

Essentials of Borrowing

By DR. ERIC LAWSON*

WE ALL BORROW money. Our needs may be different and the risks associated have different limitations. For every so-called rule-of-thumb to borrowing, it is possible to find a firm which has violated the rule and benefited. Yet, it is useful to look at the general rules which have wide use.

For short term temporary purposes, a cash budget is a useful device for determining both the amount and length of need.

One problem faced by many growing firms is the need for temporary financing that grows as the firm grows. In fact, it is possible that what was a temporary need for funds one year will become a permanent need later on. Permanent needs should not be financed from temporary sources. Borrowing should not take place unless there is a need — and no more should be borrowed than is needed.

The need for long term funds should be basically determined on the grounds of profitability of the proposed capital projects. No funds, borrowed or otherwise, should be invested in unprofitable projects. Once the prospective profitability has been determined the remaining decision depends on the alternatives and their relative attractiveness.

The small firm generally has few alternatives since it does not have access to the major capital markets. Even so, cost should be a factor to keep in mind. If the funds are available only on excessively prohibitive terms they should be rejected. The ability of the firm to generate the cash flow necessary to meet the requirements is an important consideration — and must be determined.

Small firm credit funds are most readily available from commercial banks. This is particularly true of short term funds. Banks are in the business of making short term loans and the good banks are aggressively seeking new customers.

The ideal arrangement for both the bank and the

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customer is one in which the customer knows in advance the maximum amount he may borrow during the year, although he may not wish to borrow the maximum amount for a long time, if at all. Many bankers will say that most of their lending experience involves making an unbankable loan application into an acceptable deal. This process generally involves arranging for some kind of security for the loan.

Commercial banks are also a source for long term funds, almost always secured by a mortgage. Frequently a bank knows of other sources, such as an insurance company, where the funds may be obtained if the terms are right. Other sources of long term funds include special industrial corporations, the Small Business Administration and specialized agricultural institutions.

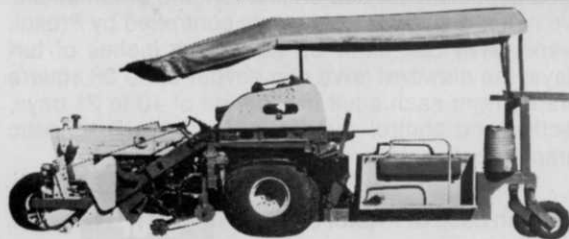
Term loans are available from some commercial banks. Such loans combine short and long term features. They are usually paid off in annual installments over a period of years. In this manner it is possible to match the cash flow of the firm to the loan repayment provisions.

A firm in the market for borrowing should consider that borrowing as a competitive process. It should be prepared to make full disclosure of all pertinent financial information including operating cash and capital budget for the future. The firm should consider as many lenders as possible and use the forces of competition to keep the ultimate terms as favorable to itself as possible.

The borrowing firms should recognize both the advantages and disadvantages of borrowing. The out-of-pocket costs of borrowing should be at a rate that is profitable to borrow. If a firm can use its capital to earn a 15% return it should be able to borrow at 10%. Obviously, if these figures are reversed borrowing should not take place.

The risk associated with borrowing is a basic question that must be answered. In the previous illustration the real question relates to the adequacy of the extra 5%: Is the 5% enough to compensate for the additional risk incurred by the indebtedness? If the answer is no, do not borrow; if it is yes, borrow. This determination must be made by the borrower.

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