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Types of debt capital

the money guides

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There are multiple types of debt and they all have their uses.

Overdraft

An overdraft simply allows you to use funds you don't have: it allows you to make payments from your account when the balance goes below zero. Banks expect overdrafts to be "fully fluctuating", which means that the overdrawn account should cycle between positive and negative. If your overdraft does not fluctuate your bank might ask you to consider a loan instead. Just because your bank suggests a loan does not mean they will give you one. The main disadvantage of an overdraft is that it is repayable on demand. That means that if your bank asks for it back, you have to pay them immediately and if you can't they can close you down.

Asset-based lending

In this case, the lender provides finance secured on assets (usually plant and machinery or vehicles). If you don't repay the loan in line with the agreed terms, the lender can take the asset and sell it. If there's a shortfall on the sale, you still owe the balance. The key thing to do with asset-based lending is to match the life of the asset with the period of the funding; for example, if you have machinery with a useful life of 5 years, you should finance it over 5 years because if you finance it over 3 years, you may have to re-finance and that can prove expensive.

Invoice finance

Sometimes called invoice discounting, confidential invoice discounting or factoring, this is where a lender will provide you with an advance when you issue an invoice to your customers. It works best where you invoice for goods or services in arrears and where you have a broad range of customers who are themselves good credit risks. Invoice finance doesn't work as well if you have very few customers and it isn't suited for businesses charging for services in advance, things like annual service contracts. However, if you have a customer profile suitable for invoice finance, it does work if you are fast-growing. The way it works is that you issue an invoice, the lender advances you most of that value (typically 80%) and when your customer pays, you collect the balance. The lender charges a service fee (this could be based on your actual or projected turnover) and a discount charge (interest) for the facility you use. The key thing to remember about invoice finance is that you don't own your sales invoices – they belong to the lender. Also, if you face a downturn, your access to finance will be constrained very rapidly.

Term loans

Term loans are simply loans over a specified period of time and the key thing, apart from the time period, is whether they are amortising (capital repaid off each month or quarter) or interest only (sometimes called bullet repayment loans because the loan capital has to be repaid in one go at the end). Term loans can be backed by security, either assets of the company or secured on the owner's assets – usually your home – and you may be asked to provide a personal guarantee.

Mortgages

Most of us are familiar with a mortgage to buy our homes. Commercial mortgages are used in the same way to buy buildings or other long-lived assets. They work in the same way and the key elements are loan term, loan to value (of the asset) and interest margin.

Other specialised loans

Lenders will lend to clients and for things that they are comfortable with. For example, you can borrow against R&D tax credit claims; there are lenders and divisions of lenders who specialise in lending against this type of asset, although they might call it "security". If you have a need for cash now rather than waiting 6–9 months, this can be worth doing. The question to ask yourself is: "What's the value of having the money now vs waiting?"

Trade finance

This is the funding of goods, usually for export, during the time they are in transit or the period from when they leave you until the invoice is due from your customer. There are specialist trade finance operators because this is more complicated. The risks include credit risk of the customer, currency risk, risk of damage or loss while goods are in transit, insurance costs, who is the legal owner of the goods whilst they're in transit and whether this is the same as the beneficial owner. If you need trade finance and you're not engaged with it already, you should talk with a trade finance specialist.

get in touch

We're here to support you, whatever you're managing – let's talk.

For an initial no obligation conversation

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