

Bank Loans and overdrafts

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.

It is therefore necessary to continually ensure that you have the right type of finance for your business, minimising the cost and the risk to yourself and the business.

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Since Redarch was established in 1995 our team of seasoned business professionals have offered their experience and knowledge in all aspects of business.

We work as advisors within your operations with demands on our services being dictated by the growth and development of the business and the individuals therein.

Our Service is there to guide and support not to dictate or take control, it is your business and we never forget this.

If you are ready to start investing in the future of your business and optimising the returns then call us on 01376 57 37 67.

The Right Finance

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.
 - Your cashflow - debts will get out of control unless sufficient cash is generated to pay the interest and repayments on loans and overdrafts.
 - How accurately can you predict future cashflow – the more accurate your predictions the higher the gearing you can comfortably justify
 - The risk you (and other investors in your business) are prepared to accept – the greater the risk the higher the gearing you may find acceptable
 - 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

2. Seldom is one form of finance on its own appropriate and a combination of loans and overdraft may be more advantageous.
 - Overdrafts should be used only to finance cashflow fluctuations and provide contingency funds.
 - Loans should be used to provide fixed term finance and working capital

Overdrafts and Bank Loans

It is important that you plan your finances and arrange them in advance of requirement, this will not only demonstrate that you are in control of your business but will also normally mean you get better rates of interest. Do not try to manage with less than you need or borrow too much as both will be detrimental to the business. 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 return your cheques, damaging your credit with suppliers and leaving you short of working capital. Similarly, if you run short of cash and then fail to make a payment on a loan, you will be technically ‘in default’ and the bank would have the right to ask you to repay the loan immediately or call upon the security.

Overdraft Facilities

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.

There are also substantial disadvantages.

- In most circumstances, the bank can demand repayment at any time.
- The overdraft has to be regularly renegotiated incurring repeat fees.
- The bank will want to check your creditworthiness has not deteriorated.
- 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 although these fees can be considerably more
- Large overdrafts may incur additional charges similar to loans
- You will pay higher fees for an 'informal' overdraft (i.e when you exceed your limit or go overdrawn without a pre-arranged facility, this can happen even when you have made deposits but they have not cleared the system)
- The effective interest you pay may be boosted by other charges.
- You pay a fixed margin over base rate, so, as base rates rise or fall, so will the interest rate charged on your overdraft.
- 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, 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.

Loans

The advantage of a loan are:

- Once agreed you know the money is there and the financing is secure for the life of the loan (unless you fail to make payments or breach any covenants).
- You can match the term of a loan to the life of an asset you want to purchase.
- 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 for the full period of the loan so know exactly what your monthly repayments will be.

The disadvantages of a loan may include:

- Lack of flexibility.
- You pay interest on the full amount of the outstanding loan, although it may be possible to get a draw down facility where you only pay interest on the amount drawn down.
- The bank often imposes legally binding covenants before agreeing to a loan.
- 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 or some other form of security
- 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 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, like the valuation of an asset.
- 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 rating
- 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.

Minimising Costs

Generally the better your credit rating the lower the cost of borrowing, most banks evaluate businesses using a process of credit-scoring. While each bank's system is different, they tend to focus on:

- The quality of the security
- The gearing of the business and strength of the balance sheet
- Putting more share capital (or unsecured director's loans) into the business may reduce the interest-rate margin demanded by the bank.
- The quality of your business plan and cash flow forecast. Your cashflow projections should be credible and should demonstrate that you can comfortably meet interest payments and loan repayments.
- Your past banking record.
- 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.
- Shop around. Then negotiate for a lower interest rate and lower, because you have been with your bank for a number of years does not guarantee they will offer you the best deal
- 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.
- 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.

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.

- 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 as 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.

- A bank may lend up to 50 to 60 per cent of the value of your outstanding debtors (sales invoices). The bank will check:
 - The credit worthiness of the Debtors.
 - The cost of collecting monies if there is a default
- 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 or no security.
- 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 and duration of the guarantee.
- 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 want to consider pledging other assets, rather than giving a guarantee or putting a charge on your home.
- 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.
- 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.

N.B. Redarch always use 'Plain English' developing Real Growth and Optimising Potential, keeping things simple, knowing that your success is ours also.