The Primary Types of Business Loans

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In the course of normal operations, it's not unusual for CEOs or CFOs to determine that they need a cash infusion from outside the business. This cash can be obtained in one of two ways: by borrowing the money, or by selling an equity stake in the business to outside investors.

In this article, we'll take a detailed look at debt as a business financing tool. Next week, we'll examine the pros and cons of equity financing.

Obtaining a Business Loan

The most common source of debt financing for most businesses is a commercial bank. While business loans are sometimes more difficult to obtain in today's post-financial crisis landscape, financially sound businesses with solid histories and strong cash flow often stand a good chance of being approved for a business loan.

Before approaching a bank about applying for a loan, you should be able to tell the banker specifically why you want to borrow money. For example:

- You are launching a brand new business and need start-up financing.
- You need working capital to help cover temporary gaps in your cash flow cycle.
- You want to expand your business by purchasing new equipment, hiring more employees, etc.
- You plan to acquire another business.
- You want to purchase business facilities.

It's important to know why you need to borrow money, because this will dictate the specific kind of loan the bank is going to try to structure for you. There are a number of different types of bank loans and it's important that your loan match your specific financing need.

Types of Business Loans

There are five main types of business loans provided by commercial banks:

1. Line of credit

The most common type of business loan, a line of credit enables a company to borrow up to its credit limit whenever it wants, without having to reapply when money is needed. It's often a good idea to establish a line of credit before you actually need to borrow money so it's readily available when you do.

Because of its ease of use, companies sometimes get into trouble by using line of credit funds for the wrong reason. A line of credit should be used primarily for short-term, recurring cash needs, such as plugging short-term cash flow gaps, funding accounts receivable and purchasing seasonal inventory. It should not be used for longer-term cash needs.

2. Term loan

These are amortizing loans typically used to finance the purchase of fixed assets like plant, property and equipment. Unlike lines of credit, term loans are longer-term in nature and should match the depreciable or useful life of the asset being financed. Term loans may also be used to finance permanent investments in accounts receivable or inventory.

3. Commercial mortgage

These are used to finance the purchase of new or existing commercial property, including office 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. Commercial mortgages and construction loans may be amortized for a period of up to 15 or 20 years.

4. Lease

Leasing is sometimes an attractive alternative to buying equipment, especially assets with built-in obsolescence (like computers and other high-tech equipment). At the end of the lease term, you can easily upgrade or replace equipment that is outdated. Leasing may also offer tax benefits and help free up cash flow, since 100 percent of the cost of equipment can be financed. This may enable you to use cash for other more productive (and profitable) purposes.

5. Government loan programs

The U.S. Small Business Administration (SBA) offers several types of loans that are designed specifically for small businesses, which are defined by the SBA as companies with tangible net worth of less than $15 million and two-year average net income of less than $5 million. These include 7(a), 504 and SBA*Express* loans. The SBA guarantees a portion of the loan, which enables banks to make loans that they might otherwise consider to be too risky.

Concluding Thoughts

A business loan can be a valuable tool to help Los Angeles and Southern California CEOs and CFOs grow or expand their 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. If you need help determining what is the best type of loan for your particular financing need, you may want to talk to an outsourced CFO services provider, who can offer specific guidance for your situation.

About CFO Edge

CFO Edge, LLC is a leading Southern California provider of outsourced CFO services. Based in Los Angeles, we are a group of experienced chief financial officers who engage with CEOs and CFOs on demand to address strategic planning, business management, and day-to-day financial operations challenges. Our seasoned professionals deliver services as interim CFOs, part-time CFOs, project-based CFOs, recruitment-to-permanent CFOs and interim-to-permanent CFOs. At CFO Edge, we're passionate about helping our clients create, grow and sustain value. For more information, visit www.cfoedge.com or call 626.683.8840.