



Article 50

September 14, 2008

Obtaining Credit – Even When Lenders Are Leery

By Les Mathews and John Brown, Mesa Capital Partners

The worldwide credit crunch has tightened credit availability for even the largest companies, and that has also made it more difficult for smaller companies to obtain credit for expansion and working capital. Banks, the traditional sources of loans for smaller businesses, have been forced to raise credit standards and make more cautious loans to smaller businesses, which causes a significant reduction in credit availability, higher borrowing costs and more restrictive credit terms.

As a result, smaller companies, the mainstay of New Mexico's economy, are seeking more innovative ways to finance their operations and growth. This is particularly true for the state's early-stage businesses: Most have no history of generating positive cash flows, and most have few unencumbered assets and minimal or negative net worth — all of which make them seem too risky in the eyes of loan officers at traditional banks.

Many owners of early-stage businesses have tried to overcome this problem by offering their personal residences as collateral for business loans. But with the mortgage market meltdown and stagnancy in the residential real-estate market, banks are getting more cautious about hedging bets even on this traditionally most stable and secure form of collateral.

In such a risk-wary climate, it's getting more and more attractive for entrepreneurs to finance business growth with infusions of equity. Doing so strengthens the balance sheet of a company and gives lenders more confidence about advancing credit on a lower loan-to-value ratio. Lowering the amount of debt and offsetting the need for debt with equity also lower the claim on cash flow for debt service.

Now what?

Most portfolio companies we work with have ongoing needs to raise money to buy equipment and other working capital. Over the past year, it has become increasingly difficult to arrange financing for these purchases.

Even when a business presents substantial collateral in the form of real estate, accounts receivable, inventory and has positive cash flows, it's been far more difficult in 2008 to obtain credit for the company than it was in 2007 and more necessary for us to turn to alternative lenders.

We have had success with debt financings from so called mezzanine lenders – lenders who extend credit on a subordinated basis. These lenders are more like private equity funds, tending to focus on a company’s historical cash flow and future prospects rather than on collateral. Because these lenders are subordinate to traditional senior debt, they require rates of return of around 20 percent. This can be achieved through a high coupon with deferred interest or by providing them with an equity position.

We’ve also had success with government-backed programs that guarantee loans to banks or alternative lenders that extend credit to entrepreneurs. As with mezzanine lenders, interest rates for government-backed loans are higher than they are for traditional bank loans because the bank and government program split the risk, but they’re nevertheless an option for those who don’t qualify for traditional loans. The federal Small Business Administration and U.S. Department of Agriculture and the state’s Smart Money program all offer backing for loans.

Working together

When even these alternative approaches don’t succeed, we turn to a venture capital or private equity firm doing business in New Mexico for an infusion of equity, which usually makes a business more likely to appeal to alternative or traditional lenders.

With more equity providers and alternative lenders going into business in our state in the past few years, a strong sense of community has developed among these organizations. The result has been more options for companies seeking traditional or novel ways to underwrite their growth even in times of economic uncertainty.

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.

