SHOULD YOU BORROW MONEY FROM A BDC INSTEAD OF A BANK?

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Business development companies are making loans available to small businesses. Is that right for you?

Despite a loosening credit market, access to capital for small businesses lags behind the economic recovery. To fill the void, dozens of private firms known as business development companies (BDCs) are making mid-size direct cash loans available to small to middle-market companies throughout the country. To do so, they invest a portion of their assets in U.S.-based, non-publicly traded small businesses and fund the loans by raising money from the public via IPOs or wealthy investors.

So which option—a bank or a BDC—is right for your company?

Key Differences

There are numerous significant differences between how the two entities operate:

- Generally, only a bank will loan you $5,000 for inventory or $25,000 for a truck. A BDC typically makes much larger loans at much higher rates than bank loans. A bank may lend money at a rate of 4 percent, whereas BDC interest rates could be in the double digits.
- A BDC may be an option for small companies that have their finances in order but were turned down by a bank. “Each BDC company has its own approach,” says Michael Chadwick, a financial adviser in Unionville, Connecticut. Their websites often provide their target range, whether it’s $3 million-$10 million loans, or $1 million-$3 million loans.
- Unlike banks, BDCs don’t make asset-backed loans against the value of a business’ real estate and equipment. Nor will a BDC loan be tied to your personal assets, says Chadwick.
- The terms of a BDC loan are also more flexible. To protect itself, a percentage of the BDC loan often comes in the form of equity in the company.
- A BDC may become involved in the business as part of its conditions—a pro or con, depending on your point of view. “In our version, you don’t have that obligation to pay the principal should you go into default,” says Joe Burkhart, the managing director of business development at Saratoga Investment in New York City. Rather than liquidate assets, the BDC would work with the business to get it back on its feet—for instance, by renegotiating leases or working with vendors to get better terms.

- Banks may require amortization of the loan in installments that consist of both principal and interest. “We don’t require fixed amortization,” says Burkhart.
- Smaller banks are limited geographically; BDCs can lend wherever they want.

Prepare for Both

When raising capital from either entity, be prepared to present tax returns, a detailed business plan, balance sheets and income statements. Burkhart recommends that businesses start by obtaining a quality of earnings report through an accounting firm.

And shop around. Small businesses should get multiple quotes from banks and BDCs alike. A bit of research may reveal which BDCs work more with your industry. Saratoga is more likely to lend to a software firm than a construction company, says Burkhart. But they’re not necessarily industry-specific. “Oftentimes they want to be diversified across all industries,” says Chadwick.