COLLATERAL 101

PURCHASE AREA DEVELOPMENT DISTRICT (PADD)
1002 Medical Drive
Mayfield, KY 42066

Collateral is used to secure a loan by some asset(s) you own. You promise to hand the asset(s) over to the lender if you cannot repay the loan as agreed. By using collateral, the lender compensates for risks it enters to provide you with the loan in the first place.

Collateral is something of value - an asset or property - that you pledge when getting a loan. If you don't repay the loan as agreed, the lender can take your collateral and sell it.

Assets for Collateral Loans
When using collateral, you give the bank the right to take your asset if you can't repay. What assets can you use?

- Automobiles
- Real Estate
- Equipment, fixtures and furniture
- Cash accounts
- Investments
- Insurance policies
- Valuables and collectibles
- Future payments / Accounts Receivable
- Assignment of rent and leases
- Corporate or personal guarantees

Collateral to Loan Valuation
To further limit their risks, lenders usually discount the value of the collateral so that they are not extending 100 percent of the collateral's highest market value. Some assets will be more discounted than others. For example, a lender might only recognize 50% of your investment portfolio for a collateral loan. The same goes for equipment and fixtures. That way, they improve their chances of getting all their money back in case the collateral loses value throughout the life of the loan. It also accounts for loss of value due to normal wear and tear (for equipment, fixtures, furniture, etc.).

Be prepared to offer and provide more collateral than just the items you are planning to finance with the loan proceeds because due to the discounts applied by the lender, the financed objects value will not be sufficient enough to cover the loan amount.

This relationship between the amounts of money the bank lends to the value of the collateral is called the loan-to-value ratio. The type of collateral used to secure the loan will affect the bank's acceptable loan-to-value ratio.

For example, unimproved real estate will yield a lower ratio than improved, occupied real estate. These ratios can vary between lenders and the ratio may also be influenced by lending criteria other than the value of the collateral; e.g., a healthy cash flow may allow for more leeway in the loan-to-value ratio.

Of course, if there are mitigating factors that affect the value of your collateral and could bring a lender to accept a higher loan-to-value ratio, you should make the lender aware of those factors. Don’t assume that lenders always know the actual value of collateral that is provided or offered to them. When in doubt, lenders will assign a lower ratio just to be on the safe side.

The following information is generic and differs from lender to lender. Specific information about the ratios used by PADD is given at the end of each category.

	**Real Estate**: If the real estate is occupied, the lender might provide between 75% to 85% of the appraised value. If the property is improved, but not occupied (e.g., a planned new residential subdivision with sewer and water, but no homes yet), up to 50 percent. For vacant and unimproved property, 30 percent. **PADD will not assign more than 80% of appraised value.**
	**Equipment / Fixtures / Furniture:** If the equipment is brand new, the bank might agree to lend 75 percent of the purchase price; if the equipment is used, then a lesser percentage of the appraised liquidation value might be advanced. However, some lenders apply a reverse approach to discounting of equipment: They assume that new equipment is significantly devalued as soon as it goes out the seller's door (e.g., a new car is worth much less after it's driven off the lot). If the collateral's value is already significantly depreciated by the borrower, loaning 75 percent of the purchase price may be an overvaluation of the equipment. Instead, these lenders would require an appraisal of the equipment and use a higher percentage loan-to-value ratio for used goods because a recent appraisal value would give a relatively accurate assessment of the current market value of that property. For example, if a three-year-old vehicle is appraised at $15,000, that's probably very close to its immediate liquidation value. **PADD does not assign more than 50% of appraised value as collateral.**
	**Securities**: Marketable stocks and bonds can be used as collateral to obtain up to 75 percent of their market value. Depending on the kind of security, the percentage might be much lower if there is a high volatility to the securities value. Note that the loan proceeds cannot be used to purchase additional stock. **PADD assigns a ratio depending upon the kind and marketability of the provided securities.**

	**Inventory:** A lender may advance anywhere from 60% up to 80% percent of value for ready-to-go retail inventory. A manufacturer's inventory, consisting of component parts and other unfinished materials, might be only 30 percent. The key factor is the merchantability of the inventory — how quickly and for how much money could the inventory be sold. **PADD usually does not accept inventory as collateral.**
	**Accounts Receivable:** For accounts that are less than 30 days old, you might get something in the range of 50% to 75%. Accounts receivable are typically "aged" by the borrower and lender before a value is assigned to them. The older the account, the less value it has. Most lenders will refuse to finance accounts that are outstanding for more than 90 days. Lenders often also apply a graduated scale to value the accounts so that, for instance, accounts that are from 31-60 days old may have a loan-to-value ratio of only 60 percent, and accounts from 61-90 days old are only 30 percent. Delinquencies in the accounts and the overall creditworthiness of the account debtors may also affect the loan-to-value ratio. **PADD usually does not accept Accounts Receivable as collateral.**

Why Use Collateral?
If you risk losing something, why pledge it as collateral? It may be because there's no other way to get a loan. Banks won't lend you enough money to buy a house unless they can take the house back and sell it when things go bad (this is known as foreclosure). Lenders want you to have some skin in the game. They're taking a risk so they want you to risk something too. Lenders define collateral requirements; if you can't meet them you may have to pay higher rates or find another lender.

Personal Guarantee Basics
Lenders always evaluate borrowers to predict whether or not they'll repay. For consumer loans, there are credit scores and a wealth of other information to help with the decision. However, businesses - especially new businesses - may not have a credit history.

With limited information it's hard for lenders to make a decision. As a result, they usually require a personal guarantee. By making business owner(s) - not just the business - personally responsible, lenders improve the chances of getting paid. Without a personal guarantee, many small businesses can't get loans. Lenders will wonder why they should take a risk if you're not willing to put skin in the game.

When you provide a personal guarantee, you allow a lender to go after your personal assets if you can't repay a business loan. The business may be incorporated to limit your liability, but that protection doesn't help with a personal guarantee.

PADD requires all individuals who own 20% or more of a business to provide an unlimited full personal guaranty.