Life After Your Loan: What to Do Now That Your Business Has Funding

fundera

Small business financing tends to focus on one thing and one thing only:

How to get capital for your business.

But that's only half the story. Let's look at the other half—what you do once you get the money. Specifically:

1. How to get your payments made on time
2. How best to invest the money
3. When to consider more financing

(Psst—there's a 6-point summary at the bottom if you're starved for time!)

How to make your payments on time

While this might seem like an easy task, it's a little more complex than you might think, what with the wide variety of payment schemes available to small businesses today. Here are a couple of different common repayment schemes you'll encounter, and how you can best stay on top of each one.

Revenue-based Repayments

Some lenders, like PayPal Working Capital, charge you a percentage of your profits to cover both the principal and the interest of a loan. Assuming relatively stable sales in line with your projections, staying on top of your loan is simple. This type of income-based loan repayment scheme is especially prevalent with short term loans for internet-based companies, who might not be eligible for small business loans from a bank.

One thing to look out for, though, is that these will usually have a minimum repayment amount in a set period, regardless of your revenue stream.

PayPal Working Capital, for example, requires you to pay 10% of your loan every 90 days. So when you're structuring your repayment, make sure that you know what your minimum repayment is and that you've got the money to make it.

3 tricks to stay on top:

1. Check what your minimums are and when they're due. Set aside that money ahead of time in case your revenue dries up.

2. Keep an eye on your revenue and projections. Most companies will only lend what you can pay back, but it's worth crunching your own numbers so you can accurately predict whether you can make your payments or not. The earlier you know you're headed for trouble, the earlier you can plan to get out of it.

3. Set up automatic reminders for your minimum due dates. It's always worth double-checking that your payments went through when they had to.

Amortized Payments

An amortized loan is probably the most common type of loan, and in all likelihood is the type of loan you have. Amortized loans are loans where you borrow money, then pay back both principal and interest in regular fixed payments over a set period. At the end of that period, you and your lender are completely square.

One example of an amortized loan is a fixed rate mortgage. Say you borrow $100,000 for a house and take out a 30 year mortgage at 3% interest. An amortization calculator would tell you:

- Your payment every month ($421.60)
- Your total interest amount over the life of the loan ($51,777.45)
- Your total payment overall ($151,777.45)
- How much of each payment is interest and how much is principal

(Amortization loans are weighted heavily towards interest at the beginning and principal at the end, because you have more outstanding debt at the beginning, and thus 3% of a larger number is a higher dollar figure.)

Amortization loans are often used for larger, longer term loans partially because they're easy to budget for. If you're a business owner, to make your loan repayments you simply set aside the same amount each month. Their fixed and predictable nature means they're relatively low-risk for the lender, but their long term means that they turn a high profit. Low risk, high reward, in other words.

And of course, the budgeting ease on the borrower side makes them an excellent choice for a loan.

3 tricks to stay on top:

1. Set up automatic payments that match the frequency of your sales (e.g. weekly, monthly, and so on). These need to total your loan repayment for the month and be ready the business day before. That way, your account will always have money in it when the repayment is taken directly!

2. Take advantage of auto debit and other automatic systems. It's one less thing for you to worry about.

3. Get paper statements. You'll always open a letter addressed to you, whereas you might only skim an email. It's a good way to check that everything's ticking over.

Balloon Repayments

These are schemes where you make interest payments for the loan period, and then a big principal and interest payment at the end. The idea is that you keep what you owe in interest down over the life of the loan, without tying up capital making principal repayments. It gives you time to get together the full principal repayment, but you can use that cash in the meantime for other ventures.

Say you borrowed $75,000 at 5% interest. To pay it back in five years, you would pay $3,750 per year for the first four years, then a one-off payment of $78,750 at the end of the fifth year (principal + one year's interest). That means that your total loan cost is $93,750.

Frankly, balloon loans are rarely a good idea. To make them worthwhile, you have to take the principal and use it to make more money than the annual interest that accumulates in the meantime. Plus, you have to have excellent financial management skills to ensure you can actually make the balloon payment at the end. It rarely works out to benefit you, but there are some cases when it's the best option.

3 tricks to stay on top:

1. Note: The strategies for paying annual interest payments are the same as those for amortized loans.

2. Make regular interest payments, grow your business, and then sell some equity to cover the balloon payment.

3. Refinance to cover the balloon payment. (More on this strategy later!)

Early Repayments

With all of these scenarios, it's naturally going to be in your best interest to pay your loan off early... Or is it?

The plus side to paying your loan off early is that no matter how your unique loan works, it's going to save you money on interest.

However, you may be charged an early repayment penalty, which is usually a percentage of the interest not paid to the lender.

For example, if you were able to pay off a $100,000 loan at 3% in 15 years instead of 30, you'd save $12,151.02 in interest. This is great for you, but the lender is going to see that as a $12K loss. That's why they charge an early repayment fee. So if the bank charged 20% of the missing interest as an early repayment fee, then you would owe an additional $2,430.20 at the end of your loan. Be sure to check with your bank to see if you have an early repayment penalty. If there is one, it's often something you can negotiate, so see what the bank can do for you.

Another downside of paying a loan off early is the opportunity cost. If you're tying up capital in monthly loan repayments, you can't spend it somewhere else.

That said, if you are set on paying off your loan early, we'd recommend the stack method (especially if you're carrying lots of different debt).

The Stack Method is simple. First, compile all your various debts and rank them in order of interest rate. Then subtract the minimum repayments from your income. Use anything you have leftover to pay off the highest interest rate loan first, then the next highest interest rate loan, and so on.

This is the best way to decide if it's worth paying off a loan quickly. Your mortgage, for example, probably has one of the lowest interest rates of all your loans, so it's unlikely that it's going to be worth paying off early. However, if you took out a short term working capital loan, it's probably got a pretty hefty double digit interest rate. Definitely worth paying down quickly. Finally, if you're on a floating interest rate with an initial fixed period, it's worth keeping an eye on what the rate is going to do when it's no longer tethered. If it's going to shoot up to the top of the list, it's worth paying down now while the rate is low. If it's going to stay relatively low, then it's probably okay to leave it in the debt queue.

How Best to Invest the Money

If you've borrowed money, you likely already have some earmarked for something in line with your business plan. After all, you probably needed one to secure the loan. But the key to knowing the best investment for your small business is knowing what's going to give you the highest return on investment (ROI). We know this sounds redundant, but for a lot of small businesses, decisions are made based on immediate needs instead of actual long term gain. Here are some ideas for what to do with your extra cash, and what you should be thinking about before you buy anything.

Expansion

Whether it's an expansion of staff, a new larger premises, or a new piece of essential equipment, expansion is a great way to use capital. For starters, it's hard to do without an injection of money. Second, it's the most direct investment into your business. For example, if you're a bakery and you buy a bigger oven, you can bake more bread.

But expansion is a double edged sword. For example, if you hire new staff and spend the time to train them, but your sales slump and you have to lay them off, your ROI is very low. Likewise, if you buy new equipment to ramp up production without the demand existing, then you're liable to simply end up with an expensive machine doing the job of a cheaper one—poor ROI.

So before you expand, you should consider:

- What is my expected ROI?
- Is it enough to cover the cost of my investment and my loan costs?
- How soon can I expect to recoup my losses?
- Is this a good long term investment for growth?

It's not that expanding your business is a bad idea! It just needs to be thought over in terms of the total cost of expansion, not the short term money on the table.

Pay Down Debt

One way to think about debt is as an investment. Say you have a credit card with a 20% interest rate. If you pay that off before the end of the month using a loan at 5%, then that's an investment with a 15% return. Not too shabby!

Another benefit of paying off existing debt is that it improves your credit score, which will come in handy for your next loan application. Over time and with repeated debt consolidation, you'll get increasingly better rates and a better handle on your finances.

Marketing

Marketing: the Achilles heel of small businesses. It's expensive, time consuming, and doesn't directly help you make your product. But according to Small Business Trends, marketing was the most popular answer among businesses when asked what they would do if they came into some extra cash.

For a lot of small businesses, the ROI on marketing is much clearer now than it used to be, with the truly staggering expansion of available marketing data out there. So while it might feel a little like a crapshoot, there are a lot of numbers behind a successful campaign driving it forward. From an ROI perspective, marketing could be the key to continued and sustainable growth.

Upgrade Your Website

No matter what you sell, your website is a big part of your business—and it's worth investing into. Some specific ways you might want to spend your money include:

Search engine optimization (SEO): getting your website close to the top of the search results list when people look up keywords in search engines like Google.

Content creation: turn your website into a destination. Are you a butcher? Start a blog about how to cook various cuts of meat! A plumber? Handy how-to guides! A service company? Convert more sales with a great landing page!

Website redevelopment: if your site is a little dated and doesn't look so good on a mobile phone, it might be with some money to get a developer and designer to take a look and make it pop.

Upgrade Your Internal Systems

Automation has one of the best ROIs going. There are so many competing software-as-a-service (SaaS) companies out there that the price is lower than ever and the quality is top notch. Accounting, field service, web analytics, ordering, taxes, sales, marketing, CRMs: whatever it is, automate! Automated systems can be a little time consuming to set up, but definitely pay off in the long run.

When to Consider More Financing

We know, we know—you just got through signing the last round of forms! But no rest for the weary. Small businesses, especially ambitious ones, are in constant need of capital, which means that loans are likely to be a big part of your life. The reality is that it's never too soon to think about more financing—but that shouldn't depress you! More capital means more growth, more opportunities to take, more control you have over your small business. Borrow smartly and responsibly, and the process will become exciting rather than stressful.

The best time to think about more financing is when you're capable of paying back what you borrow.

For a lot of growing businesses, this probably won't be straight away. If you borrow to hire new staff, for example, there's probably going to be some lag between spending your loan and seeing a return. Likewise if you borrowed to capitalize on a supplier sale or buy a new piece of equipment—these investments take time to bear fruit.

While you should always be looking for new financing options and avenues to help you grow your business, it's unlikely that you're going to feel ready to take on more debt directly after securing financing. Plus, with a third of businesses being uncomfortable with their debt level, it might be worth sitting back and squirrelling away some cash before jumping back into the borrowing game.

Finally, if you can hold off a little on the borrowing front, you're more likely to get a better rate. First, because over time you'll pay down some debt. Second, you're likely to improve your cash flow and financial situation when your initial loan starts to pay dividends. All in all, while you should be thinking about financing all the time, you do have a bit of a reprieve right after you secure a loan.

The exception, of course, is refinancing.

Refinancing

Even if you've just finished your last round of financing, you should always be keeping your eyes peeled for a better deal. Refinancing is when you take out a new loan, use the money to pay off the old loan, and then make payments on the new one. Here's an example.

Say you have an amortized loan for $100,000 at 3.5% interest and a ten year repayment period. Let's say you're at the end of year two. Here's what those numbers look like:

- Your monthly payment is $988.86
- So far, you've paid $6,426.57 in interest and $17,306.04 in principal
- Your remaining loan balance is $82,693.96
- Your remaining interest payments total $12,236.47

But what if you find a new loan at 3% interest? To pay off your loan in the remaining time (seven years) you'd only pay $9,089.49 in interest, saving you a quick $3,146.98.

In that case, it's definitely worth refinancing. But it's not the only case when refinancing make sense. You might also refinance to:

- Consolidate your loans into one low interest loan
- Get cashback
- Cover an upcoming balloon payment
- Avoid a high floating interest rate

There are some caveats, of course. Refinancing is only really worth it for amortized loans when they're new. Because amortized loans are front-loaded with interest, if you're most of the way through a loan then you've already paid most of the interest, so there's no point in refinancing since you're only paying principal. Second, refinancing comes with lots of fees which can eat into any potential savings extremely quickly.

TL;DR

Too long? Too busy? Here's the six-point summary:

1. Revenue-based payments are easiest—just watch out for repayment minimums.

2. Amortized payments are also simple because they're always the same. Budget accordingly and have the money automatically transferred as soon as it's in your account.

3. Balloon payments, while usually not a great idea, can be good if you sell equity, sell your business, or refinance to cover the balloon.

4. There are lots of ways to invest your loan—even portions that aren't earmarked in your business plan. Expanding your operations, paying down debt, marketing your business, and upgrading your website and internal systems are all good options. But it's ultimately going to depend on what your business needs.

5. You can take a hiatus from financing directly following a new injection of capital, but if you want a good deal, you should plan accordingly for your next round. (The SBA sometimes takes up to four months.)

6. Refinancing, on the other hand, usually needs to be completed quickly following your loans to get the most out of it—especially with amortized loans. It's always worth watching out for low interest refinancing opportunities.

Hopefully you're a little wiser now on how to pay off your existing loans on time, what to do with the money you've already secured to get the best ROI from it, and when to start pounding the pavement for more loan financing.

Happy borrowing!