



AbdulJaami, PLLC

International Commercial Transactions

Small Business Finance

Thinking Strategically

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Small Business Finance on the Increase

The U.S. Small Business Administration estimated that, as of June 2005, there were outstanding small business loans of US\$601 billion, *a 22.6% increase from June 2004.*



Thinking Strategically About Finance

- Loan Type
- Loan Purpose
- Some Key Terms
- Matching Finance to Project or Cash-Flows
- What's the Bottom-line? – Loan Costs and Expenses
- Covenants – When Collateral is not Available
- Loan Term Flexibility – Changes, Slippage, Waivers
- Need a Boost? – Credit Enhancement
- Syndication and Subordination: 2's a Company; 3+ is a Crowd!
- Review



Loan Type

- Secured / Balance Sheet
 - Collateralized loan based on the strength of borrower's assets (e.g. a home mortgage)
 - Availability of collateral
 - Cost of secured loan vs. unsecured loan
 - Future loan requirements and impact on availability of collateral
- Unsecured / Cash Flow
 - Loan based on the strength of borrower's credit rating (e.g. a credit card)
 - Credit rating
 - Strength of projected future cash flows
 - Availability and cost of credit enhancement



Loan Purpose

- Working Capital
 - Funds needed to produce, sell, deliver products or services
- Plant / Equipment Finance
 - Funds needed to purchase income-producing assets, build/modify plant
- Trade Finance
 - Funds needed to execute a specific sale or monetize accounts receivable resulting from a specific sale
- Project Finance
 - Funds needed to finance a project distinct from current operations
- Transaction Finance
 - Funds needed to effectuate a merger or acquisition



Some Key Terms

- Credit Agreement = documentation of credit facility
- Credit Facility = the actual loan or bundle of loans
- Term Loan = a one-time loan of x dollars for y years
- Revolving Loan = a loan of up to x dollars over y years
- Swingline Loan = short term loan made by agent bank
- Base Rate = particular bank's lending rate "prime rate"
- Spread = difference between loan rate and base rate
- Floating Rate = interest rate that varies with the market
- Representations and Warranties = statements of fact
- Covenants = promises to do or not do something

Matching Finance to Project or Cash-Flows

Financing should be matched to situation

- Time Frame
 - Can loan be matched to project life? 5 year project; 5 year loan
 - If not, will there be a gap in funding? Can it be plugged?
- Availability of Funds
 - When are funds needed, up-front? Over time, in varying amounts?
- Interest Rate
 - To what extent do project cash-flows fluctuate with interest rates?
- Repayment
 - Are cash-flows relatively fixed? Minimal at first? At Project end?



What's the Bottom-line?

- Direct Costs
 - Loan interest rate, fixed or floating
 - Arrangement fees
 - Commitment fee
 - Utilization fee
 - Other fees
 - Compensating balance requirements
- Soft Costs
 - Transactions costs; bank counsel fees; other advisory fees
- Prepayment Costs
- Costs of Late Payment or Default

Covenants – When Collateral is not Available

- Unsecured lenders use covenants to decrease the probability of late debt-service or loan default
- Types of Covenant: Affirmative, Negative, Financial
 - Compliance, Financial Reporting, Inspection; Limits on debt incurrence, liens, certain payments, investments, asset sales, mergers or sales of substantially all assets; balance sheet or income statement financial ratios
- Key Issues:
 - Do the covenants fit your company?
 - How do they impact future plans? 2, 3, 5 years down the road?
 - Is there enough slack for predictable (seasonal) business events?



Loan Term Flexibility

- Changes in the business
 - Is it likely that internal or external pressures will cause temporary or long-term changes in the business?
 - How likely is it that the lender will work with you?
 - What will be the cost? (extra fees, additional interest, etc.)
- Financial Ratio Slippage
 - Will you be able to timely monitor business compliance with financial ratios?
 - Is there enough lag before reporting financial results to repair short-term slippage (e.g. due to seasonality)?
- Waivers



Need a Boost? – Credit Enhancement

- Two Situations for Credit Enhancements
 - May be necessary just to get the loan
 - May be instrumental in decreasing the cost of the loan
- Types of Credit Enhancement
 - Guarantee
 - In the event of credit agreement default, 3rd party unconditionally agrees to meet loan obligations
 - Bank Letters of Credit
 - For a fee, bank “lends borrower its balance sheet”
 - For a fee, bank backstops borrower; standby or direct pay L/C
 - Use of Bankruptcy Remote Special Purpose Vehicles
 - Securitization of high-credit receivables



Syndication and Subordination

- Syndication: multiple banks fund loan, splitting the risk
- Issues:
 - Relationship between the Agent bank and other syndicate banks
 - Ability of lenders to transfer or assign commitments, loans or rights to 3rd parties
 - All lenders are not alike; does borrower have a say in the transfer?
- Subordination: if there is a default, lenders have a hierarchy of recovery
- Issues:
 - Impact on ability of borrower to negotiate with junior creditors
 - Impact of subordination on loan cost



Review

- Credit facility as a reflection of business reality
- Long-term impact of credit documentation
- Credit facility Direct cost (interest, fees) and Indirect cost (flexibility)
- Impact of Credit Enhancement on loan cost
- Impact of Syndication or Intercreditor issues
- Questions/Comments?
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