiable is marshaling. This ensures that business assets be utilized first rather than personal assets, in order to pay any indebtedness incurred, in the event that your business encounters future problems and a liquidation proceeding is necessary. Marshaling can designate the order of liquidation of assets, leaving any personal assets intact as long as possible. The failure to discuss this issue at the outset of the loan process will give the bank the option to elect which assets it will first proceed against when the borrower defaults.

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Still another significant aspect of a loan is the covenants designated within the loan-commitment letter. These covenants, which may be both affirmative and negative, govern specifics that the borrower can and cannot do throughout the term of the loan. They may run the gamut from predetermined salary limitations for the company's principals, to prohibitions on future acquisition of capital assets, and also prohibitions on additional borrowing from third party lenders. Carelessly crafted loan terms can leave the borrower without options in the event that the borrower needs additional financing, and is prohibited from obtaining it, which may tend to preclude a company's ability to expand.

Covenants, such as maintaining a minimum net worth, or loan balance to fair market collateral value, i.e. equipment or real estate, effectively provide a report card for the business. They establish financial expectations that must be met on an annual basis as a condition of the loan. Therefore it is important to include an accountant who will be able to review these covenants in order to provide reasonable assurance that they can be complied with on a timely basis.

An attractive interest rate may initially be very seductive for a borrower; however, evaluating a business loan upon any single standard may tend be dangerous becausethis provides the potential that the loan may not be advantageous to you on an overall basis. By focusing on a lower interest rate you may be overlooking other critical aspects of the loan, which may be far more harmful than an extra point or percentage of a point. One key factor to keep in mind is that virtually all terms and conditions of the loan commitment may be negotiable.

No business should enter into a loan commitment with a financial institution without the benefit of professional advisors, who will work to protect its best interests. ❖

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