Fundraising? Consider Your Community Bank

By Nadine Kavanaugh

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By Robert J. Chalfin, Lecturer at The Wharton School, CPA, JD

While much attention has been focused in recent years on startups raising money from venture capital and private equity funds, another source that should be considered are local community banks (CBs).

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Over the years I have found these banks to be a valuable and reliable avenue to obtain debt for ventures that meet their lending criteria. In my experience, CBs usually have a two part test before they lend money. First, they look for strong collateral that is located in their geographic area, such as real estate, inventory, receivables, or equipment, and will lend up a percentage of the value of these assets. This percentage can vary but frequently centers around 80%. Second, the business should have sufficient cash flow to adequately and easily service the debt.

CBs are typically owned and operated by local entrepreneurs who have a vested interest in their community. They lend money to local businesses, organizations, and people that live and work in their geographic area. For a variety of reasons including the business model, size, scale, and complexity of the loans, their lending guidelines as well as the terms and loan requirements are typically different than those that are offered by the large money center banks (MCBs) and regional banks (RBs). I found it refreshing that when borrowing money from a CB, I am not working with an unknown analyst at the other end of an email. I am working with someone with whom I have developed a relationship of mutual trust and respect where the understanding is that there will be a long-term relationship, and not merely a “one-off” loan. As a result, in addition to the other salient lending criteria, the personal relationship between the bank and the borrowers is an important component in the bank’s decision to lend.

The size of the loans extended by the MCBs and RBs allow these lenders to take advantage of huge economies of scale when pricing their loans. This results in lower costs to their borrowers. Conversely, the size of the loans that the small and medium sized businesses (SMBs) usually require are merely “rounding errors”, at best, for the MCBs and RBs. In many cases, it is not profitable for the larger banks to make the smaller loans. As a result, cost, as a percentage of the gross loan amount, is typically higher with a loan from a CB. (The definition of a SMB can vary based on the industry or sector, but it frequently is used to refer to a business with fewer than 500 employees.)

However, many SMBs, whether they are local manufacturers, distributors, multi-location retailers, car or equipment dealers, franchisees, service firms, real estate developers, or a host of other enterprises, find that the CBs offer a vital and much-needed solution. In many situations, the entrepreneurs who own and operate these businesses find a kindred spirit when they speak with the CEO or chief lending officer of the local CB. Another advantage is the prime contact at the bank frequently has the experience and ability to quickly advise the business owner/executive if he/she reasonably expects the application to be approved by the bank’s loan committee. An added benefit is that the lenders are usually intimately familiar with the local economy and can offer (free) advice to the entrepreneur. Moreover since the lender and borrower operate locally these relationships can become synergistic. The banks can refer customers to their borrowers and the borrowers can refer customers to the banks. Generally both parties quickly realize it is mutually advantageous for the other to grow and prosper.

Each bank has a legal lending limit. This amount, subject to some exceptions, cannot be more than 15% of its tier one capital, less unencumbered loan loss reserves, and limits the size of loans that can be obtained from a CB by any one borrower or related group of borrowers. However some CBs will syndicate the loan and allow other local banks to participate. This increases the size of the loans that a borrower can obtain from this source. Moreover, many banks will not fully commit its their legal lending limit to one borrower, since they need to maintain a reserve in case the borrower suffers unanticipated setbacks and additional borrowings are required.

In my experience CBs typically require personal guarantees from the borrower. Both CBs as well as MCBs and RBs usually require an ongoing relationship including maintaining all deposit accounts at the bank.

The value of showcasing the operation while obtaining advice and guidance from a banker who can easily visit the business should not be overlooked. This familiarity can expedite the process of obtaining additional funding as the business’ needs evolve. As a result, I recommend borrowers remain in close contact with the CB since it can be a mutually beneficial relationship.

As an entrepreneur, I am continually exploring opportunities. I have borrowed from and invested in many CBs over the years. The entrepreneurial spirit at many of these banks coupled with their ability to participate in the growth of the local economy while helping other enterprises is exciting and, in many cases, rewarding.

Bio: Robert J. Chalfin is a lecturer at The Wharton School where he teaches courses to MBA candidates on business acquisition. An attorney and a CPA, he is an entrepreneur and has invested in numerous closely held businesses, including three minor league baseball teams. His book *Selling Your IT Business: Valuation, Finding the Right Buyer, and Negotiating the Deal* provides more detail about due diligence. He can be reached at bob@chalfin.com, 732/321-1099, or www.chalfin.com.