855-2thesba
855-284-3722

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The Advantages to Refinancing Business Debt

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How tight is money in your small business? Over the past two-and-a-half to three years when credit markets locked up like a badly neglected gear, many small businesses had loans come due just at a time when sales were slumping. Wanting to refinance, these businesses were unable to find lenders. Others scrambled to rid themselves of the indebtedness and not infrequently ended up using more expensive money to keep the business running.

In more normal times, when you have more control over using debt as a strategy, refinancing can be useful. On the assumption that we are heading back into such times now, we checked in with Charles Green, principal with Charles Green & Company in Atlanta.
"The purpose of refinancing," said Green, a small-business financing advisor with 30 years of experience as a banker, venture capitalist and small-business owner, "is to improve cash flow, push the cost of the capital and the repayment of the principal further out [to the point in time] where you are going to be fully realizing the benefit of that expense."

He offers as an example a loan for a delivery truck. The truck is going to last five years, with your drivers putting 20,000 miles a year on it.
"So you don't want to pay it off in three years when you're still going to be using it two years after that," he said. "You want to be spreading the cost out over the period where you're going to be generating revenue" from the asset. And by not paying it off so quickly, your cash flow improves, which allows you to "take profits out of the business or to reinvest in other expansion costs earlier on."

Refinancing is a strategy to correct unfortunate earlier choices, he said. It lets the business "schedule the debt repayment out in a more appropriate time frame."

Play Defense
Sometimes, a smart decision might be to do a refi that significantly reduces cash outflow, even if it increases the cost of borrowing. Green describes a situation where a small printing company is leasing equipment that has a useful life of five years and could be given another five years in service by rebuilding it. The company leased the equipment from the manufacturer on a three-year contract. But after one year, financial challenges come into play, sales are down, costs are up, and vendors are giving no ground on terms.

"One of the ways they can relieve pressure on the cash flow is to get a different kind of loan," Green said. "Leases are not all that flexible on used equipment, but something like a U.S. Small Business Administration-guaranteed loan could be, where they would go and buy out their lease." U.S. Small Business Administration equipment loans can carry a 10-year term, "so the money they were originally scheduled to pay back over the following two years they might get scheduled out over 10." Even if the loan were at a higher interest rate, it would be a good business move because it would significantly improve cash flow.

Rules of Refinancing
When you weigh the short-term and long-term value of doing a debt restructuring, the decision you make will depend on your own preference and risk tolerance, Green said. Answer these questions: Do you want to defer profit and plow everything back into the business, paying down debt and getting your equity built up? Or do you want to push that debt obligation out further, which will involve more risk over the long term and higher cost by having a longer debt repayment, but you'd be freer to pursue expansion plans today?

Before you make a decision on that, talk to a tax advisor. Define why you want to restructure debt. There may be other options if cash flow is the basic problem, such as to pledge the receivables, or to try to work with your vendors or your current lender. Read all the disclosures from the old and new lender.

Green points out that with the new Small Business Jobs and Credit Act of 2010, signed into law in September, funds for refinancing should be more available. For one thing, the bill permanently raises the limit of a government-guaranteed loan, through the U.S. Small Business Administration, from $2 million to $5 million. "What that will do is it will allow tens of thousands more businesses to get under the umbrella of the U.S. Small Business Administration guarantee. This will make it easier for the bank to reschedule their debt if there's additional protection for the bank… [as there is with] a U.S. Small Business Administration guarantee."

He suggests this example: "If I'm a small-business owner eligible for U.S. Small Business Administration financing but my building costs $4 million, so I couldn't use U.S. Small Business Administration financing to acquire it seven years ago, so that means I didn't get that 25-year term locked in. I only got, say, a seven-year term. Now, the bank has got a lot of capital pressure and they don't want to renew the $4 million loan, although I made every payment on time and the building is relatively OK in terms of its value versus the balance of the loan.

"Now, that loan can be refinanced with a U.S. Small Business Administration guarantee attached to it for 75 percent of it, which means the bank can sell off that 75 percent guarantee tranche and get some money off the books," Green said. "They get a fee income stream started from that money that they sold off, and they're still able to accommodate that good paying customer."

The Small Business Authority's business lending division specializes in this particular type of U.S. Small Business Administration loan. As a benefit of the new law, all fees are waived on such loans through the end of 2010.

Charles Green's blog, Advice on Loan, regularly covers topics related to finding funding.

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