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Do You Need a Term Loan or a Working Capital Line of Credit? Does it matter? The Answer is "YES" – and Here's Why.

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Not understanding the difference between a working capital line of credit and a term loan can inadvertently put your business into a serious cash crisis.

Business owners come across different borrowing needs to fund various aspects of their business. These needs can range from paying day-to-day bills of suppliers, wages, buying new machinery, or even buying another company. Depending on the use of the financing, a business can either choose to source a working capital line of credit or a term loan. But first, let us understand what each one is, which would help you understand what is right for your business.

What is a Working Capital Line of Credit?

A working capital line of credit is used to deal with the timing difference that businesses face when bridging the gap between the time that your customer pays the invoice and various payment terms your business has with its vendors, employees, government agencies and any other payment that the business needs to make. Salient features of a working capital line of credit are as follows:

> Revolving lines of credit provided by traditional banks are the most common example of a working capital line of credit.

- It is a revolving facility which means that it can be drawn as many times as required.
- It is usually margined against certain assets, such as accounts receivable or inventory. For example, lenders would be willing to lend up to a predetermined % of your accounts receivable (AR) or inventory.
- The amount of working capital line of credit that a business needs depends on the cash conversion cycle and cost of running the business.

Usually, companies that have seasonality or cyclical sales rely on working capital to either ramp up inventory purchases to meet seasonal needs or to cover operating costs during slower months when revenues dip.

Revolving lines of credit provided by traditional banks are the most common example of a working capital line of credit. Other examples include factoring, ABL, purchase order financing, etc. I will soon be writing another article on what factoring is and explain how it works.

What is a Term Loan?

Term loans are typically used to finance specific projects or long-term financing requirements of a business. Examples include the purchase of new machinery and equipment, automotive, leasehold improvements, software and app development, acquisition of a business, etc. Salient features of a term loan are as follows:

The approval of the loan would depend on various factors, such as what it is being used for, ability of the business to repay the loan, risk assessment by the bank, etc.

- Have a specified repayment period with monthly or quarterly principal and interest payments.
- Is typically repaid over a period of 3 to 7 years which is referred to as the amortization of the loan. The amortization usually depends on the useful life of the asset.
- Due to their long-term nature, it requires more lender due diligence than working capital lines of credit.

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Some examples of term loan products include Canadian Small Business Financing Loan, acquisition financing, asset financing, equipment financing, etc.

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What Common Mistake Do Small Businesses Make?

Sometimes, businesses use their lines of credit to purchase fixed assets, such as machinery or equipment. This would cause the business to have a cash crunch as there is, in effect, a permanent reduction in the line of credit availability. The business will not have liquidity or cash flow to bridge the timing differences between the collection of AR and the payments needed to be made to vendors, CRA, rent, payroll and other short-term cash flow needs. In turn, this can result in late payments to critical suppliers or expensive interest and penalties charged by CRA. Hence, business owners should be careful not to use the working capital of the business to purchase long-term assets.

To conclude, though term loans and working capital lines of credit are both sources of financing, business owners must understand the key differences and use the right product that is suited for their needs. Inappropriately using it could lead to a cash deficit. However, when rightly used, this can be a lifeline for the business or a way to grow the business to the next level.

At Isaacs Advisory, we have extensive experience in advising, structuring, and sourcing a wide range of traditional and non-traditional financing solutions for SMEs.

For more information on raising financing solutions for start-up, early stage, growth, in-transition or business in distress, please contact Dheeraj Nair at 647-673-4969 or dnair@isaacsadvisory.ca.