Commercial Loans: What to Know Before You Sign

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Many business owners in need of financing for their business look to banks and other commercial lenders. After all, interest rates are low and a commercial loan usually does not require owners to give up any equity in the company or control of operations and strategic direction. However, commercial loans do come with several costs and obligations that can place a heavy burden on a business and that can be easily overlooked.

When applying for a loan, the first document that is presented by the lender is the Term Sheet. It sets out the general guidelines under which the lender will consider lending to the borrower. There is no legal obligation or commitment by either party at this stage. If the loan application proceeds the lender will conduct its due diligence on the business and its finances as well as the finances of the owner.

When the lender is prepared to make the loan, they will present the business with the Loan Offer. The Loan Offer is the binding contract that sets out the specific terms of the loan. It needs to be studied carefully by the borrower to ensure they understand their commitments.

The requirements specified in the Loan Offer will include:

- Financial tests
- Reporting requirements
- Security
- Fees
- Penalties

The financial tests are a series of ratios used to evaluate the performance of the business. The financial ratios specified in the Loan Offer must be maintained throughout the life of the loan. Examples of ratios required by lenders include:

- Quick ratio - a company's ability to meet its current obligations using its most liquid assets
- Current ratio - the number of times current assets exceed current liabilities
- Debt to equity - used to measure a company's financial leverage, calculated by dividing a company's total liabilities by its stockholders' equity

If it was difficult for the business to achieve the required ratios when applying for the loan it may be difficult to maintain them throughout the repayment period.

The reporting requirements of the loan may also place a significant cost and time burden on the business. If a full audit is required, the cost will be significant and should be considered as part of the cost of the loan. A 'review' or 'notice to reader' by an independent accountant of the business's finances will not be as time consuming or expensive, but still should be considered when reviewing the Loan Offer.

The security for the loan is another important consideration. Owners of incorporated companies will often be required to provide guarantees and their personal property as security, along with the assets of the business. The Loan Offer may specify that the assets of the business include not just physical property, but inventory, receivables and intangibles such as intellectual property.

In addition to the interest rate, the Loan Offer will include details of the fees the borrower must pay to the lender for making the loan. These fees can be for the costs of the due diligence process, loan processing fee, on-going loan administration, closing costs and an annual review. These fees can all add up. In many cases, the high fees are hidden behind a very attractive interest rate. Do the math. It may well be worthwhile paying a higher interest rate in exchange for a reduction in fees.

Finally, there is the issue of penalties. If a business fails to satisfy all the contractual obligations of the Loan Offer, the lender can call in the loan. If the transgressions are mild, the lender may give the business 90-120 day to repay the loan. If the breach of the Loan Offer terms is more severe, the time frame could be significantly shorter. Either way, the business owner will need to spend considerable time and energy finding an alternative lender in a very short period of time.

Owners looking for loans to fund a growing business must remember to look at the full cost of loan beyond the interest rate and repayment schedule. The specifics of the Loan Offer contract may not make that loan worthwhile. And remember, contracts can be negotiated, but not after they are signed. If there are terms you are unhappy with, raise them with your lender before signing. You may well be able to agree on terms with which you are both comfortable.

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