A simple guide to business loans

Businesses usually use finance when they're starting out, growing or expanding.

Access to finance can also help you manage your cash flow, cover unexpected expenses and purchase the equipment you need to grow. Different loans are designed for different circumstances, so it's important to find the one that best meets your needs in the most cost-effective way. To help you get started, we've taken a look at the pros and cons of some of the most popular options.

An overdraft or line of credit

Both an overdraft and a line of credit can provide access to revolving credit, which means the money you repay is available for you to use again as you need it. An overdraft allows you to overdraw on your business bank account up to an amount approved by your financial institution. A line of credit may take the form of a business credit card or a debit card linked a separate account. Both can be useful for smoothing your cash flow or provide a useful source of short-term capital.

Pros:

- Flexibility: you can use funds as you need them and repay the loan at your own pace
- If they're well managed, they can help to establish a good credit history for future borrowing
- A line of credit is available whether or not you have money in your account.

Cons:

- With an overdraft, you may have to pay fees even when you're not using the facility
- You may have to pay a penalty fee if you exceed your overdraft limit
- Some business lines of credit need to be secured, so you may need to use your home or business property or other business assets as collateral.

Term loan (secured or unsecured)

A term loan has an established repayment schedule over a number of years – anywhere from one to 25 years and can have a fixed or variable interest rate. This type of loan can be used for plant and equipment, core inventory acquisitions or another business purpose as well as business start-up costs.

Pros:

- You can choose the type of term loan that provides more flexible repayment options, including fixed, variable and split rates
- Repayments can initially be interest-only to assist with business cashflow requirements
- You may be able to borrow relatively large sums over a longer term at a relatively low interest rate
- Ideally, you will match the term of the loan to the lifespan of the underlying asset.

Cons:

- The application process can be time-consuming and demanding if you go directly to the bank
- You may have to provide property or business assets as security and often more than is really required if you go directly to the bank, as they want as much security as possible

- If you choose a variable interest rate, your repayments will increase whenever interest rates rise.

Commercial property loans

A commercial property loan will enable you to purchase rather than lease your business premises. It's similar to a home loan but tends to be for a shorter period and the lender will take things like the nature and location of your business into consideration as well as the income-producing potential.

Pros:

- Rather than paying rent, you'll be investing in a capital asset
- As you pay off the loan, you may be able to use the equity to grow your business
- You may be able to claim depreciation of fixtures and fittings
- Can also be used to purchase commercial investment property.

Cons:

- If you choose a variable interest rate, your repayments will increase whenever interest rates rise
- Some lenders require a personal guarantee, so assets such as your family home could be at risk
- You'll need to factor in expenses such as rates and repairs, which are normally covered by a landlord.

Hire purchase

Hire purchase can be a good choice if you can't afford to buy an asset outright but eventually want to own it. A lender purchases the equipment on your behalf, and you hire it from them for an agreed period of time. You take ownership when the purchase price and interest have been paid in full.

Pros:

- Hire purchase can be flexible, with a choice of contract lengths and, in some cases, the option of a final balloon or residual payment to reduce monthly outlay
- Interest is usually fixed, so it's easy to budget for your payments
- You may be able to claim appropriate tax deductions.

Cons:

- Interest can add significantly to the cost
- Some lenders require a deposit
- You don't own the asset until it's fully paid for so, if you default, you could lose the asset and the payments you've already made.

The type, quality, uses and costs associated with business loans are varied and usually complex. Obtaining the wrong type of loan can also be devastating for your business. For example, getting a term loan when you are having cash-flow issues. For these and other reasons, it's best not to go directly to a bank or lender but to use the services of a professional, tried, tested and proven finance broker like Chocolate Money to provide you with suitable options.

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