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Borrowing money helps small businesses grow and thrive. Access to funds can help small business owners buy new equipment, hire staff, consolidate debt and more. With new online lenders emerging, access to affordable funds is increasing and small business owners are feeling better about their prospects. According to research this year from American Express OPEN, of the small business owners interviewed, 93%

said that they were confident they could access the capital required to grow their

growth.

However, there is a relatively easy way for borrowers to discover the actual loan cost, by determining the loan constant. The loan constant is one of the oldest concepts in lending and used regularly by banks to calculate debt service burdens for both consumers and businesses. Banks commonly used both actual constants and stress constants against their debt portfolios to test for credit risk. The loan constant reflects the full amount of cash required annually for debt service.

The benefit of using the loan constant to determine a borrower's cost of debt is its simplicity. A prospective borrower needs only to annualize their monthly payment obligation, or multiplying it by 12 and then divide the figure over the original loan balance. The resulting percentage is the true cost of borrowing as it reflects the total payment, interest as well as amortization for loans that require principal paydown. If small businesses calculate the loan constant for loans they are considering, they will be able to compare interest rates as well as short and long-term deals, as shorter-term deals have heavier principal payments. Given the choice of two loans, a borrower will generally opt for the one with the lower loan constant, since it will have the lower debt service requirement.

For example, a merchant cash advance, a loan type with very high rates, charges a percentage against credit card/debit card sales. A typical rate of 15% against revenues does not sound unreasonable for a small business loan. However, when these loan payments are compared to the total loan balance, the annual percentage rates and loan constant can exceed 100% – a staggeringly high cost to a small business, especially for short-term debt. Borrower confusion on payment obligations can easily contribute to higher defaults, particularly during an economic slowdown.

More conventional loans available on-line often advertise competitive interest rates but often with short loan terms of less than three years resulting in a 'whopping' monthly payment. Underemphasized in the marketing of "best and lowest rates" by

years.

Unlike residential mortgages, small business borrowers are typically offered fully amortizing, short-term loans rarely exceeding 3 years. Fully amortizing structures require businesses to pay their balances to 0 by loan maturity, with no balloons outstanding. Loan terms are equal to amortization terms in this case. The aggressive paydown inherent in a fully amortizing loan is amplified by a short-term. Borrowers should always ask lenders how payments differ if you lengthen the amortization period. Like residential borrowers, businesses should always look for the longest period to reduce their ongoing debt burden. By capturing the overall payment including the portion of the payment, which pays down principal, the loan constant will show the substantial impact from short terms.

SmartBiz provides qualified small business owners SBA loans to help grow their business. Here's an example of how the loan constant is calculated for a SmartBiz loan:

Principal Balance: $100,000

Rate: 6.0%

Term: 10 years

Amortization: 10 years

Payment: $1,110.21

Loan Constant: 13.3%

And here's an example of an unfavorable loan constant for the same size loan:

Loan Constant: 57.6%

In addition to factoring the loan constant, there are other aspects to consider before taking out a loan. Small business owners should compare the upfront lender fees required when borrowing as well as prepayment penalties. Also, check with the lender to see if they report to the credit bureaus. Loan information not provided to credit bureaus could prevent a small business from building credit to qualify for a future loan.

The bottom line? Research, research, research. Make sure you've taken out an affordable loan with affordable payments. If calculating that monthly or annual payment is confusing, that's not a good sign. Reach out to local small business support groups or find a successful small business mentor to guide you through the loan process.

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Leo Jacobo is the Director of Operations & Lending for SmartBiz. He is responsible for group operations, loan volume production, personnel training and management of bank relationships. SmartBiz (www.smartbizloans.com) is the #1 online marketplace for SBA loan originations $350,000 and under providing fast, low cost SBA loans to small businesses across America. The company streamlines the SBA application process, enabling banks to make loans efficiently and small businesses to apply and get funds quickly.

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