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Bank Loan Negotiations

A Tutorial

By Ralph Gotto

Negotiating a Bank Loan or Renewal of Lines of Credit (LOC) can be a dreaded ordeal, even if you're not behind on your current loan. But if you come prepared to the negotiating table, it can be an enjoyable experience of strategy in action.

Banks nowadays are looking for good small businesses to invest in. But not just any small business. Banks have been skittish since the 2008 downturn, especially those left holding a lot of housing mortgages. But the money is there, and the climate is favorable.

Bidding Your Business

For renewals, the best advice is to start the process early, preferably 90 days before the due date. This will give you time to seek out other banks who may be interested in your company's business.

Most companies make two key mistakes in securing loans. First, not going after a large enough loan; you can always come down. Second, not going after bids from two or three banks. Yes, this takes more time, but it pays off bigger, saving you significant

interest with lower rates. Always try to have a few banks bid on your business, not just the incumbent bank. This will give you leverage as a potential client.

Make sure you ask all banks for the same data, apples-to-apples. Then put their bids into a spreadsheet and compare bank-to-bank. This will give you insight into which banks are most competitive. Look for banks that specialize in your type of business. Are they small-business-friendly, and will they assign a contact person to your account? Be wary of banks that have been bought out recently, because their lending policies could change drastically in the future.

It's best not to use multiple banks for different company needs – a line of credit from one, daily transactions from another, etc. Overall, it's to your advantage to have one bank hold all your business. It's not unlike insurance: you get cheaper car rates if you insure your house with the company.

Ask about everything. As everywhere, standard procedure often hides expenses that lenders will try and pass on to you. Many details need to be spelled out, many calculations weighed.

Doing the Math

Starting with the amount of the LOC – do you need \$500,000 or \$1,000,000? Credit is easier to obtain if you aim a little low. \$1M loans usually need to go through a special committee, which entails more scrutiny, with rules more stringent, and takes more time, usually an extra 30 days to get that approval.

What is the interest rate? Is it Prime Plus, or can you get Libor Plus? Libor is the London Interbank Offered Rate, and is usually lower than Prime. This is better-known overseas; relatively few companies in the U.S. are aware of Libor, and many smaller banks will not offer Libor rates. Larger banks with international ties are more open to this option.

Today, Libor stands at .26 percent and Prime is 3.25 percent. The benefit of Libor is that it moves more slowly than Prime, especially were inflation to hit the U.S. economy. The Plus adder for Libor is usually 2.85 – 3.5 percent, while the Plus adder for Prime is .5 percent – 2.5 percent.

(I once worked for a \$6B company whose debt-to-equity ratio was .25, meaning 25 cents debt for \$1.00 of

equity; yet they could never borrow at less than Prime plus 3.5 percent because of erratic earnings: one loss year vs. two profitable years. Since then, I've worked for smaller companies and have never paid more than Prime plus one percent, even with a high debt-to-equity ratio, most of the time below Prime, which is at Libor Plus.)

Does the bank have an interest rate floor or minimum? Recently, when interest rates dropped during 2008-2009, the topic of interest floors arose. As an example, if you have a Prime Rate (3.25 percent today) plus one percent, for a total of 4.25 percent, and the floor is 5 percent, your interest rate never goes below 5 percent.

Are there any closing fees? – these can run as high as one percent of the Loan Facility. Try to get them as close to zero percent as possible.

Is the term of the Loan for a year minimum? If you can go beyond one

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year, fine; but banks are now skittish, often reluctant to go beyond the one-year term.

Paying It Back

Make sure the Loan is interest-only payment, no principal payment. Most banks will want a 30-day paydown period (30 days with no loan amount taken or Loan balance). If you don't have high and low periods in your borrowing

cycle, you may need to also have a Term Loan. This is more like a mortgage, and is more expensive. If you can't get your paydown period down to zero for 30 days, go for 15 days and ask the bank for forgiveness. You can usually stretch Payables for 30 days, using advance payment on some of your client contracts to meet these goals.

Make sure your LOC is 100 percent available, not 80 percent of the Receivables amount. Make sure you don't have to submit a Borrowing Base Certificate each time you borrow. This is a document that must be filled out before you borrow against the Line of Credit. You have to list all invoices outstanding, a very time-consuming task. It also says that you have to manually borrow and repay the loan each time you need money.

There's one way around this: will the bank automatically lend when your balance goes negative, then repay the loan when you have excess cash available? Termed "Auto-Loaning," the bank advances from the LOC to cover any overdrafts. This is like having overdraft protection on your checking account. Cash-Sweep pays off the LOC when you deposit cash, and then invests the excess funds overnight.

Make sure the bank has remote deposit capability. This saves time spent running to the bank to deposit each check. You can also have clients wire funds directly to your bank.

Again, to keep your costs down, make sure to question all terms and practices.

Disclosures and Guarantees

To bid on your business, banks will need to review certain information. Be prepared to give them two years of Financials, and two years of Tax Returns, both company and personal. They'll also want your last

month's Receivables & Payables. All these reports may be internally prepared by your accountants.

If you are a private company, make sure that they don't need Audited or Compiled Financial Statements. These become more expensive, and must be prepared by an outside CPA firm. As a private firm, you can get by with Company and Personal Tax Returns and Personal Financial Statements.

Most banks will ask for collateral of all assets. The first asset the bank looks for is Accounts Receivable. The quality of this asset will determine how well you will negotiate. From a bank's standpoint, the more receivables from Fortune 100 customers, the better. They'll also ask for all assets as coverage. If your assets are less than 100 percent of the Loan value, you may be pushed into the Leveraged Buyout area. Financing then gets more expensive.

Personal guarantees are typically required. When negotiating, see if you can get this reduced in the second year. The bank will ask for unconditional guarantees, which means all your personal assets. The best way to ease the guarantee is to keep your profits growing, while leaving some cash in the business as equity.

Working the Game

With all these schedules and figures in hand, working from your spreadsheet, you can go back to those less competitive banks and ask them to improve their terms. Without naming the competing bank, tell them which offers are better, item by item. Usually you'll wind up with two banks that are very competitive. Work these two for the best deal.

If a bank wants your business, they'll usually adjust certain areas in order to land your account. Larger corporations usually are locked into one of the top five banks. So in order to expand, banks are going after good smaller businesses.

Recently, for instance, I had four banks bidding on a LOC renewal. The old line was \$650K, while the new one is \$975K (slightly under \$1M, to avoid committee approval delays).

In my own dealings, I've found that my leverage was greatest when I had three or four banks bidding. Go back to the banks that you like and see if they'll change their bid. Treat it as

a game – which it is, only a business game. If you're going to work at your business, you might as well have fun.

So follow this outline, have an enjoyable negotiation, and get a LOC that will help your company grow to the next level. **N**

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