nerdwallet

Know Before You Borrow

NerdWallet's guide to what you should know before applying for a small-business loan

Being your own boss is a dream shared by millions of Americans.

You get to choose the location of your business, schedule your own hours and make all the final decisions. However, these perks of independence come with some serious challenges. One of the biggest for entrepreneurs is getting access to funding. Our guide will help you learn the basics so you can focus on running your business.

Contents

Chapter 1

Why do you need a small-business loan?

It's easy to get caught up in loan offers, interest rates and even advertisements from lenders. But start by asking yourself: Why do I need a loan? Your answer will likely fall into one of four categories:

- **To start your business:** If you need capital to start your business, it'll be tough to get a small-business loan. For outside financing, you'll likely have to rely on business credit cards, borrowing from friends and family, crowdfunding, personal loans or a microloan from a nonprofit lender.

- **To manage day-to-day expenses:** If you need extra money to cover payroll, rent and other bills — especially if your business is seasonal or you have gaps between when you pay your vendors and when you get paid — you're experiencing a cash-flow gap.

- **To grow your business:** If you've been in business several years and want to expand to a new location, add a new product or service or buy a new piece of large equipment, you'll want a term loan. But your loan shouldn't outlast the product or equipment you're buying.

- **To have a safety cushion:** If you don't need cash immediately but want to put aside money in case of an emergency, you'll want to get a line of credit or a term loan with the lowest rate possible. Ideally, you should get a bank line of credit long before you actually need it.

Chapter 2

What types of small-business loans are available?

Small-business owners have numerous financing options outside of traditional banks, including microloans from nonprofit lenders and a new breed of online lenders. Here are four of the main types of products available from lenders:

- **Term loan:** A term loan provides a lump sum of cash and requires fixed repayments.
- **Line of credit:** A line of credit allows you to borrow and repay only the money you need (similar to a credit card).
- **Invoice factoring:** Factoring, for business-to-business companies, lets you sell unpaid invoices at a discount for immediate cash. The factoring company advances you a lump sum of money upfront, and then the rest after it gets paid by your client, minus a fee.
- **Merchant cash advance:** An MCA provides you with a lump sum of cash, just like a term loan. Instead of making fixed repayments, however, you agree to sacrifice a percentage of your future credit or debit card sales until an agreed-upon sum has been repaid in full. There's no firm date in which the amount has to be repaid, as it depends solely on your credit card sales. When business is strong, you repay more, and when business is slow, you repay less.

Nerd tip: Although merchant cash advances typically don't require collateral or a good personal credit score, their cost typically ranges from 70% to 350% APR (all fees and interest included), making microloans and online small-business loans a much more affordable option. In short, MCAs should be considered only if you've exhausted all other options and if you expect your profit to exceed the total cost of the MCA.

Chapter 3

Where should you go to get a small-business loan?

There are many financial institutions and nonprofit lenders offering small-business loans. Here are some of your main options:

Banks

For borrowers with collateral who don't need cash fast, banks may be the way to go, especially if the purpose is to buy real estate, refinance debt or make large investments.

Upsides: Traditional banks offer a variety of borrowing options, including term loans, lines of credit and commercial mortgages to acquire properties or to refinance. The U.S. Small Business Administration provides a variety of loan programs for small businesses through banks — general small-business loans through its 7(a) loan program, as well as smaller, short-term microloans and disaster loans for those in need. **SBA loans** range in size from about $5,000 to as much as $5 million, with an average loan size of $371,000, according to the SBA. Banks typically offer lower APRs and longer repayment terms on small-business loans than many other options.

Downsides: Compared with larger, more established companies, small businesses typically have lower sales volume and cash reserves. Add to that bad personal credit or a lack of collateral — an asset such as real estate that secures a loan — and many small-business owners in need of funds come away empty-handed with traditional lenders. And even if you do qualify for a loan, the process is long (typically two to six months before the funding comes through). Startups and younger businesses in particular can have a hard time getting approved for these loans, given their lack of a strong track record.

Microlenders

For entrepreneurs who are having trouble getting a traditional loan, microlenders could be the best fit.

Upsides: Microlenders or microfinance

companies are nonprofit organizations that typically offer short-term loans of less than $35,000. They can be good options for smaller companies or startups that can't qualify for traditional bank loans because of a limited operating history, poor personal credit or a lack of collateral.

Downsides: Microloans are, by definition, small. The average microloan from the SBA is about $13,000. The APR on these loans is typically higher than bank loans. The application may require a detailed business plan and financial statements, as well as a description of what the loan will be used for, making the application process a bit arduous.

Online lenders

Small businesses that need cash fast but lack the collateral and operating history required to get a bank loan should consider online lenders.

Upsides: Also known as alternative lenders, these are nonbank lenders that provide small-business loans and lines of credit ranging in size from $500 to $500,000. The benefits include higher approval rates and faster funding than traditional banks, as money can be obtained within just a few days to a week. For larger loans from online lenders, you may see costs similar to those from traditional banks.

Downsides: Online lenders typically can't compete with traditional banks in terms of APR. So if you qualify and don't need money immediately, a bank loan will probably be the less expensive option.

Nerd tip: If you qualify, the most affordable financing will typically come from traditional lenders and SBA loans.

Chapter 4

What do I need to apply?

To obtain financing, you'll likely need to go through an application process that involves providing the following information to the lender:

- **Personal and background information** such as your home address, education and work experience, and business information such as your address, type of business, tax ID number and telephone number.

- **Your own personal credit history** and credit score, which can determine whether you qualify for a loan, your ability to repay it and how much money you'll be able to borrow. More established businesses may be required to provide a business credit score.

- **Personal and business income** tax returns for the past two or three years.

- **Legal documents** such as articles of incorporation, business licenses and franchise agreements.

- **The financials of your business**, such as profit and loss statements, balance sheets, cash flow statements and financial projections that factor in the loan.

- **For larger loans**, an overview of your business and its history, as well as a solid, detailed financial plan that clearly states why you need the money and what you plan to do with it.

- **Some online lenders** require you to link to online business or accounting software, such as Intuit QuickBooks or Xero. Invoice financing companies may require you to link your bookkeeping app to their site in order to upload your invoices.

- **Some lenders** may require you to sign a personal guarantee to secure financing. This is a written promise that allows the lender to go after your personal assets if you fail to repay the loan, and it puts your personal credit at risk.

The exact application requirements will depend on the type of loan you are seeking, the size of the loan and the requirements of the lender.

Nerd tip: Before you sign a loan agreement, you need to look carefully at your business's financials, especially cash flow, and evaluate how much money you can reasonably afford to put toward loan repayments each month. Some online lenders require repayments daily or twice a month, so be ready to factor that into the equation.

To comfortably repay your loan each month, your total income should be at least 1.25 times your total expenses, including your new repayment amount, says Suzanne Darden, a business consultant at the Alabama Small Business Development Center. For example, if your business's income is $10,000 a month and you have $7,000 worth of expenses including rent, payroll, inventory and so on, the most you can comfortably afford is $1,000 a month in loan repayments.

Conclusion

Find and compare small-business loans.

Getting a small-business loan can be tough but necessary. Whether it's to buy equipment, hire new employees, renovate an office or refinance existing debt, a small-business loan can provide your company with a much-needed cash infusion. However, finding the right lender for your small business can be challenging, given all the options available. We've done the homework for you by providing a comparison tool that will help you identify your best financing option.

Click here to learn more.

Nerd tip: Small-business loans can provide you with the capital needed to grow and expand your business, but you should carefully weigh the terms, fees, APR and how you'll repay the loan before making any commitments.