Romancing THE LOAN

Although the lending environment has improved, integrators are still struggling to find sources to give them money, and that could lead to more consolidation.

By Phillip M. Perry and D. Craig MacCormack

THERE'S SOME GOOD NEWS for anyone seeking a loan: Banks are showing new signs of vigor after a long period of infirmity following the financial meltdown of 2008.

"Bank profits are up, and most have paid back the money they received under the federal Troubled Assets Relief Program (TARP)," says Bill McDermott, CEO of Atlanta-based McDermott Financial Solutions.

Many small businesses, spurred by improving economic conditions, are starting to gear up for the kind of aggressive growth that requires outside financing. "Business owners are starting to spread their wings," says John McQuaig, managing partner of McQuaig & Welk, a Wenatchee, Wash.,-based management consulting firm. "There is more demand for expansion and equipment loans than there has been at any time since the Great Recession."

As with most good news, there is of course a caveat here: While lending in general may be up, that's not necessarily the case for contractors as a whole, among which we group commercial integrators.

"It's much easier today to get existing lenders to continue lending money than it is to find new ones," says Alex Calderone, managing director at Calderone Advisory Group LLC of Birmingham, Mich.

"A number of banks are very risk-averse today. They're looking at more than just cash flow. They want to see assets and they're asking for personal collateral on some of these loans," he says.

Concentrating on Cash Flow

Part of the problem is that the economy, while showing improvement, is doing so only slowly. Banks, therefore, are very cautious about lending money to businesses with overly optimistic revenue increases.

Furthermore, federal banking regulations introduced after the Great Recession often act as roadblocks to loans that might otherwise be made. Marry that fact with a persistent low interest rate environment and it's little wonder many loan officers sit on their hands (*See sidebar, "What's Holding Banks Back?"*).

So how do you cut through the financing thicket? You can ease the way by making sure you produce the financials the banks desire. "Historically banks have looked at the five Cs of credit," says McDermott. "Those are character, collateral, cash flow, credit and conditions (economic)."

In the years prior to the recession many banks were willing to make loans with one or two of the Cs missing. They would often just look at collateral such as commercial buildings. Not so today. Bankers are likely to look at all five Cs. Cash flow, in particular, has taken a front seat. Why? A desire to reduce the risk of default. It's not unusual today for a bank to ask for cash flow reports for the previous 18 months before granting a loan.

Cash flow requirements may become even more conservative because of widespread expectations that interest rates are about to start rising again. Says McQuaig: "The bottom line is you have to have as much cash flow as you can."

"I DON'T KNOW IF I CAN THINK OF A MORE IMPORTANT PARTNER THAN YOUR BANK," SAYS TIM CZYZAK OF IVIDEO TECHNOLOGIES, WHO WONDERS WHY MORE IN THE INTEGRATION SPACE DON'T MEET REGULARLY WITH THEIR BANKS.

Read Your Covenants Carefully

Cash flow (and other) requirements are defined in the "covenants" that appear in your loan document. Overlooking them can be costly. Even if the bank does not immediately call your loan, it may require drastic changes to your operations to better secure the cash it has at risk.

"The bank may issue a 'forbearance agreement,' which extends the line of credit in exchange for something," says McDermott. "That something might be a plan that shows how you will turn around the business. That might involve a move into a new market, the introduction of a new product or the selling of inventory and real estate to skinny down your company to its core profitable business."

Keep in mind that maintaining the required cash flow can mean adjusting your selling prices.

"Many small businesses don't have margins set properly, so they are not making the money they need to cover their loans," says Marilyn J. Holt, a Poulsbo, Wash.,-based management consultant. "That's where they get into trouble."

Seasonal or cyclical businesses (such as retailers or systems integrators) have a special problem, says Holt. They need money to invest in materials or inventory for the next sales season or big-ticket project. That kind of investment can be looked down upon by banks, which are nervous that the business will not make the sales needed to justify the investment.

Picking Your Target Wisely

It might be time to reassess the banks you are approaching. Even in the best of times the larger banks with household names — the ones you are likely to think of first when seeking loans — are less than ideal partners for the small enterprise. McQuaig says that many such banks tend to be interested only in larger clients requiring over $50 million in financing.

The lack of an easily tapped knowledge bank causes problems for business owners in general, and especially for those without a financial background. "Small business owners are turning for financial advice to their CPAs and attorneys," says McDermott. "But those people do not have experience as bankers."

As a result of these issues, smaller banks are more attractive to small businesses. "Community and local banks are doing well financially, have no or fewer regulatory issues, and are also more open to making small business loans," says Holt.

Since taking over 25-employee iVideo Technologies in Cleveland in January 2010, president Tim Czyzak has met each quarter with a representative from Lorain National Bank, a large community bank in the area that helped him move from investment banking into AV and broadcast integration. They do a business performance review and talk about what each side expects from the other over the next three months.

He's met the president of the bank, he says, and feels connected to the institution and believes they feel that same allegiance to him and his business. "I don't know if I can think of a more important partner than your bank," says Czyzak.

Czyzak has noticed more "want and willingness" to lend money than in the past and his bank representative is more likely to offer Czyzak money for potential investments than in the past. "Having a four-year history with them helps that too," he says.

Czyzak wonders why more in the integration space don't meet regularly with their banks.

The right community bank will take the time and effort to understand your business requirements and take care of your needs on a long-term basis. But do your groundwork first.

"Start by figuring out your business vision and be able to articulate it," says McQuaig. "Then make sure your bank understands it. Build

What's Holding Banks Back?

BANKS ARE ENJOYING IMPROVED PROFITS — the best, in fact, since the Great Recession of 2008. But for many a small business owner with a healthy P&L statement and an ambitious agenda, getting a loan application approved is still tough.

Why the reluctance to lend? For starters, banks have to comply with a number of federal regulations introduced since 2008 to avoid another meltdown. Those regulations can cause lending officers to sharpen their pencils when analyzing the financials of loan applicants.

A number of other factors are cited by Bill McDermott, CEO of Atlanta-based McDermott Financial Solutions.

"Many banks have less money to loan because they need to maintain elevated cash reserves to comply with the Dodd–Frank Wall Street Reform and Consumer Protection Act," he says. Any cash that needs to be stockpiled for federal review can't be lent to small businesses.

McDermott cites another reason "Banks make less profit on their loans than in the days prior to the Great Recession because of the current low interest rate environment," he says. Banks typically loan money to business customers at the rate of 2.5 percentage points above prime, which is the rate charged a bank's most credit-worthy large corporations. And the prime rate, hovering recently at around 3.25 percent, remains close to an all-time low.

Interest rate stability is still another depressant on lending activity, says McDermott. An economic environment with rising interest rates would be more favorable for banks, because they would not have to raise the rates they paid depositors as quickly as they could hike interest rates for new loans. The "spread" between the two interest rates amounts to additional profit for the bank. Absent such opportunity to make money from the spread, banks feel less incentive to make loans.

While banks see diminished opportunity for profitable lending, they are also incurring expenses in two areas. The first is investment in technology for the support of mobile banking. The second is compliance with federal regulations related to legislation such as Dodd-Frank, the Patriot Act, and the Bank Secrecy Act. Given their need to make a certain level of profit to pay for all those expenses, many banks are prone to lend money only at rates less than attractive to the typical small business owner.

It all adds up to a challenging lending environment despite the favorable factors of higher bank profitability and a recovering economy. The right bank will be eager to lend, but that doesn't mean every business will qualify. "Banks will fall over each other for a good company," says John McQuaig, managing partner of McQuaig & Welk, a Wenatchee, Wash., based management consulting firm. "But they still can't afford to take much risk, so poor quality deals will remain hard to place."

That's not great news for integration firms or contractors in general, although there are still ways to get loans, says Alex Calderone of Calderone Advisory Group in Birmingham, Mich., who advises contractors to seek out specialty finance companies rather than more traditional banks.

Calderone expects you'll see more consolidation of integration companies, with the larger ones buying the contracts of their smaller counterparts "at distressed prices" in many cases.

a relationship with one or two bankers who know what you are doing and what you are trying to achieve. If you make your vision clear to them they can help you get in position to accomplish your mission."

Speaking of smaller financial institutions, include credit unions on your short list. But choose carefully.

"Credit unions are relatively new to commercial lending," says McQuaig. "Make sure you are with one that has a true commitment to business lending, and is in it for the long term."

That can be bad, because it's usually more favorable for a business to consolidate all of its banking activity under one institutional roof.

Thoroughly Vet Your Lender

While smaller banks may be more approachable, they are also more prone to fail. Perform some due diligence when checking out a new bank.

"Most financial information is available online from the banks themselves," says Holt. "But you should also go to the site of your state banking commission. You can look up the records on every bank operating in your state, including their ratings from S&P, D&B and other agencies."

Is your prospective bank struggling with capital adequacy problems? (That is, are its cash reserves insufficient to satisfy new and more stringent federal regulations?) If so, it may be looking to trim its assets to get its balance sheet in line. "A bank that is undercapitalized may not renew loans that it otherwise would," says McDermott.

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Are there merger rumors? Problems can arise when a bank is acquired by another that wants to exit your industry. Just one more reason why your loan might not be renewed come maturity. You can also get a bead on the quality of the institution by personal visits. Do they take a real interest in your business?

As for getting references, a prospective bank will not give you the names of their current business customers because that is a violation of privacy. But you can ask for feedback from fellow members of organizations to which you belong, such as the Chamber of Commerce and Rotary.

"It's a good market for companies to ask for money and grow their businesses," says Czyzak. "It's a favorable banking market, especially compared to a few years ago."

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