Need a Loan? Four Principles to Consider Before You Choose A Lender

Picture this: A real estate developer from New York City visits a Philadelphia suburb, sees a building for sale at an attractive price and is tempted to buy it. He calls his banker, only to be told that the institution isn't making real estate loans. What should he do? Or consider this: While browsing through a business daily, a retail store owner learns that a bust dot-com's product inventory – worth $10 million – is on sale for 20 cents on the dollar. That would be a bargain, if she could only raise $2 million to grab the opportunity. To whom should she turn?

Situations such as these constantly arise in business. Unfortunately, solutions are rarely available easily – especially when deadlines are tight. The U.S. economy may be slowing in the aftermath of the tech-stock collapse on Wall Street, but that does not signify fewer business opportunities. In fact, an economy heading toward recession sometimes generates more opportunities for savvy companies. The key question such companies face is: How can we raise capital when we need it, so that we can respond rapidly to opportunities as they come along?

The answer is both complex and multi-layered, according to experts at the Wharton School of the University of Pennsylvania and GE Capital. They point out that picking the appropriate lender for a particular capital requirement is among the most important choices a borrower can make. If the choice is made wisely, not only will it facilitate opportunistic deals – such as snapping up real estate or product inventory at lower prices – but it will also establish a strategic relationship that can help the company achieve its long-term goals.

In making these decisions, it is important to have a general understanding of the significant changes that have occurred in the U.S. business-lending marketplace during the last two decades. As has been widely noted by banking, finance, and academic experts, a large segment of the business credit market has shifted from banks to commercial finance companies. Numerous factors have played a role in this shift:

- Financial deregulation created more competition between bank and non-bank lenders
- Risk-based capital regulations increased capital requirements for the banking industry
- Banking consolidation greatly reduced the number of commercial banks
- Substantial loan losses during the 1987-93 economic downturn and the need to strengthen capital positions led many banks to tighten terms and standards for underwriting business loans
- Technological changes in information storage and communications have enabled finance companies to gain access to money and capital markets.

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Concurrent with these changes, financial assets at commercial finance companies have grown dramatically, increasing from $197 billion in 1980 to $956 billion in 1999.1 Finance companies are now major suppliers of credit to American business and provide important alternative sources of funding to the traditional commercial banking lenders.

Keeping this background in mind and paying attention to four related principles can help borrowers avoid errors in choosing the right lender for a transaction.

1. Examine your goals and needs.

"Know thyself," said Shakespeare, and that is just what a company wishing to choose a lender must do. Specifically, this involves analyzing both the type of loan the borrower needs and its size. In selecting a funding source for a particular transaction, borrowers should take into consideration current capital needs, as well as future business plans.
For example, if a company needs a revolving line of credit, real estate financing or structured financing to re-capitalize, financing decision makers need to know that different lenders specialize in these types of lending. "Banks do not typically offer a long term, fixed rate real estate loan product.," points out Bill Gregory, Senior Vice President of GE Capital Business Asset Funding. "If you need a revolving line of credit, you typically would not go to a term lender. Some companies are experts in these businesses and others are less focused on them. Once you have identified your company's needs, that knowledge will direct you to the -type of lending institution that is best able to provide an appropriate solution."

The size of the loan is another key factor. A large real estate investment trust that needs $500 million for long-term development projects may be able to raise capital on Wall Street. The same option may not be available to a medium-sized property developer who needs $2 million to $10 million to complete a transaction. The size of the funding requirement – and also that of the borrowing company – help determine what kind of lender the borrower should consider.

2. Understand the regulatory environment.

Although this is a complicated exercise, recognizing the regulatory factors shaping financial markets is as critical for a borrower as understanding the company's goals and needs. The financial environment has been going through a period of rapid change. Historically, the Glass-Steagall Act of 1933, which was intended to calm the fears about bank failures following the Great Depression, has shaped the regulatory environment of the financial services industry today.

In recent years, however, according to research by Anthony Santomero, former director of the Wharton Financial Institutions Center and David L. Eckles three forces have "conspired to make the restrictions of the Act increasingly irrelevant." These forces, according to Santomero, include technological innovation, regulatory circumvention, and new delivery mechanisms. These have led to changes in the market infrastructure and altered the competitive dynamic between banks and

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finance companies such as GE Capital, General Motors Acceptance Corp. and Ford Motor Credit.

One major effect of banking deregulation – a phenomenon that got a shot in the arm after the Financial Modernization Act was passed two years ago – has been to spur bank consolidation. This development has important implications for companies that wish to borrow funds from banks. From 1987 to 1993, the banking industry consolidated radically through nearly 3,000 mergers. These mergers sharply reduced the number of small banks, which tend to specialize in lending to small and medium sized business borrowers. 2Meanwhile, finance companies continued to develop their traditional core asset-based customers in the small and middle market. As a result, it has become more difficult for mid-market borrowers to obtain, maintain, and extend levels of funding from major bank sources and relatively easier for finance companies to serve this market.

As institutions that raise deposits from the public, banks are closely regulated by government agencies. This has crucial implications for potential borrowers. "Banks have lending limits, and they have to stay within certain financial ratios," explains Gregory. This makes it difficult for these institutions to explore market opportunities as freely as they might like. "For example, banks sometimes contact us when they are 'out-of-ratio' on investments such as real estate mortgages," he adds. "Regulating agencies, which were lax during the past several years, are beginning to tighten up again. Some banks are trying to be proactive by selling pieces of their portfolios in order to bring ratios back in balance." Borrowers must recognize these possibilities when choosing a lender.

Several real estate companies felt the impact of bank regulatory pressures during the recession of the early 1990s. Stung into action by massive S&L failures following the real estate bubble of the 1980s, bank regulators introduced tough lending requirements that left large numbers of developers scrambling for capital. "Banks began to call loans that were performing and pull credit lines from borrowers so that they could bring their portfolios back in line with government mandates," says Gregory. The borrowers that best survived these traumatic times, he adds, were those that had strong relationships with both banks and finance companies.

3. Explore lending practices.

Borrowers must recognize that banks, finance companies, insurance firms, pension funds and other lenders view borrowers in different ways. An important factor in choosing a lender involves understanding the lender's approach towards its customers. "In general, banks look for loans of a certain quality, and they set up a pass-fail system," says Gregory. "Either an application for credit passes or fails based on the bank's lending criteria." In contrast, finance companies generally set up risk-reward continuums, whereby loans are priced according to their degree of risk. While this gives finance companies greater flexibility in making loans, it also has helped support the view that loans from finance companies tend to be more expensive than those from banks.

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The lending practices of different institutions are closely related to their exposure limits to various borrowers. This sometimes makes it difficult for a company to borrow more from a lender. "Borrowers tend to overlook their total exposure with a lender. A borrower may have a $10 million or $20 million credit line and they need to understand that the line is counted as part of their total exposure– even if the credit line is not fully utilized," Gregory points out. "If the borrower's business is growing, and the company needs to increase its credit availability for working capital, it may run into a situation where it hits an exposure limit." Should that happen, the borrower could run into trouble.

Yet another aspect borrowers should consider is the extent to which the lender's overall activities affect its lending practices. Consider, for example, how diversification and specialization affect the practices of banks and finance companies. As noted above, banks are subject to diversification requirements that proscribe concentrations of loans to single borrowers. This may prevent a single borrower from obtaining additional funding from a particular bank. Finance companies, however, limit exposure according to internal risk management criteria, which are often more flexible in extending multiple loans to credit worthy borrowers.

Also, be aware of the fact that banks serving small and middle market businesses may be geographically concentrated, tending to serve a broad range of borrowers in a given region. The larger finance companies, on the other hand, tend to specialize in a certain industry segments or asset collateral groups on a national scale,3 and, as a result, are more familiar with the capital needs of the industries that they serve.

Jos. A. Bank Clothiers, for example, a men's clothing company headquartered in Hampstead, Maryland, needed a cash infusion to open 30 more stores to add to its existing 118. Company officials researched getting a loan from the bank, as well as other finance companies, but ended up putting a mortgage on its corporate office and distribution center through GE Capital Business Asset Funding and securing a loan for $5.5 million. "Some banks prefer to lend money against inventory, whereas GE Capital Business Asset Funding specifically goes after real estate," explains David Ullman, Jos. A. Bank's executive vice president and chief financial officer. "Because they're familiar with the type of asset if they ever needed to liquidate, they would know the value of the property."

Commercial banks play a valuable role as lenders, adds Ullman, who emphasizes that Jos. A. Bank still relies regularly on its bank for non-real estate-related services. But whether a company is a $206 million corporation like the clothier, or a small business, it often can benefit from the flexibility and expertise offered by non-bank lenders.

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4. Focus on establishing a strategic partnership.

A longstanding relationship with a lender helps engender trust and establishes a strategic partnership that can reduce documentation and processing time. "Once you establish a relationship all the surprises are gone," Gregory explains. "At GE Capital, our strongest accounts are our strategic partnerships – borrowers who understand our needs just as we understand theirs."

When a company establishes a strategic relationship with its lender, it can ride out market turbulence more easily than if it were to focus narrowly on one-off deals. For example, in 1998, when the capital markets went haywire, several companies were left without sources of funding. At such times, lenders rushed to rescue borrowers with whom they had the closest relationships. GE Capital, for example, "supported as many borrowers as possible," says Gregory. "But we first assisted those with whom we had strategic relationships."

In their effort to choose lenders—either finance companies or banks—borrowers should examine their business operations much in the same way that they evaluate business risk from their customers. "If a company gets 75% of its revenues from one customer, it would probably see this as a major risk," Gregory points out. "Should that one customer go out of business, they would lose 75% of their revenues. Borrowers should apply the same philosophy to their lenders. If the lender has a change in its philosophy, borrowers may be adversely impacted."

Borrowers are busy people –and sometimes they may be tempted to act quickly in seeking financing. But they are well-advised to carefully consider appropriate sources of funding. Business owners making financing decisions should select the appropriate lender for a particular transaction, understand the impact of regulation, specialization, and diversification on lending practices, and establish a strategic relationship with their lenders of choice. Adhering to these principles will enable borrowers to focus on business operations.

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[1] U.S. Census Bureau, *Statistical Abstract of the United States*: 2000.p. 508,
[2] *Federal Reserve Bulletin*, November 1996. P. 985
[3] Simonson, Donald G. *Business Strategies*: *Bank Commercial Lending vs. Finance Company Lending*. April 1994. Pp. 12-13

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