Features of debt products

**Overdraft**

By enabling you to overdraw from your cheque account, an overdraft is particularly useful at times when income is temporarily insufficient to meet payments that are due. Overdrafts do not require regular monthly payments.

Overdrafts are 'on demand' facilities. This means that the bank has the right to cancel the facility at any time. The overdraft facility is generally reviewed on an annual basis and, subject to the financial position of the business, is renewed each year.

Interest is only paid on the amount of the overdraft drawn down.

**Business loans**

A business loan provides finance for additional equipment, stock or capital improvements to premises. These loans are for a fixed period, with terms and repayments to suit your business. Variable or fixed interest rate loans are available. There are several repayment options: principal and interest, interest only or a combination of both. Additional repayments, lump sum reductions or full repayment of a variable interest rate loan can, usually, be made at any time without penalty. Business loans are generally, secured by property, or business assets.

**Fully drawn advance or term loan**

This is a long-term loan that requires principal and interest repayments over the term of the loan. It is mostly suitable for financing permanent or longer-term funding requirements for property, plant and equipment or the purchase of a business.

A fully drawn advance is provided for a fixed period. The loan is reduced by monthly repayments, which include both interest and principal components. The interest rate can be either fixed or variable. There may be penalties for early repayment if the rate is fixed.
Commercial bills or bank bills

These are securities that are issued in the money market. They are used by investors because when a bank has added its name as an ‘acceptor’, the bill is essentially guaranteed by the bank.

Bills may be used to fund short-term working capital requirements or to fund longer-term requirements for capital purchases. The bills are generally for amounts of $50,000 and over. The term could vary from three months to five years.

Commercial bills are purchased securities that are discounted upfront. For example, for a bill with a face value of $100 and a discount of $5, the lender will provide $95 upfront to the borrower. At the end of the bill term, the borrower will repay $100.

The commercial bills facility is available for a specific term, as well as a roll over period. For example, your may have a 12-month facility where the bills ‘rollover’ on a 30, 60, 90 or 180 day term. The roll over term will determine the timing of the discount being taken, ie effectively the interest being incurred. Each time the bill rolls over the discount rate will vary based on market rates.

Mortgage secured loans

Mortgage secured loans are long-term loans where property is used as the primary source of security, and the proceeds are used in the business.

Generally, lenders will lend up to 80% of the value of residential property, however they may lend a different percentage depending on the type of property being used as security. The interest rate for mortgage secured loans is normally much lower than other business loans.

These types of loans are suitable for purchase of capital assets such as land and buildings and permanent working capital requirements. The term of the loan is generally fixed. Repayments typically involve both principal and interest. Interest can be variable, fixed or capped.
Small Business Management Toolbox

Undertake financial planning

Features of debt products

Cashflow lending

Cashflow lending is suitable for those small businesses that generate solid cashflow, but do not own significant fixed assets to provide as security.

The finance may be secured by working capital assets of the business, such as stock and debtors. The cashflow forecasts need to reflect the ability of the business to meet capital and interest repayments.

Cashflow lending facilities operate like a business line of credit facility, allowing you to draw down on funds as required. This type of lending is best suited to fund changes in working capital.

The loan is similar to that of an overdraft facility, in that it is approved for a specific term, with a regular review requirement. Interest is charged monthly on the daily balance outstanding.

Debtor finance

Also known as factoring, or working capital finance, the funding is secured by the value of debtors. The finance is generally available up to a percentage of the book value of debtors (eg 70% to 90%).

When the debtor is invoiced the financier will pay the agreed percentage of the invoice, and the reminder is received when the debtor pays the balance of the invoice, usually net of the financier’s fee.

Features of debt products

It is important that you can identify and understand the important features of debt products and choose those products that will give you the features that you need. The following are a few of the features you should consider when you make comparisons of alternative debt products.

- **Interest rate** – Is the interest rate variable or fixed. If variable, you need to consider the likelihood of changes in interest rates, as well as your business’ ability to meet the repayments should interest rates increase. If you are not expecting to have a strong cashflow position in the future, you may wish to fix the interest rate on your finance.

- **Redraw facility** – The facility to repay funds off a loan and being able to redraw on the extra funds paid, when required. This may be useful, for example, for businesses that experience seasonal fluctuations.
• **Early repayment or lump sum repayment** – This feature may be important to you if there is the likelihood that you will be in a position to make lump sum payments or to repay the loan early.

• **Term of the loan** – This is the period of finance. It is important to match the length of finance with the use of the finance. For example, if you require finance to purchase land and buildings, you would typically seek long-term finance, as short-term finance would be inappropriate.

• **Minimum or maximum funding or turnover limits** – Debt products may have a minimum or maximum funding limit, or relate to a specific size of company. For example, commercial bills are, generally, for amounts over $50,000. You need to be aware of any funding limits and assess whether these limits will meet your circumstances.

• **Amount and nature of security required** – The percentage of security required might be governed by the risk nature of the product. You must decide what level of security you are willing to offer and also be aware that your security may be valued at a lesser amount by the financier. Also, you may find that the percentage of security varies depending on the purpose of the finance.

• **Fees and charges** – Fees that may be charged include establishment costs, annual fees, monthly fees and document preparation fees. You need to take these fees into consideration when comparing alternative debt products as they may affect the overall cost and type of the finance.

• **Offset features** – You may be able to reduce interest by offsetting short-term excess funds against borrowings to reduce interest paid.

Make sure to do your homework and research the alternative debt products and their features. Identify which features are important to you and why. Then match the products and features to your business needs. The security you can offer, the nature of your business and your business financial position will ultimately assist in narrowing down your options.
Comparing debt products

When you are comparing different debt products, you need to have a common basis to start your comparison. You might start by comparing:

- the rate of interest payable
- fees and charges payable
- product flexibility
- risks associated with the product.

Your aim is to match the correct debt product to your business needs, at the most economical cost and at maximum tax advantage. In order to do this, you must understand the following about your business needs.

- Why do you need the funds?
- What are you going to use the funds for?
- How long do you need the funds for?
- How much do you need to borrow?
- What type of security do you have available?
- How will the financier value this security?
- How will the financier assess risk for your business?

Being prepared with answers to these questions should assist you in, initially, short-listing possible debt products and, ultimately, deciding on the product that will best suit your business needs.

Lease/hire purchase

Leases and hire purchase finance are generally used to purchase a specific asset, such as a motor vehicle or plant and equipment. The funded asset is usually the main source of security for the borrowings. Financiers providing this facility will fund the full value of the asset.

The leased asset is owned by the financier throughout the term of the lease and at the end of the lease term, the business has the opportunity to purchase the asset from the financier at its residual value.

Hire purchase finance is similar to a finance lease, except that the hirer is treated as the owner at the outset of the transaction. A hire purchase can also be a hire contract with an obligation to purchase the asset at the end of the contract.
Leases and hire purchase finance are generally over a three to five year period. The repayments are usually on a monthly basis and include components of interest and principal over the term of the product. At the end of a finance lease and hire purchase contract, there is usually a capital residual to be paid.

**Line of credit facility**

A line of credit facility is a form of short-term finance typically used to fund purchases from overseas suppliers. This facility allows an importer to draw funds from its bank to pay for imports, thereby giving the overseas supplier greater assurance of payment.