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When a Loan is Not the Right Answer

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Throughout this series of articles we have addressed preparations for obtaining a business loan, whether from a traditional bank or an alternative lender like The Loan Fund. While paying cash is often the best option for covering the expansion needs of your business, sometimes – like when you are looking to buy new, very expensive equipment or to double the size of your plant – paying cash may not be an option.

Both of these examples include the purchase of hard assets and banks will often lend a large portion – 70 to 80 percent – of the purchase price. But non-collateral needs such as working capital to hire more salespeople, often can't be met by traditional lenders.

The key word is *successful*. It is extremely hard to get anyone, even your Uncle Louie, to lend you money, let alone invest equity in a business if it is not profitable. If your business has lost money for the last two years, if you are struggling to meet payroll, if you have little or no backlog of orders, or if your product or service is just ordinary, the chances of attracting any kind of capital becomes more difficult. Lenders and equity investors want to do business with someone who has been or will be successful.

The advantages of a loan are that you know how much it will cost each month and how many months of payments there are. At the end, you tear up the note and own the asset. Based on the quality of the asset, the amount of money you want to borrow, and your credit history, the rate should be fairly low. A rate of 8 to 10 percent may seem expensive, but it is reasonably priced debt based on historical rates.

Even if your business is successful, there are several very good reasons that a lender may say no to a loan.

You may have too much debt or your debt-to-equity ratio is too high. You may not have enough retained earnings in the business.

Your interest and principal may be too high relative to your income, resulting in a low debt-to-service ratio that could affect your ability to make timely payments.

Your proposed collateral may be insufficient to support the loan, or your business may simply be growing too fast.

While all are legitimate reasons for a lender to say no, having more equity might allow the lender to say yes.

This was probably the case with growing companies that have been in the news lately – companies like Eclipse Aviation, Advent Solar and Miox, Inc. All three are growing rapidly and have needed new or expanded facilities and manufacturing equipment. Money has been needed for marketing and employee hiring. All three have raised equity capital, and in the case of Eclipse Aviation, it has been a lot of equity capital.

While these companies probably have sizeable loans outstanding, none of them would have arrived at the point they are without attracting equity capital. The founders of all three probably now own less than 50% of their businesses, but the value of their remaining ownership has increased significantly.

Attracting an equity investor is not easy. Getting \$250,000 to \$750,000 from a professional investor is even more difficult. Managing and growing your business through debt is often the right way to go. However, the New Mexico Small Business Investment Corporation (NMSBIC), through its equity partners, has invested in 29 New Mexico businesses over the last three years. While many of these are technology businesses, our partners have invested in chili producers, specialty bird-food manufacturers, an oil field service company, a home security company, and several other more traditional businesses. To date, all but one has been successful. Most, if not all, have increased revenues, developed new products, expanded their marketing, hired new employees, attracted board members, and experienced varying degrees of success. None could have grown as quickly without equity from outside investors.

Finance New Mexico is an initiative of the New Mexico Small Business Investment Corporation (NMSBIC), New Mexico Small Business Development Center (NMSBDC), Empowering Business Spirit (EBS), the New Mexico Venture Capital Association (NMVCA) and other partners to assist individuals and businesses in obtaining skills and funding resources for their business or idea. To learn more about resources available to New Mexicans, go to www.FinanceNewMexico.org.

