



Commercial Lending For Small & Emerging Companies

By Andrew J. Sherman, Esq.

No small or growing company survives and prospers without some debt component on its balance sheet. Whether it's a small loan from family or friends at its start or a sophisticated term loan and operating line of credit from a regional commercial lender, most companies borrow some amount of capital along their path to growth. The use of debt in the capital structure (commonly known as "*leverage*") will affect both your company's valuation and the overall cost of capital. The proper debt-to-equity ratio for your business will depend on a wide variety of factors, including:

- the impact that your obligation to make payments under the loan will have on the cash flow of your business;
- the costs and expenses relating to obtaining the capital;
- your need for flexibility in the capital structure so you can respond to changing economic or market conditions;
- your ability to get access to alternative sources of financing;
- the nature and extent of your company's assets (tangible or intangible) that are available to serve as collateral to secure the loan;
- the level of dilution of ownership and control that your shareholders (and managers) are willing to tolerate; and
- certain tax considerations (interest payments are a deductible expense, but dividends are not).

The maximum debt capacity that an entrepreneurial growing company will ultimately be able to handle will usually involve balancing the costs and risks of defaulting on a loan *against* the owner's and managers' desire to maintain control. Many entrepreneurs want to maintain control over their company's affairs, so they'll take on the higher level of risk that is inherent in taking on additional debt obligations. So, your ability to make payments must be carefully considered in the company's financial projections. Another key issue in debt financing is *timing*. It is critical to start the process of looking for debt capital early and not wait until you are in a real cash flow crunch because you will lose your negotiating leverage and weaken your company's financial position which will be a major turn-off to most lenders.



If your Business Plan and cash flow projections reveal that making loan payments will strain your company's financial condition (or that you don't have sufficient collateral) then you should explore equity alternatives. It's simply not worth driving your company into bankruptcy (voluntarily or not) solely to maintain maximum ownership and control. Remember the saying, 60% of *something* is worth a whole lot more than 100% of *nothing*. You should also compare the level of debt financing you against the more typical business ratios for your industry. Once you've figured out your optimum debt-to-equity ratio, you can look into the various sources of debt financing, and the business and legal issues involved in borrowing funds from a commercial lender.

The Basics of Commercial Lending

Although you should consider all available alternative sources of debt financing, traditional bank loans from commercial lenders are the most common source of capital for small growing companies. The frenzy of mergers and acquisitions by and among large regional banks has made it somewhat more difficult for small business borrowers to get access to and build relationships with a commercial loan officer. As a smaller borrower, some entrepreneurs have complained that it is getting increasingly more challenging to get the attention of the loan officer in a bigger bank who may be more focused on the bigger borrowers and customers. As a result, the small business owner has often needed to turn to smaller and neighborhood banks who may be more receptive to winning their business but may offer a more limited range of services and have smaller lending limitations.

BOX A The Eight Most Important Questions When Seeking Debt Capital

1. How large of a loan do you need?
2. How will you use the money?
3. How will the loan benefit your business?
4. When can you pay it back?
5. How will you pay the loan back?
6. Why are you and your company a good credit risk?
7. What if the business fails or you can't repay the loan?
8. Are you growing too fast or in a manner which will put your ability to repay in jeopardy?

Understanding The Lender's Perspective

There's often a lot of confusion and resentment the relationship between bankers and entrepreneurs. The entrepreneur believes the banker doesn't understand and appreciate his business requirements, while the loan officer may have had bad experiences with entrepreneurs who expect to borrow more than a million dollars (collateralized *only* by a dream), or the loan officer has had to foreclose on a default by a small business.



So you see why it's in your best interest to try and understand the lender's perspective. Banks are in the business of selling money and *capital* is the principal product in their inventory. Bankers, however, often personally risk-averse and have internal controls and regulatory restrictions affecting their risk tolerance. The bank's shareholders and board of directors expect loan officers to take all steps necessary to minimize the bank's risk in each transaction, and obtain the maximum protection against default. As a result, the types of loans available to growing companies, the terms and conditions, and the steps the bank takes to protect its interest all have a direct relationship to the loan officer's assessment of the perceived level of risk.

The management team assigned to obtain debt financing from a commercial bank must embark on an immediate risk mitigation and management program to prepare for negotiating the loan documentation.

BOX B **What Are Bankers *Really* Thinking When They Evaluate Your Proposal**

- Have you shown sound business judgment in the past? Have you always had a written plan with a timeline for specific business goals (accompanied by a back-up contingency plan)?
- Have you gone to see your banker only when you were in a tight spot and needed immediate help (This indicates a lack of planning)?
- Do you inform them monthly of good news and bad (including steps taken to mitigate the effects of the bad)?
- Do you show your banker you have proper financial controls in place?
- Do you discuss dealing with your suppliers, your pricing strategies, your marketing plans and your sales results?
- Do you send customer mailings and samples of new products to your bankers?
- Do you exhibit a clear understanding of your company's assets, liabilities and trends in your industry?
- Have you invited your banker to visit your business? Do you arrange for him or her to meet with your employees?
- Do you have a strong five-year strategic plan for your business in place? Is it updated in a timely manner and shared with your banker?
- Are you maintaining a strong growth plan for your business, including its involvement in community projects? Have you considered co-sponsoring community causes with your financial institution?
- Do you invite input from your banker as part of your future planning activities?
- Are you actively addressing safety and environmental concerns within your business?
- Are you seen as a strong community leader?





Preparing The Loan Proposal

The Loan Proposal should demonstrate the presence of a strong management team; an aggressive internal control and accounts receivable management program; financial statements and projections that demonstrate the ability to meet your repayment obligations, solid relationships with suppliers, distributors and employees; and an understanding of industry trends. In addition, many commercial loan officers will apply the traditional test of the four “C’s” of creditworthiness, namely *character* (reputation and honesty), *capacity* (business acumen and experience), *capital* (ability to meet debt-service payments) and *collateral* (access to assets that can be liquidated in the event of a default). Loan officers will assess all of these elements to determine your credit-worthiness and the relative risk to the bank in making the proposed loan. Loan officers will also assess whether your company and proposal present an opportunity to build a long-term banking relationship, where you will need additional services and larger loans from the bank down the road. Be sure to help the loan officer understand your long-term needs and your desire to build a relationship as well.

Although the exact elements of a loan package will vary depending on the size of a company, its industry and its stage of development, most lenders will want the following fundamental questions answered:

- Who are you?
- How much capital do you need and when?
- How will the capital be allocated and for what specific purposes?
- How will you service your debt obligations (application and processing fees, interest, principal or balloon payments)? and
- What protection (e.g., tangible and intangible assets to serve as collateral) can you provide the bank in the event that you are unable to meet your obligations?

These questions are all designed to assist the loan officer in an assessment of the risk factors in the proposed transaction. They are also designed to provide the loan officer with the information necessary to persuade the loan committee to approve the transaction. You must understand that the loan officer (once convinced of your creditworthiness) will serve as an advocate on your behalf in presenting the loan proposal to the bank’s loan committee and for sheparding it through the bank’s internal processing procedures. The loan documentation, terms, rates and covenants that the loan committee will specify as a condition to making the loan will be directly related to the ways in which you can demonstrate your ability to mitigate and manage risk as described in your business plan and formal loan proposal.

The loan proposal should include the following categories of information:



- Summary of the Request. An overview of the history of the company, the amount of capital needed, the proposed repayment terms, the intended use of the capital, and the collateral available to secure the loan.
- Borrower's History. A brief background of your company; its capital structure; its founders; its stage of development and plans for growth; a list of your customers, suppliers and service providers; management structure and philosophy; your main products and services; and an overview of any intellectual property you own or have developed.
- Market Data. An overview of trends in your industry; the size of the market; your market share; an assessment of the competition; your sustainable competitive advantages; marketing, public relations and advertising strategies; market research studies; and relevant future trends in your industry.
- Financial Information. Pro forma financial statements (prepared on a best case/expected case/worse case multi-scenario basis), federal and state tax returns, company valuations or appraisals of key assets, current balance sheet, credit references, and a two-year income statement. The role of the capital requested (regarding your plans for growth), an allocation of the loan proceeds, and your ability to repay must be carefully explained, and a discussion of your ability to make your loan repayments on a timely basis, must be supported by a three-year projected cash-flow statement broken-out and presented in a monthly format.
- Schedules and Exhibits. As part of the Loan Proposal, you should also assemble certain key documents such as agreements with strategic vendors or customers, insurance policies, leases, employment agreements, etc. to be attached as exhibits. Resumes of your company's principals, recent articles about the company, a picture of your products or site, and an organizational chart should also be appended as exhibits to the loan proposal.



* * * * *

ABOUT THE AUTHOR

ANDREW J. SHERMAN is a Partner in the Washington, D.C. office of **Dickstein, Shapiro, Morin and Oshinsky**, a prominent law firm with over 350 lawyers in Washington D.C. and New York City. Mr. Sherman is a recognized international authority on the legal and strategic issues affecting small and growing companies. Mr. Sherman is an *Adjunct Professor* in the *Masters of Business Administration (MBA)* program at the *University of Maryland and Georgetown University* where he teaches courses on business growth, capital formation and entrepreneurship. Mr. Sherman has been General Counsel to YEO since 1987. Mr. Sherman is the author of twelve (12) books on the legal and strategic aspects of business growth and capital formation. His most recently published books include **The Complete Guide to Running and Growing A Business**, published by **Random House** in November of 1997 and **Mergers and Acquisitions: A Strategic and Financial Guide for Buyers and Sellers** published by AMACOM in March of 1998 and **Parting Company** published by Kiplinger's in May of 1999, as well as **Raising Capital** published by Kiplinger's in Spring of 2000. **Fast Track Business Growth**, was published by Kiplinger's in January of 2002. Mr. Sherman can be reached at (202) 833-5000 or e-mail andrew@growfastgrowright.com.