



How Businesses Use CreditHow Businesses Use

PARTICIPANT GUIDE

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Credit Purpose

Think about your business's current credit needs. Understanding exactly how you will use credit and knowing when you will need the funds allows you to plan for the future and build a healthy business.

BUSINESS PURPOSE	HOW MY BUSINESS WOULD USE CREDIT	HOW MUCH CREDIT MY BUSINESS WOULD NEED	WHEN I WOULD NEED THIS CREDIT
Start Up			
Provide Working Capital/Cash Flow			
Grow My Business			
Purchase Fixed Assets			

My Credit Types

Check off the types of credit you already have.

FINANCE OPERATIONS/ SHORT-TERM NEEDS	FINANCE ASSETS/ LONG-TERM NEEDS
<ul style="list-style-type: none"> <input type="checkbox"/> Lines of Credit <ul style="list-style-type: none"> <input type="checkbox"/> Secured line of credit <input type="checkbox"/> Unsecured line of credit <input type="checkbox"/> Business Credit Cards 	<ul style="list-style-type: none"> <input type="checkbox"/> Term Loans <ul style="list-style-type: none"> <input type="checkbox"/> Secured term loan <input type="checkbox"/> Non-real estate secured term loan <input type="checkbox"/> Real estate secured term loan <input type="checkbox"/> Real Estate Secured Loans <ul style="list-style-type: none"> <input type="checkbox"/> Owner-occupied real estate loans <input type="checkbox"/> Non-owner-occupied commercial real estate loans

Lines of Credit

What Is a Line of Credit?

A line of credit is a short-term financial tool that allows you to borrow up to a specific dollar amount. You can repay this loan with interest over a period of time. This type of loan can be secured or unsecured.

SECURED LINE OF CREDIT	UNSECURED LINE OF CREDIT
Requires the borrower to put down collateral that the lender can obtain if the borrower defaults on the loan	Does not require any collateral
Typically has a lower interest rate because a secured loan poses less risk to the lender	Has a higher interest rate because the lack of collateral means the lender has limited avenues to get its money back if the borrower defaults
May have a higher credit limit	Has a lower credit limit due to increased risk
Is easier to obtain, as long as there are sufficient assets to secure the loan	Is difficult to obtain, especially if a new business requests a substantial sum of money

Best Practices

- Apply for a line of credit *before* you need it.
- Know the interest rate and, if the loan has an adjustable interest rate, the index that it is tied to.
- Know the maximum and minimum the rate can adjust to.
- Be sure you borrow only an amount you can repay.
- Be sure your business will have enough cash flow to pay off the loan.
- Use this short-term financing tool for short-term cash flow needs, such as accounts payable.
- Consider other forms of credit, such as term loans and real estate secured loans, when financing long-term assets.

Credit Uses

- Fund ongoing operational costs
- Have easy access to cash and working capital
- Have cash flow, especially during seasonal fluctuations
- Acquire inventory
- Meet short-term goals
- Take advantage of trade discounts

Qualifying for Lines of Credit

Whether you can get a secured or unsecured line of credit depends on your current cash flow and asset ownership. To qualify for a line of credit, be sure that you meet the following criteria:

- Your business has been operational for one to two years.
- Your business shows positive cash flow.
- Both you and your business have a good credit history.
- There are sufficient assets for secured lines of credit.

Pros and Cons: Lines of Credit

Review this chart to learn about the pros and cons of lines of credit.

PROS	CONS
<ul style="list-style-type: none"> • More flexible based on cash flow needs—especially during seasonal fluctuations—or unexpected situations • May build business credit history, if managed responsibly • Can be repaid incrementally 	<ul style="list-style-type: none"> • May be riskier: depending on the type of business you have; you may be personally liable if your business fails • May have adjustable interest rates • May have annual fees and require you to provide financial documents every year • May have to be fully repaid at some point during each 12-month period

Line of Credit Scenarios

Deciding to use a line of credit can be tricky. Consider some scenarios.

Read each scenario and circle the type of funding you might use.

Scenario 1

You own a computer parts store and employ two part-time employees, one full-time manager, and a team of freelance computer repair technicians. There has been an epidemic of people spilling liquids onto their computers, so business has been great! You have completed several projects and are expecting funds in your account within a week, but it's the end of the month, and your employees need to be paid. You don't have enough in your account to pay them.

Which type of funding would you use?

- Line of credit
- Term loan
- Business credit card

Scenario 2

You own a grocery store, and one of your vendors is offering a great deal on a line of shampoos that are suddenly very popular. The only caveat? You must order it immediately.

Which type of funding would you use?

- Line of credit
- Term loan
- Business credit card

Scenario 3

Two employees will be traveling to a trade show to demonstrate your newest product. They have to book their travel arrangements (flights, ground transportation, hotels, and food) and will need a daily allowance.

Which type of funding would you use?

- Line of credit
- Term loan
- Business credit card

Business Credit Cards

What Is a Business Credit Card?

A business credit card is a credit card issued to a business, rather than an individual, to make purchases related to the business. It may have a higher credit limit than personal credit cards.

Uses:

- Establish your business’s creditworthiness
- Have purchasing power wherever you go
- Have easy access to cash
- Allow key personnel to make purchases

Best Practices:

- Pay your credit card bills on time.
 - If you are comfortable with it, set up autopay so you don’t miss any payments.
- Avoid paying interest on the borrowed amount by paying your balance in full.
- Cancel, destroy, or safely store any cards related to an unused account.
- Research alternatives to authorizing employees on any business cards. Programs such as Automated Clearing House (ACH) may help credit money into employee accounts for expenses.
- Understand the terms of your business card regarding fraudulent and unauthorized activity.

Pros and Cons: Business Credit Cards

Review this chart to learn about the pros and cons of business credit cards.

PROS	CONS
<ul style="list-style-type: none"> • Can add other authorized users and track their expenses • Can assign credit limits for authorized users • Keeps your personal expenses separate from your business expenses, which helps keep your business and personal credit reports separate and is helpful when reporting taxes • May have a robust rewards system, which can be useful for your business 	<ul style="list-style-type: none"> • Because authorized users are not responsible for paying the bills, they may misuse the card • Mishandling a business credit card account may negatively affect your personal credit report • If you have a large balance, interest can add up quickly

Compare My Business Credit Cards

Complete this chart to compare the credit cards you have, which will allow you to better understand the terms and use them most effectively.

FEATURES	CARD 1	CARD 2	CARD 3
Annual Fee			
Interest Rate			
Additional Card Fee			
Cash Advance Fee			
Rewards			
Cash Back			

Business Credit Card Scenarios

Deciding to use a business credit card or line of credit can be tricky. Look at some scenarios.

Scenario 1

You are at an office supply store over the weekend and need to stock up on basics, such as paper, printer toner, and pens.

Which form of credit would you use?

- Line of credit
- Personal credit card (and be reimbursed later)
- Business credit card

Scenario 2

You own a construction business. With the real estate boom in your town, you've been extremely busy. You need to buy more equipment—tractors, wheel loaders, and excavators—to keep up with the demand for work. You also need to expand operations with an office in the next town.

Which form of credit would you use?

- Business credit card
- Line of credit
- Term loan

Term Loans

What Is a Term Loan?

A term loan is a long-term financing tool. It is typically a fixed amount for a specific purpose and runs for a fixed period. You can usually repay the loan in installments, and you will need to apply for a new loan if you require additional funds.

There are three different types of term loans. As with lines of credit, the major difference between each type of term loan is whether collateral is required and, if so, what may be used as collateral.

Best Practices:

- Use for purchases that will take many years to pay off.
 - Use this type of loan to purchase assets that will last and will be useful to you for a long time.
- Use your financial projections to show how the loan will help increase business or drive profit. These projections will inspire confidence in lenders and will increase your chances of getting the loan.

Types of Term Loans

Take a look at the types of term loans.

TYPE OF LOAN	UNSECURED TERM LOAN	REAL ESTATE SECURED TERM LOAN	NON-REAL ESTATE SECURED TERM LOAN
What Is It?	Borrowers can apply for and receive funds without putting up any assets as collateral	Borrowers put up real estate as collateral	Borrowers put up collateral that could include equipment or a vehicle
Collateral Requirements	None	<ul style="list-style-type: none"> Real estate, such as an office building, warehouse, or home Borrower must maintain and insure the asset to enable the lender to recoup the principal of the loan if the borrower defaults 	<ul style="list-style-type: none"> Non-real estate assets, such as automobiles, equipment, etc. Borrower must maintain and insure the asset to enable the lender to recoup the principal of the loan if the borrower defaults
Qualification Criteria	<ul style="list-style-type: none"> Profitable Operational for one to two years Fair to good credit history 	<ul style="list-style-type: none"> Profitable Operational for one to two years Fair to good credit history 	<ul style="list-style-type: none"> Profitable Operational for one to two years Fair to good credit history
Term Periods	3–5 years	Up to 30 years	4–10 years
Interest Rates	Higher, depending on the lender and your creditworthiness	Lower, depending on the lender and your creditworthiness	Lower, depending on the lender and your creditworthiness

Check with your financial institution to learn more about the specific details and plans related to these three term loan types.

Uses:

- Purchase vehicles or equipment
- Purchase capital assets, or anything that has long-term value and durability apart from real estate or software products
- Close on acquisitions
- Fund construction projects

Pros and Cons: Term Loans

Review the following chart to learn about the pros and cons of term loans.

PROS	CONS
<ul style="list-style-type: none"> ● Help finance major expenses and keep cash available for working capital ● Repaid with fixed monthly payments, which allows for easy budgeting and financial management ● Used to purchase equipment, vehicles, or other long-lasting assets ● Used to fund well-established, profitable businesses that require permanent working capital ● Provide one lump sum at the time of funding 	<ul style="list-style-type: none"> ● May have higher fees and interest rates than lines of credit, depending on whether a loan product is secured or unsecured ● Require borrowers to reapply if additional funds are needed

Term Loan Scenarios

Deciding to use a term loan, business credit card, or line of credit can be tricky. Look at some scenarios.

Scenario 1

You own a high-end industrial fan production company and want to expand from the commercial sector into the residential sector by acquiring a housewares company. You estimate that it will increase sales by about 22%. The only collateral you have is your equipment and company trucks.

Which form of credit would you use?

- Unsecured term loan
- Real estate secured term loan
- Non–real estate secured term loan

Scenario 2

Your family-owned-and-operated restaurant has been in business for 10 years. Your father bought the restaurant space outright when he first set up the business. Now you're ready to offer delivery options to customers in a moderate geographic area. For that, you're going to need at least two delivery vehicles and employees to make deliveries.

Which form of credit would you use?

- Unsecured term loan
- Real estate secured term loan
- Non–real estate secured term loan

Scenario 3

You own a children's clothing store. You've been in business for only one season (three months). You have been renting retail space on the top floor of a chic salon, and you get your entire inventory delivered to your shop address. You want to purchase a collection for the upcoming season. You always buy one season ahead to get the best deals.

Which form of credit would you use?

- Unsecured term loan
- Real estate secured term loan
- Non–real estate secured term loan
- Line of credit

Comparing Your Financing Options

Review this chart and assess your current (and anticipated) business needs to help determine which tool or resource might best fit your credit needs.

TYPE OF FINANCING OPTION	BUSINESS LINE OF CREDIT	BUSINESS CREDIT CARD	BUSINESS TERM LOAN
Use	Operating and short-term needs	Operating and short-term needs	Assets and long-term needs, such as equipment, vehicles, and large capital expenditures
Benefits	<ul style="list-style-type: none"> • Can use, repay, and use again • Useful when income or sales vary seasonally 	<ul style="list-style-type: none"> • Convenient and helps separate business and personal expenses • No need for collateral • Easiest for new businesses to qualify for 	Fixed interest rates and payments
Drawbacks	<ul style="list-style-type: none"> • Variable interest rates • May require annual review • May have a drawdown requirement 	<ul style="list-style-type: none"> • May encourage accumulation of debt • Lacks a regular repayment schedule • May pay more interest 	<ul style="list-style-type: none"> • Fees to close the loan • May require collateral

Real Estate Secured Loans

What Is a Real Estate Secured Loan?

Real estate secured loans are loans to purchase property for the business. There are two types of commercial real estate loans that are most relevant to small business owners: non-owner-occupied real estate loans and owner-occupied real estate loans. Repayment terms are often between 5 and 20 years, with a longer amortization period of up to 30 years. This generally leads to a lower monthly payment and higher interest rate, with a large final amount, called a *balloon payment*, due at the end of the term.

Uses:

In general, these loans may be used for the following purposes:

- Acquire or purchase commercial property
- Improve or rebuild commercial property
- Construct a new building
- Finance real estate
- Expand agricultural business

Best Practices:

- Keep your debt service coverage ratio (DSCR) above 1.25. DSCR measures available cash flow to pay current debt obligations and can be an indicator of stable cash flow.

Types of Real Estate Secured Loans

Review this chart to differentiate between the different types of real estate secured loans and what they can be used for.

LOAN TYPE	NON-OWNER-OCCUPIED REAL ESTATE LOAN	OWNER-OCCUPIED REAL ESTATE LOAN
Use	Purchase property that will generate its own income	Purchase property or improve land that will be used by the business to conduct operations
Example Uses	Multifamily residential properties, retail outlets, or hotels	Office, warehouse, or retail location

Qualifying for Real Estate Secured Loans

- Be creditworthy
- Show three to five years of positive growth via financial statements and income tax returns
- Have a debt service coverage ratio of 1.25 or more, indicating stable cash flow

Pros and Cons: Real Estate Secured Loans

Review this chart to learn more about the pros and cons of real estate secured loans.

PROS	CONS
<ul style="list-style-type: none"> • Flexible terms of up to 20 years, with an option to repay in installments • Opportunity to finance real estate, such as owner-occupied properties • Opportunity to finance land improvements 	<ul style="list-style-type: none"> • Down payments may be higher • Additional fees may raise the total cost of the loan • May have prepayment fees, severe penalties, or even lockdowns on early repayments • Interest rates may be higher than those for personal real estate loans because the risk to the lender is higher

Residential vs. Commercial Real Estate Loans

Review this chart to differentiate between residential and commercial real estate loans.

TYPE OF LOAN	RESIDENTIAL MORTGAGE	COMMERCIAL REAL ESTATE LOAN
Recipient	Individual borrowers	Companies or businesses
Repayment Schedule	Terms are typically 30 years, 25 years, or 15 years	Terms are typically 5 to 20 years
	Loans are repaid according to a fixed payment schedule over a fixed period of time	Borrowers may be required to make a <i>balloon payment</i> (one large lump sum at the end to pay off the loan), depending on the terms
Prepayment	Prepayment is allowed, and penalties are enforced only if they meet certain strict conditions	Prepayment is allowed, but may carry penalties
Loan-to-Value Ratios (LTV)	Loans with up to 100% LTV are acceptable for certain categories (e.g., VA or USDA loans)	Will likely require larger down payment
Debt Service Coverage Ratio (DSCR)	Not applicable	The DSCR tells lenders if a business has positive or negative cash flow
Interest Rate and Fees	Tend to be lower than commercial real estate loans	Tend to be higher than those for residential mortgages and include fees, such as survey, legal, and appraisal fees

Real Estate Secured Loan Scenarios

Deciding when to use a term loan or a real estate secured loan can be tricky. Look at some scenarios.

Scenario 1

As the owner of a small freight trucking business, you've rented your space for five years and are ready to purchase your own small office facility.

Which form of credit would you use?

- Owner-occupied real estate loan
- Non-owner-occupied real estate loan

Scenario 2

Your company has recently acquired a competing company. To fully merge the two and create the type of company culture you want, you will need to have everyone headquartered in the same office space. You are tired of renting and want to purchase a building big enough for all of your employees.

Which form of credit would you use?

- Owner-occupied real estate loan
- Non-owner-occupied real estate loan