Understanding Debt Finance

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Introduction

Many small businesses seek to raise external funding at some stage, with debt finance being one of the most common sources for both start-ups and existing firms. There are, however, several different types of debt finance, and the ability of a business to raise external finance will depend on a number of factors such as its trading history, business type and security. Borrowing money often requires the owner or director of the business to provide personal guarantees, which can put their personal finances at risk.

This factsheet describes the types of debt finance available to businesses. It outlines the key issues that should be considered before taking on debt, and the associated risks.

What is debt finance?

Most debt finance takes the form of a loan that ultimately has to be repaid to the lender. The total cost of a loan is the repayment of the principal sum, plus any interest incurred on the loan, plus any additional fees such as arrangement and valuation fees.

Bank loans

Bank loans are one of the most common forms of debt finance as they are flexible and relatively accessible. Typically referred to as 'term loans', they are repaid over a specific period. The loan is usually secured against a business asset or a personal asset of the business owner or director, so that if the loan repayments aren't made in full the lender has some security that can be seized in order to recover the sum owed.

Interest will be charged on the full amount of the loan, so it is important to borrow only the money the business needs in order to save unnecessary interest charges.

One advantage of bank loans is that the term of the loan can be matched to the expected life of any asset that is used as security against the loan. For example, a short-term asset (such as computer equipment) can be matched with a short-term loan, and a long-term asset (such as production equipment and machinery) can be matched with a long-term loan.

When looking for a bank loan, it is useful to shop around to see what deals are available from both online and high-street banks. The interest rates, loan terms and loan agreements offered by different banks should be compared to ensure that the loan repayments are manageable and the terms are acceptable. It is also worth checking whether any incentives such as an initial repayment holiday, reduced initial interest rate or reduced set-up fees are available.

When banks are assessing whether to offer a business loan, they will look at the business' gearing'. Gearing is the ratio of debt to equity in a business. Equity is the money that has been invested in the business.

Gearing is usually calculated as debt divided by capital employed - capital employed being the sum of the debt and equity - expressed as a percentage. Increasing the debt in the business will increase its gearing, which will in turn increase the bank's perceived risks associated with the business. Banks typically aim to ensure that gearing does not exceed 50%, but they can sometimes be persuaded to go much higher.

Banks are also likely to look at 'interest cover'. This is a ratio of net profit to interest and is a measure of the ease with which the business can meet its interest payments out of its profit. It is calculated by taking profit before interest and tax and dividing it by interest paid. Banks look for an interest cover ratio of at least two, and ideally want a higher ratio.

Commercial mortgages

Commercial mortgages are loans that are typically used to buy, refinance or develop business property. They are usually repaid over long periods with terms of 10-20 years or more. However, some commercial mortgages have repayment periods as short as three years. Mortgages are secured on the property, which will be at risk if the business defaults on the repayments, and consequently the interest rates are relatively low compared to unsecured loans and overdrafts. Most commercial mortgages have a variable interest rate that fluctuates in line with the Bank of England base rate.

Most banks and building societies provide commercial mortgages and all will investigate the business' current position, outlook and credit history before considering an application. In addition, some may check the personal credit history of the business owners or directors before offering a commercial mortgage.

The costs of taking out a commercial mortgage comprise interest payments, capital repayments and various charges imposed by the lender, such as arrangement fees, valuation fees and late payment penalties. See BIF019 Commercial Mortgages for further information.

Overdrafts

An overdraft is a simple, flexible way to finance a business. The lender will set a maximum level of overdraft that should not be exceeded and interest is only paid on the amount that is overdrawn. The interest rate is usually higher than that on a loan but interest is calculated on a daily basis, so it is often a cheaper option.

Overdrafts are normally used to finance short-term cash flow requirements rather than capital items. They are repayable on demand and the lender will require security, which is often a fixed and floating charge over all the business' assets. As with bank loans, set-up fees are payable when an overdraft is taken out. Credit cards Business credit cards are a convenient form of finance that enable purchases to be made, up to an agreed credit limit, and paid for at a later date.

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Credit card holders are sent a bill each month that details all the purchases that have been made. It is not necessary to repay the whole amount owed, as most business credit card accounts allow for a minimum monthly payment, but interest will be charged on the outstanding balance. Interest rates are usually higher for credit cards than overdrafts and loans, so it can be an expensive way of financing business purchases.

Although it is possible to use a personal credit card to finance a business, this can be risky as the cardholder is personally liable if bill payments are not made. It can also cause problems to mix personal and business spending.

If the business will be able to support the repayments, it may be worth taking out a 0% interest credit card, which will offer an initial interest-free period. This will provide a comparatively cheap form of finance, provided that any money owed is repaid before the interest-free period runs out.

Factoring and invoice discounting

Factoring and invoice discounting are financial services that allow a business to be paid an advance against invoiced sales that have been issued under credit terms. The advantage of this form of finance is that the business receives any money owed to it by its customers without having to wait for them to pay.

Factors advance a certain percentage of the value of approved invoices (usually 80% to 90%). The invoices must be accepted as a reasonable financial risk by the factor before they are approved. The business raises the invoices and sends them to customers as usual, but the factor collects the payments. Customers pay the factor directly and the business receives the balancing payment, minus the factor's fee and interest.

Invoice discounting is similar to factoring except that responsibility for collecting payments from customers remains with the business. Invoice discounters charge a monthly fee plus interest on the net amount of cash advanced. Because customers pay the business directly, they are unaware that this facility is in place. The invoice discounter will inspect the amount of outstanding debts on a daily basis and vary the facility accordingly.

Factoring and invoice discounting are available from a variety of sources, including high street lenders and specialist firms. For more detailed guidance, see BIF034 Factoring and Invoice Discounting.

Asset Finance

Asset finance is where the lender provides finance to buy capital equipment and the loan is secured on the asset acquired. There are two types of asset financing: leasing and hire purchase. With leasing, the asset is returned to the lender at the end of the lease period. With hire purchase, the business takes ownership of the asset at the end of the agreement, once the full amount has been repaid. For more information about this type of finance, see BIF232 Leasing Business Equipment.

Choosing the most appropriate debt finance

The most appropriate type of debt finance for a business depends on a number of factors:

- How much the business needs to borrow.

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- What the money will be used for.
- The period of the loan.
- The security required.
- The repayments the business can afford.
- The level of risk the business owners or directors are comfortable with.

For example, a short-term cash flow problem could be resolved with an overdraft, but if the business needs to buy expensive equipment, a longer-term bank loan or asset finance may be more appropriate.

Deciding how much to borrow

To help decide how much to borrow, it is important to consider what the money is needed for and to estimate the total cost of borrowing the money. It will also be necessary to prepare a detailed cash flow forecast and include the capital repayments, interest and any fees associated with the debt. This will help to determine whether the business can manage the costs of the debt.

It is wise to amend the cash flow forecast for a variety of scenarios (with sales falling below budget, for example) and see the effect of the debt on the business's cash position. Although it may be tempting to ask for extra cash so that the business has a financial buffer, this will be an additional cost to the business and most lenders will not lend more than is really needed.

See BIF058 How to Forecast Cash Flow for further information.

Providing information for lenders

In order to decide whether to lend money to a business, lenders will require the following information:

- Business bank statements.
- Accounts for the last two years (preferably prepared by an accountant).
- Budgets and cash flow forecasts.
- Details about customers (especially for factoring and invoice discounting).
- Details about business assets for security.
- The personal financial position and assets of any individual who is providing a personal guarantee for a loan.

Risks of debt finance

The ultimate risk of debt finance is being unable to make the necessary repayments, for whatever reason. The lender could seize and sell any business assets that have been provided as security, in order to pay off the remaining debt. If the debt was secured under a personal guarantee, the individual or individuals who gave the guarantee will have to pay the debt.

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If there is a default on the agreed payment plan, there is a risk that the loan will be recalled, and the lender will demand repayment of the entire loan amount. This would be more common with an overdraft than a loan but in all cases it will create a financial problem for the business.

It is important to notify the lender of any financial difficulties as soon as possible so that any issues can be resolved. Putting things off or trying to deceive lenders will only create bigger problems in the long run.

Useful resources

'The Business Finance Guide: A Journey from Start-up to Growth'
ICAEW and the British Business Bank
www.icaew.com/technical/corporate-finance/Business-Finance-Guide/About/Download

The British Business Bank operates a range of programmes to support access to finance for smaller businesses. It works with over 130 partners, such as banks, leasing companies, venture capital funds and web-based platforms. Its website provides news and research about the finance market, and a Finance Hub with guidance for start-up and scale-up businesses.
www.british-business-bank.co.uk

Responsible Finance is a membership body for finance providers in the UK. Its website provides a 'Finding Finance' directory of responsible lenders, as well as news and research relating to business finance.
https://responsiblefinance.org.uk

The Finance & Leasing Association is a trade body representing the asset, consumer and motor finance sectors in the UK. Its website features information for business about asset financing and a searchable directory of members.
www.fia.org.uk

UK Finance represents providers of finance, banking, markets and payments-related services in the UK. It publishes statistics, reports and guidance on business finance, as well as a directory of members.
www.ukfinance.org.uk

Related factsheets

BIF034 Factoring and Invoice Discounting
BIF040 Sources of Finance for Starting a Business
BIF043 Opening a Business Bank Account
BIF058 How to Forecast Cash Flow
BIF062 Financing Your Business with Venture Capital
BIF232 Leasing Business Equipment

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