

Difference Between Working Capital Loan and Term Loan

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Bottom line

A working capital loan covers day-to-day operational expenses like rent, salaries, and utilities, and is typically short-term with the option to reapply after repayment.

One of the starting points in independent business planning is recruiting financial assets serving as an initial investment. There's no denying that this initial investment is an important determinant of a business's future. Large business entrepreneurs often don't come across a financial dead end as they already possess a good wealth resource for the start of their business. On the other hand, a small business person is all the more likely to face such struggles. It may arise as a result of a lack of financial assets or an ill-planned budget. Whatever the reason be, a small business owner is liable to seek financial aid at some point in the business. As the market has started flooding with more small business owners, there has been a subsequent increase in financial assistants instruments. The tools currently available for small business investments include business/commercial loans, mutual fund investments, or private lending authorities. The two most commonly used loans for a small business are the Working Capital Loan and the Term Loan. A new business owner needs to understand the concept of these types of loans and then decide what type of loan is more suitable for their business objectives and future ventures.

A Working Capital Loan: meaning, features, advantages, and disadvantages

What is a working capital loan?

A great addition to the world of independent businesses, a Working Capital Loan is a type of financial resource assigned to a business owner or a particular business that works to navigate through the business's present expenses or cost of operation. As the name suggests, a working capital loan is used to counteract the costs endured by a business's functioning. Thus, this type of loan is not helpful as an initial business investment but is more beneficial to keep the business up and to run. A fully functional business is destined to gain specific expenses, no matter what type of business it is. These expenses can be in the form of rent payments for the office or factory building, salary deposits of the employees, or costs of providing amenities related to the business or an employee. Such type costs are unavoidable, and hence the business owner should keep them in mind while planning the business's budget. A question that arises here is, 'If the business is fully operational, why would there be a need for claiming a loan?' A working capital loan is useful when the business lacks a fluidity of capital or assets. Under such circumstances, covering the day-to-day tariff of the business and its management and operation can be a daunting task. This scenario ultimately leads to a business owner paying the costs out of their pocket. Hence, a Working Capital Loan comes as a helpful aid where the business owner is self-sufficient in keeping up with the daily business charges without getting drained in losses or disturbing the business's balance of assets and capital.

Features of a Working Capital Loan

The features of a Working Capital Loan are:

- The working capital of a business is the number of earnings made by a business that possesses greater liquidity, and the business can use it for daily tasks.
- The business owner can avail of these loans as short-term or medium-term loans. The businesses primarily use a short-term basis of Working Capital Loan.
- The profitable feature of a Working Capital Loan is that the business can claim such loans more than once. It doesn't matter how many times a business has previously claimed a working capital loan; it can still be sanctioned to the same business again.
- However, repeated sanctioning of a working capital loan depends on the payback of the last loan. If the business has successfully repaid the prior loans, a new loan can be claimed.
- The amount of loan that will be sanctioned as a Working Capital Loan depends on the business portfolio.
- A Working Capital Loan may also be associated with the business owner's credit history and influence the entrepreneur's credit score.
- Certain types of Working Capital Loans may also require a business asset to serve as security or mortgage for a loan.
- A business owner may choose to avail of a loan on either a secure-basis or non-secure basis.

Advantages of using a Working Capital Loan

- Easier application process: One of the most important benefits of acquiring a working capital loan is that it takes lesser time to get the loan sanctioned to the business. The loan has a hassle-free application procedure and a much rapid approval process. Thus, a business owner saves time and money on such loans.
- Coping with daily costs: a prominent feature of the Working Capital Loan is that they provide the business with a facility to stay relevant and cope with the daily charges that are imposed as a result of the operation of the business. It includes long-term financial stability to the business and takes the headache of management of cash flow from the business owner's mind.
- Control over business: As the Working Capital Loan is a form of debt financing, the business owner has better control over transactions in the business than those that occur in an equity transaction.
- Feasibility of non-secure loan: Working Capital loans is amongst those rare business loans which provide the business owner with a choice between a secure and non-secure loan. Thus, if the business owner selects a non-secure loan sanctioning, they need not worry about the safety of the business under a situation of failure of loan repayment.
- Building business inventory: The capital resource from the working capital loan can be utilized to expand the fundamental resources of a business that are essential for its development and operation.

Disadvantages of using Working Capital Loan

- Higher rates of interest: As these types of loans are more on the short-term end, they impose a higher interest rate than other types of business loans. This may be a limiting factor for the income made by the entrepreneur.
- Effects on credit score: Transactions and sanctioning related activities of the loan directly influence the entrepreneur's credit score. Thus, a failure of loan amount payback may negatively affect the credit score of the business owner.
- Collateral loans: It is imperative for a small business that has little or zeroes credit to opt for a Working Capital Loan on a secure basis. Thus, mortgaging an asset or property as loan security may be a con for various business owners.

Term Loan: meaning, features, advantages, and disadvantages.

While some may confuse term loans as similar to a Working Capital loan, these two are quite different in reality.

What is a Term Loan?

A Term Loan is a business owner's funding to improve the cumulative assets under the business's wing. Such type of loan is involved in the procurement of a capital asset for use in business expansion. These capital assets are generally those tools that have a specific function for the business and may do so up to a particular time. Thus, the business owner can use such loans as a form of aid to purchase such assets.

Features of a Term Loan

The features of a term loan are as follows:

- A business owner can choose to claim a business term loan for a long period. Such loans are sanctioned on a long-term basis.
- The capital assets purchased using a Term Loan should not be up for sale.
- The loan payback associated with a Term Loan depends on the cost of business production and the business's cumulative earnings.
- Interest rates that fall under a Term Loan are transient, i.e., they keep changing as the loan tenure moves ahead. The interest rate at the end of the loan period may be much higher due to cumulative changes.
- The loan amount sanctioned under a Term Loan is much higher as these loans occur on a long-term basis.

Advantages of availing a Term Loan

- Expansion of the business workforce: A Term Loan typically ensures capital assets' accumulation under a business. Therefore, these are a good source of enhancing the business personnel or the task force that will ultimately result in the business's growth. The increased workforce will also benefit new clients as the diversity of the business portfolio increases.
- Enhancing business capital assets: With the financial resource available from a Term Loan, a business owner can reach out and receive the ownership of newer assets that can be claimed in the form of property or equipment purchases. It increases the Net Asset Value of a business.
- Applications of business: In case a business owner is not interested in procuring the capital assets for their business, they can still use the fund from a Term Loan for other business applications such as a renovation in business layout or the business technology. The fund may also be employed to clear the payment of any remaining debt in the business.

Disadvantages of Term Loan

- Much higher loan interests: The major con of a term loan is that their interest rates keep changing during the span of the loan. As the sanctioned loan amount is on the higher range, the corresponding interest rates can hamper the business's finance and assets .
- Strict loan repayment regulations: Term loans are always related to collateralizing, and hence, the inability of the business to generate sufficient capital as loan repayment can quickly lead to a state of financial demise or bankruptcy. The bank or other lending authorities are pretty strict over their loan-related terms and conditions.
- Effect of market inflation: Term Loans are greatly affected by market inflation. These effects come into play as the changes in the debt cost of business.
- Additional charges: The application procedure for Term loans involves a set of additional fee charges that need to be paid during the claim process.

Working Capital Loan VS Term Loan: Comparison at a Glance

Feature: Loan Period | Working Capital Loan: Such loans are acquired for a short-term or medium-term basis | Term Loan: Such loans are acquired for a long-term basis.

Feature: Use of loan fund | Working Capital Loan: These loans are acquitted of achieving the business requirements at the current business operation. Such loans help to cope with the day-to-day expenses incurred by a business. | Term Loan: Such type of loan is acquitted for capital asset expansion or the procurement of important business-related tools or equipment.

Feature: Number of loan repayment installments | Working Capital Loan: Such loans typically involve one or two loan repayment installments. The business owner can choose to pay the loan amount as a cumulative sum at one go or as a two-time payment. | Term Loan: These loans involve several installments. Thus, the business owner can choose to repay the loan by breaking down the amount into a number of installments.

Feature: Loan application process | Working Capital Loan: Here, the loan application process is much swifter and rapid. It requires a lesser amount of paper or documentation work. | Term Loan: The application process of such a loan is comparatively more profound in approach and may contain a lot of documentation work and policy compliance.

Feature: Payback period of the loan | Working Capital Loan: The loan payback period is of a short duration of 2 months as it is a short-term loan. | Term Loan: The loan payback period under such loans in the range of 1-10 years depends on the amount sanctioned.

Feature: Loan rate of interest | Working Capital Loan: Owing to a shorter payback period, the interest rates of such loans can go high. | Term Loan: Although the interest rates are of considerable value in such loans, they are comparatively lower than the Working Capital Loans.

Feature: Amount of fund | Working Capital Loan: Under such loans, the loan amount is of smaller value. | Term Loan: High loan amounts can be availed under these loans.

Feature: Process charges | Working Capital Loan: Application processes for such types of loans are generally free from any additional costs. It may amount to 3% of the loan amount. | Term Loan: Typical to the other common loan application procedures, these loans do involve an additional charge during the sanctioning loan process.

Feature: Collateral/security | Working Capital Loan: These loans display an option of both secure as well as non-secure loan sanctioning. Thus, the provision of collateral depends on the business owner. | Term Loan: Such loans incorporate collateral for lending the fund to the business owner as they are the secure-based loans.

Feature: Effect on credit score | Working Capital Loan: Such type of loans involves the entrepreneur's credit score; thus, it can influence the credit score. The impact is lesser than term loans. | Term Loan: Here the credit score of the business owner has a higher possibility of upgrading than the other loans. These loans involve debt-financing and hence are helpful for the credit score.

Feature: Varieties of loan | Working Capital Loan: This loan may be availed in the form of a Business credit line, as advance or factoring, or as an account receivable loan. | Term Loan: Term Loans are classified according to the term of use as Long-term, Intermediate-term, or Short-term loans.

It was the bigger picture of the fundamental difference between the Working Capital as well as Term Loans. Acknowledging the concept and factual difference between both types of loans shall help the entrepreneur make a more informed and accurate business decision. Furthermore, as both of these loans involve a different objective related to business operation, the business owner can opt for either of the loans based on the requirement they seek to fulfill. The business owner can choose the loan that is best suited for the target of the business. Thus, it will be beneficial for the success of the company in the long run. However, as these loans are different in their goal and functionality, the yields produced upon using them will also be different. That is why the entrepreneur's discretion is advised when availing either of the loans.

References

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