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CONSULTING

Common types of business loans for SMEs

Introduction

In 2014 the FCA & CMA concluded that only 13% of small and medium-sized enterprises ("SMEs")[1] trust their bank to act in their best interests and that while levels of dissatisfaction are low (10%), the annual rate of switching banks is even lower (4%)[2]. The report went on to note, somewhat uncharitably & unfairly in our opinion, that along with high barriers to entry, banks had little incentive to improve their service & product offering.

While this reflects clear disenchantment with lenders, banks continue to face unprecedented structural & regulatory challenges in the post-2008 environment. This has seen increasing disenchantment with the Financial Services sector by customers, regulators & the media. Whether this is justified or not is a broader discussion, however we firmly believe that, by you understanding your relationship with your bank and the products & services they provide, will benefit your banking relationship & most importantly your business.

Below we have summarised some of the key products & services offered to SMEs. Whilst we do not consider this to be an exhaustive guide, we believe that if you are able to identify your needs and the most appropriate loan for your business you will achievable the optimum and most cost-effective outcome.

UNCOMMITTED FACILITIES

Overdrafts

An overdraft ("OD") is the most common form of finance used by UK SMEs and their features are well known. Borrowers pay an arrangement/renewal fee in order to draw funds subject to a maximum limit. Interest is charged daily on the overdrawn balance, most typically at the Bank of England Base Rate plus a given margin.

There are however a number of misconceptions. As a short term facility, an OD is best suited to financing working capital and in a seasonal business your current account should ideally be in credit at some time during the year. If you find that a significant portion is drawn all year round, this may be viewed as "hard-core" debt and ideally should be refinanced with a cheaper form of amortising loan.

An OD includes no formal arrangement for the loan to be paid back at the end of the period, as per a normal amortising loan. Conversely, the lender is not committed to renewing the loan. Of most importance is that an OD is considered to be an on demand loan, therefore it may be called by a bank at any time, even if the borrower has complied with all the terms and is not in default.

For SMEs an OD is most likely to be secured with one or more of the following: property, accounts receivable, plant/equipment, bonds/shares, bills of lading & inventory.

[1] The European Commission defines an SME as a firm with less than 250 employees and either a turnover of less than €50m or balance sheet total of less than €43m.

[2] Banking services to small and medium-sized enterprises - A CMA and FCA market study, July 2014

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Finally many business owners admirably wish to minimise their overdraft limit to save on fees and maintain financial discipline. While this is to be applauded it may disadvantage the business in the long run.

For example, if we were to compare a business with a £1.0m OD with an average utilisation of 90% (£900,000) that requests a small excess ca. 2-3 a year with the same business with the same average balance but with a £1.5m OD. An average utilisation of 60% with no excesses would likely be looked on more favourably by your lender possibly resulting in cheaper financing going forward. While we would not necessarily recommend increasing an OD limit unnecessarily, it does emphasis the need for both parties to maintain an open dialogue with your bank & Relationship Manager.

Working capital facilities

Working capital loans are a slight variation on an OD and are designed as short-term solutions for businesses in need of money to help run their operations. These funds can then be used to pay bills, cover payroll & purchase inventory.

The advantage of a working capital loan is that it gives small businesses the ability to keep their operations running while they search for other ways to increase revenue. Some downsides of a working capital loan are that they often come with higher interest rates and have short repayment terms. The facility may also require that the account be in credit at some stage during the year, therefore it is often more suited to a seasonal business.

COMMITTED FACILITIES

Revolving Credit Facility ("RCF")

An RCF has a number of features in common with an OD (arrangement fee, secured, multi-currency, variable pricing) and combines elements of both an OD and a term loan. Its structure however is better suited to larger SMEs.

Under an RCF a borrower may draw down & repay tranches up to the maximum, whenever it chooses during the term of the loan. Amounts repaid can then also be re-borrowed. Thus, the commitment is said to 'revolve'.

The key distinction between an OD and a RCF is that it is committed (a bank cannot withdraw it) and pricing, which remains variable but is based on LIBOR. Without delving too deeply into the highly technical world of corporate finance, LIBOR (London Interbank Overnight Rate) is the interest rate received/paid on US dollar deposits/loans to non-US banks outside the US, primarily in London.

As such it is a highly liquid & transparent proxy for a bank's cost of funding. Usefully it is also quoted for different terms so that pricing may match the tenor of the drawdown. As well as a commitment fee, lenders will also levy a non-utilisation fee on the undrawn portion (ca. 50% of the margin) reflecting the additional cost in committing those for the borrowers use.

An RCF can be used for both working capital and general corporate purposes, a description so broad that we have yet to experience anything it excludes! Joking aside it does however highlight a fundamental concept of corporate finance, that the tenor of a liability should broadly match the tenor or useful life of the asset and the cash generated by the asset should cover debt service payments.

For large corporate & institutional borrowers more than one bank may be involved (multi-lateral as opposed to bilateral) and are termed club or syndicate deals. Some investment grade facilities may be unsecured with a period/tenor of up to 5 years. They are most useful when funding needs are uncertain & many are set up so at maturity the borrower has the option of converting them into a term loan.

RCFs are also commonly used as Commercial Paper (CP) standby facilities.

Standby credit facilities

Standby facilities enable a borrower to draw down a loan in stages or tranches without losing the availability of the undrawn section. Once repaid, however, the money cannot be re-borrowed. It tends to have a shorter term than a term loan and may support other anticipated borrowings, e.g. commercial paper. The standby credit may not even be drawn if the 'normal' borrowing method is successful.

Term loans

A term loan allows a borrower to draw down one lump sum or a series of drawings (tranches) over a short to medium period for a specific purpose. The tenor is generally 5-7 years with a potential to tailor the repayment schedule that suits both the borrower & the lender. There is a considerable degree of negotiation involved. Unlike the above facilities, funds that have been repaid cannot then be re-borrowed in the future.

The most common repayment methods are (1) amortisation where a loan is repaid in equal payments, comprising both principal & interest, at regular intervals over the term of the loan or (2) instalments with a final bullet repayment, usually the largest payment, at expiry.

Loans may also include interest only periods, cash sweeps (variable repayments), grace periods or PIK functionality where no payments are made until refinancing or maturity. Term loans and revolvers may be combined (multi-tranche) in order to provide acquisition financing for a highly leveraged transaction.

Interest rates are either (1) fixed or (2) variable depending on changing market conditions, and the documentation may also require an interest product (IR ceiling) be incorporated into the documentation. Naturally, such structures are geared (no pun intended) to larger more sophisticated borrowers. The borrower can also tailor a loan to their specific needs through direct negotiation with the lender.

Commercial mortgages

These are used to finance the purchase of new or existing property, buildings, warehouses and retail space. In addition, banks may offer construction loans to finance the purchase of land and construction of owner-occupied plant and buildings, which are drawn down on a gradual basis (upon presentation of invoices) which then convert to a standard amortising mortgage upon completion. Commercial mortgages and construction loans may be amortised for a period of up to 20 years.

Summary

A business loan can be a valuable tool to help you expand you businesses or meet short-term cash flow needs. But care must be taken to make sure that the right loan is used for the right purposes.

While high street banks and traditional lenders may provide all the above products to varying classes of clients, they are unlikely to provide all products to all clients. Non-bank financial institutions (NBFIs) or sources of alternative finance (private placements, P2P or crowdfunding) may provide finance in only niche areas.