# Overdrafts and bank loans

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**Overdrafts and loans are the most common form of external financing available to businesses. Used properly, they provide a simple and effective way of financing the growth of your business.**

But despite their widespread use, they are not always used wisely. Many businesses make the wrong choices or incur unnecessary costs. At best, this raises the cost of financing. At worst, the business runs the risk of failure.

This briefing focuses on:

- Deciding which form of financing to use.
- Minimising the cost of financing.
- Security.

## 1 The right finance

**1.1** Decide what **gearing** you want (what proportion of your financing you want to be in the form of debt). This will depend on:

- What your cost of capital is and what returns your business expects to achieve.
- How much cashflow you generate.
  Your debts will spiral out of control unless you generate the cash to pay the interest and repayments on loans and overdrafts.
- How risky your business is.
  High gearing is less appropriate if you cannot confidently predict future cashflow.
- What financial risk profile you want.
  If you (and other investors in your business) are prepared to accept higher risk in the expectation of higher returns, you will want higher gearing.
- How much security you can offer lenders.
  The amount of debt banks are prepared to offer you, and the interest rates they charge, will partly depend on how well secured the debt is (see **5**).

**1.2** Establish the most **appropriate mix** between overdraft facility and loans according to the 'matching principle'.

- Use an overdraft facility to finance cashflow fluctuations and to provide contingency financing.
  For example, to cover seasonal troughs in cashflow, long payment delays and to cope with sudden cashflow demands.
- Use loans to provide fixed-term financing.
  For example, to cover development and start-up losses, to buy fixed assets such as plant and equipment, and to fund the fixed portion of your working capital requirements.

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**1.3** Make sure you have **enough finance**.

Arrange all your financing at once and allow for unexpected cashflow shortfalls. Do not try to manage with less than you need in return for a lower interest rate.

- If you arrange too small an overdraft facility, and then exceed your overdraft limit, you will pay additional bank charges and higher interest rates.
  The bank may also bounce your cheques, damaging your credit with suppliers and leaving you short of working capital.
- If you run short of cash and then fail to make a payment on a loan, you will be technically 'in default'.
  The bank may let you miss a payment, but may impose higher costs. Alternatively, the bank may call in the loan and security.

## 2 Overdraft facilities

**2.1** Overdrafts have two clear **advantages**.

- An overdraft is a simple, flexible way of financing changing cashflow requirements.
- You pay interest only on the amount you are overdrawn each day.

**2.2** There are also substantial **disadvantages**.

- In most circumstances, the bank can demand repayment at any time.
- The overdraft has to be regularly renegotiated, depending on how long it is needed for.
  The bank will want to check your creditworthiness has not deteriorated.

**2.3** The bank will charge you **setting-up costs** as well as interest.

- You are usually charged an arrangement or commitment fee whenever you set up or renew an overdraft facility.
  A typical fee might be 2 per cent for a £5,000 facility, falling to 0.25 per cent for facilities of £1 million or more.
- Large overdrafts may incur additional charges similar to loans (see **3.3**).
- You will pay higher fees for an 'informal' overdraft (eg where you go overdrawn without agreeing it in advance with your bank) than you would for a pre-arranged, or 'formal', overdraft.

**2.4** The effective **interest** you pay may be boosted by other charges.

- You pay a fixed margin over base rate.
  As base rates rise or fall, so will the interest rate charged on your overdraft.
- You can try to negotiate a narrower margin.
  A margin of one to five per cent over base rate is typical. In general, the larger the facility and the better your credit score (see **4.1**), the lower the margin will be. There is less room for negotiation on facilities of £100,000 or less.
- Larger overdraft facilities may carry a non-utilisation fee on the amount of the facility you are not using.
  A typical charge is 1.5 per cent.
- You may also have to pay for regular (typically quarterly) reviews.

## 3 Loans

**3.1** The biggest **advantage** of a loan is the fact that you can bank on having the money.

- Once you have arranged a loan, the financing is secure for the life of the loan (unless you fail to make payments or breach any covenants — see **3.2**).
- You can match the term of a loan to the life of an asset you want to purchase.
  For example, you can finance the purchase of a machine which will have a working life of five years using a five-year (or shorter) loan. By the time the machine is obsolete, the loan will have been paid off.
- You may be able to tailor the loan to match the cashflow of the project you are using the loan to finance.
- You can usually fix the loan interest rate.

**3.2** The **disadvantages** of a loan may include a lack of flexibility.

- You pay interest on the full amount of the outstanding loan.
- The bank often imposes legally binding covenants before agreeing to a loan. For example, the bank may insist you keep your overall gearing below a certain level.
  If you breach these conditions, the bank will be entitled to immediate repayment.
- You do not have access to the portion of a loan which you have repaid, unless you apply for a new loan.
- The bank will usually require a fixed charge (see the box on page 4) or some other form of security (see **5**).

**3.3** The **setting-up costs** for a loan may be just as high as for an overdraft.

- You are usually charged an initial arrangement or commitment fee.
  A typical fee might be 1.75 per cent for a £30,000 loan, falling to 0.25 per cent for a

"Small businesses seem to be using overdrafts rather less than they did. This could be because they're being asked for more stringent security guarantees and are looking at alternative forms of providing working capital, such as factoring or invoice discounting."
**Richard Holloway, management consultant**

➨The Government's Small Firms Loan Guarantee scheme covers 75 per cent of the lender's risk and you have to pay an annual premium of 2 per cent of the outstanding loan balance.

loan of £1 million or more.

- You might be required to take out insurance, such as key man cover.
- You may be charged for the bank's other costs. For example, for an assessment of the value of the security you are offering or to manage exceptionally complicated loans.

**3.4** As well as **interest**, you will have to pay **other charges**.

- You usually pay a fixed margin over base rate for floating rate loans of less than £100,000. A margin of one to three per cent is typical, depending on your credit score (see **4.1**).
- For larger amounts, you can choose to negotiate a fixed rate loan. This makes it easier to budget for interest payments.
- If you want to repay a loan early, you may be charged a pre-payment fee.
  A typical charge is one per cent plus a charge to compensate the bank for its interest costs.

## 4 Minimising costs

**4.1** Do what you can to improve your **credit score**.

Most banks evaluate businesses using a process of credit-scoring. While each bank's system is different, they tend to focus on:

### Extra choices

**A** You can control your **exchange rate risks** by borrowing in the same currency as you will be generating income in.

**B** For larger loans (typically £1 million to £5 million or more), you may be able to use **sophisticated financing** techniques. These include:

- Caps, which limit the interest rate you pay on a floating rate loan, no matter how much interest rates rise.
- Floors, where you agree always to pay at least the floor rate of interest, no matter how much interest rates fall.
- Collars, which combine a cap and a floor.
- Swaps, which reduce your costs through advanced financial engineering.

Never enter into a sophisticated financing arrangement unless you are clear of the costs, benefits and risks. Seek independent, expert advice.

- How good your security is (see **5**).
- How low your gearing is and how strong your balance sheet is.
  Putting more share capital (or unsecured director's loans) into the business may reduce the interest-rate margin demanded by the bank.
- What your cashflow projections are.
  Your cashflow projections should be credible and should demonstrate that you can comfortably meet interest payments and loan repayments.
- Your past banking record.
  For example, whether there have been problems with previous loans or overdrafts (including your personal banking or other businesses you are associated with).
- Your business' past financial performance.
- How professional your business plan is.
  This includes credible commercial plans, not just profit and cashflow forecasts.
- How expensive the financing will be for the bank to administer.
  It may be cheaper to consolidate all your borrowings with one bank.

**4.2** Ask the bank to calculate and itemise the **total cost** of any overdraft or loan offer.

- The total amount you will pay over the life of the financing provides a rough guide.
- For a loan, the total cost of interest and all charges can usually be expressed as an annual percentage rate (APR).

These figures make it easier to compare different offers.

**4.3** **Shop around**. Then negotiate for a lower interest rate and lower charges (even if you have only received one offer of finance).

- A bank is usually more willing to improve its offer if you have other quotes. Your negotiations are more likely to succeed if you have a good credit score or have a good relationship with your bank.
- Most banks will only provide a quote once you have completed a full application for finance and they have assessed its viability.

**4.4** Build a **relationship** with your bank manager, so the bank will be more supportive if you need additional finance in the future.

- Provide periodic management and financial information. Notify the bank of any major business decisions.

"If you are a business with significant intangible assets — like strong brands or intellectual property — you may want to show their value on the balance sheet, or at least explain them to the bank. Otherwise, your gearing may appear to be too high."
**Richard Holloway, management consultant**

## 5 Security

A bank usually wants security to ensure that it is repaid if things go wrong. The bank puts a legal charge over your business or personal assets, which can be sold if you default.

**5.1** Freehold or long-leasehold **property** is often the most valuable security you can provide.

A bank will usually lend up to about 50 to 80 per cent of the value of a property, although other specialist lenders may advance as much as 90 per cent.

- Specialist premises may be valued at less than you spent on them.
- For smaller businesses, taking a mortgage on personal property (and then lending the money to the business) can pay off. Mortgage rates are below business loan rates, there are no ongoing arrangement fees and lenders will advance up to 95 per cent of the property value. Some mortgages have flexible repayment arrangements, reducing your risk of defaulting.
  Using personal finance to expand your business may be the best option if you would otherwise risk your house anyway.

**5.2** A bank may lend up to 50 to 60 per cent of the value of your outstanding **debtors** (sales invoices). The bank will check:

- How likely the invoices are to be paid.
- How much it costs to collect the debts. For example, collection costs mean that several small debts may not be worth the same as one large debt.

**5.3 Equipment, stock** and **work in progress** will only be valued at their resale price — usually what they would fetch at auction.

- Specialised equipment which is difficult to sell, and equipment which becomes obsolete quickly, such as computers, provides little security.

**5.4** Directors of limited companies are often asked to provide **personal guarantees**. (Sole traders and partners are automatically liable for all the business debts.)

Giving a personal guarantee exposes you to serious financial risk, as your personal assets are at risk if the business fails.

- Ask to limit the scope of the guarantee. For example, the bank might agree to a guarantee which is less than the total amount of the loan or overdraft facility.
- Ask to limit the duration of the guarantee. For example, the bank might agree to release you from your guarantee after a set period of time, or once cashflow reaches an agreed target.
- You may want to renegotiate any guarantees whenever you take out a new loan or overdraft facility.
- If any friends or relatives offer third-party guarantees, the same risks apply to them.

You may be charged for any legal fees and negotiations.

**5.5** You may want to consider pledging **other assets**, rather than giving a guarantee or putting a charge on your home.

- For example, life insurance policies, shares and other investments.
  Alternatively, you may use these as security for a larger and less expensive personal loan and lend the money to the business.

### Charges as security

**A** Most bank loans are secured with a **fixed charge**.

- You may be asked to sign a debenture agreement to provide the bank with a fixed charge.
- Typical fixed charges are over a property (for example, a mortgage on a house), fixed plant and machinery, or debtors.

**B** Some debts may be covered by a **floating charge**.

- The charge floats on some or all of a company's assets, even though these assets come and go in the ordinary course of doing business. It can cover stock, work in progress, furniture and equipment, and also goodwill and other unspecified assets.

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