Small Business Loans: The Complete Guide

Although traditional business lending has rebounded since the start of the great recession, the recovery has not been as robust for the smallest small businesses—the small merchants, restaurants, drycleaners, and mechanics most of us think of when we think of small businesses. Fortunately, in addition to a term loan at the bank, small business loans can be found outside the bank.

Borrowing from the Bank

The local bank has traditionally been the source of capital for small business owners in the United States. In fact, when most small business owners realize they need financing, their local bank is the first place they think of. This makes sense when you consider they often use other bank services; like a business checking account, maybe a business credit card, a merchant services account, or even a business savings account.

Business borrowing from the bank can be a good option for many small business owners, provided they can meet the potentially rigid qualification criteria. Nevertheless, even if you do have the right credit score, have sufficient collateral, and meet the other requirements, a loan at the bank might not be the best loan to address your situation, so it makes sense to understand more about a loan at the bank and investigate all the options to make sure you pick the *right* loan to meet your small business needs.

How Will the Bank Review My Loan Application?

Although any particular bank may evaluate you and your business differently, here are some pretty basic criteria most banks are looking at when you're applying for a small business loan:

1. **Personal Credit Score:** Most banks like to see a personal credit score of 700 or better, although some will go as low as 680 if the borrower can demonstrate an otherwise healthy business and other criteria are met.
2. **Collateral:** Obtaining approval for most small business loans will typically require some form of collateral to secure the loan. This helps the bank mitigate their losses should a borrower default. As a general rule, something like equipment, real estate, or other high-value asset that can be sold by the bank is generally accepted as collateral.
3. **Time in Business:** Although they don't all require the same amount of time in business, all lenders look at your track record in the past to make decisions about whether or not a small business owner will be able to successful service the debt of a small business loan in the future. As a general rule, the bank likes to see several years (even four or five) in business before they will approve a loan.

How Does a Term Loan Work?

The way a loan at the bank works is also very familiar to anyone who has ever had a mortgage or an auto loan. In the phrase "term loan," the word "term" applies to the length of the loan. For example a 30-year mortgage would be considered a 30-year term loan. In the same way a four-year auto loan would be considered a four-year term loan. A small business loan at the bank will typically carry a term of four to 10 years—sometimes longer. So if your loan purpose would be served by a longer-term loan, a loan at the bank could be a good option.

Although many traditional term loans at the bank require a monthly periodic payment, some banks are requiring a more frequent periodic payment schedule. This is something you'll want to confirm with your bank as they discuss loan terms, payment schedules, and interest rates.

The interest rates you'll pay at the bank will vary depending upon the following:

- **The current index rate** (usually the Prime Rate, LIBOR, or the Treasury Rate—depending upon the type of loan)
- **The perceived credit risk** represented by your loan (your personal and business creditworthiness)
- **The length of the loan term**

Interest rates may be either fixed or variable. A fixed rate will not change throughout the loan term, regardless of what happens to the Prime Rate, LIBOR, or Treasury Rates. Therefore, a good time to get a fixed-rate loan is when the interest rates are low.

Variable rates are based upon the above index rates and will fluctuate with the rate as it moves up or down. When you agree to a variable rate, you are agreeing to a rate based upon the index, plus a defined spread. In other words, as the lenders cost of funds changes, so does the interest rate you pay—going either up or down.

When Could a Loan From the Bank Be a Good Choice?

There are a number of loan purposes that make sense for a term loan from the bank, including:

- Equipment, machinery, and other tools for manufacturing, service, and repair businesses
- Technology and other office equipment, such as computer equipment, phone systems, copiers, furniture, and other similar technology
- Real estate, office space expansion, renovations, and new construction

Applying for a loan at the bank will require submitting an application with information about you and your business. The specific information required can be different from bank to bank, but you should be prepared to dive into the details of your businesses financial health as well as your personal creditworthiness. Some of what the bank may want to see includes:

- A detailed business plan that outlines why you are looking for a loan, what, if any, assets will be purchased with the proceeds from the loan, and how you expect the business to benefit from using the borrowed funds in this way.
- Business financial statements for up to the past three years, including balance sheets and profit and loss statements (P&L).
- Tax returns for both the business and the owners for the past three years.
- A debt schedule.
- Personal financial statements of all the business owners.
- The lease for the business premises, if applicable.
- Financial projections for three years showing what you expect revenue and expenses to be. You should also plan on demonstrating how those operations will make it possible to repay the proposed loan.
- Resumes for all business owners and key employees.
- Information about the assets to be purchased, including a copy of the sales contract or purchase agreement, if applicable.

As a small business owner, it's likely that your personal creditworthiness will always be a factor in loan approval decisions—particularly at the bank. Many bankers look at your personal credit score as the first go-no-go metric when making decisions about your loan application. Your business credit profile will also factor into the decision-making process, so it's important to understand what is reported within your personal and business credit profiles.

The turnaround time for a bank loan can take up to several weeks, so it makes sense to be prepared to help streamline the process as much as possible. You can start by having the above-mentioned information at your fingertips. You should also be prepared to respond quickly with any additional information they might ask about.

Small Business Loans From the SBA

Although many business owners misunderstand this, the SBA doesn't actually make loans. They work with participating banks, credit unions and other licensed non-bank lenders within a loan guarantee program. As a federal agency, the SBA promotes small business ownership in several ways, including their loan guarantees. The loan guarantee is basically credit insurance for the SBA lender. In other words, the SBA will cover a portion of any losses incurred by the bank—up to 90 percent.

Participating SBA lenders adhere to specific lending terms including interest rate caps set by the SBA. The SBA then shares the risk with the lender, making small business lending more attractive to the bank. They do this to encourage the bank to make small business loans because these businesses create two out of every three new jobs in the U.S. and account for a little over have the American workforce.

Because of the guarantee program, borrowers who might not be able to completely collateralize a loan or otherwise qualify for a traditional loan at the bank may qualify for an SBA loan.

When applying for an SBA loan, you won't actually talk to anyone at the SBA, but will rather apply at a participating lender who will make the decision about whether or not to submit your application to the SBA. If they determine that you meet the criteria, the lender will submit your application directly to the SBA to get the guarantee.

Not all banks offer small business loans from the SBA loan guarantee program, so if you're looking for an SBA loan, you can start your search with SBA.gov to find the SBA lenders in your area.

An SBA 7(a) Loan

There are several different SBA loan types depending upon your loan purpose and the size of the loan. The most popular SBA loan program is the 7(a) program. It's designed for a broad range of general-purpose business needs with a maximum loan amount of $5 million and the funds may be used for many business need, including:

- Starting a new business
- Funding working capital
- Buying land or a building
- Acquiring another company

7(a) loans are often used to purchase assets like real estate and equipment because the terms make sense for those larger purchases and allow the borrower to repay the loan in terms compatible with the asset being

purchased. For example, 25-year terms for real estate and 10-year terms for equipment. The longer repayment terms facilitate lower payments and make sense for the loan purposes.

Loan purpose matters and there are some restrictions for how a business owner may use funds from an SBA loan. For example, they may not be used to fund an investment or any passive business activity, like purchasing a building that will be leased to another business. Funds may also not be used to reimburse a business owner for money he or she has previously invested in the business or be used to repay money owed the government, such as a tax debt.

Is a 7(a) Loan a Good Fit for My Business Need?

Determining whether or not a 7(a) loan is a good fit for you business will depend upon how you match up with the SBA loan criteria:

- You have reasonable invested equity
- You have used alternative financial resources, including personal assets, before seeking financial assistance
- You are able to demonstrate a need for the loan proceeds
- You will use the funds for a sound business purpose
- You are not delinquent on any existing debt obligations to the U.S. government

There are some businesses where the SBA will not grant a loan approval, including the following:

- Financial businesses primarily engaged in the business of lending, such as banks, finance companies, payday lenders, some leasing companies and factors (pawn shops, although engaged in lending may qualify in some circumstances)
- Businesses owned by developers and landlords that do not actively occupy the assets acquired or improved with the loan proceeds (except when the property is leased to the business at zero profit for the property's owners)
- Life insurance companies
- Businesses located in a foreign country (businesses in the U.S. owned by aliens may qualify)
- Businesses engaged in pyramid sales distribution plans, where a participant's primary incentive is based on the sales made by an ever-increasing number of participants
- Businesses deriving more than one-third of gross annual revenue from legal gambling activities
- Businesses engaged in any illegal activity
- Private clubs and businesses that limit the number of memberships for reasons other than capacity
- Government-owned entities
- Businesses principally engaged in teaching, instructing, counseling, or indoctrinating religion or religious beliefs, whether in a religious or secular setting
- Consumer and marketing cooperatives (producer cooperatives are eligible)
- Loan packagers earning more than one third of their gross annual revenue from packaging SBA loans
- Businesses in which the lender or CDC, or any of its associates owns and equity interest
- Businesses that present live performances of an indecent sexual nature or derive directly or indirectly more than 2.5 percent of gross revenue through the sale of products or services, or the presentation of any depictions or displays, of an indecent sexual nature
- Businesses primarily engaged in political or lobbying activities
- Speculative businesses (such as oil exploration)

In addition to the above restrictions, the following additional restrictions apply:

- A business that caused the government to have incurred a loss related to a prior business debt
- A business owned 20 percent or more by a person associated with a different business that caused the government to have incurred a loss related to a prior business debt
- A business owned 20 percent or more by a person who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral depravity

Applying for an SBA Loan

Applying for an SBA loan is very similar to the process required at the bank (which makes sense as most SBA loans start at a bank or credit union). You SBA loan application will need to include:

- A detailed business plan
- Business financial statements for the last three years, including balance sheets and profit and loss statements (P&L)
- Tax returns for the business and its owners for the past three years
- Detailed information on any other business loans the business may currently have
- Personal financial statements on all the owners who hold more than 20 percent of the business
- The lease for the business premises, if applicable
- Financial projections for three years showing what you expect revenue and expenses to be, and demonstrating that business operations will be able to repay the proposed loan

You may be required to supply additional information related to the specific loan purpose. For example, if you're planning to use the loan proceeds to buy another business you'll need to provide a copy of the purchase agreement, the target company's financial statements, tax returns, and other details about them (your loan officer will inform you as to the specific documents you may need to add to your loan application).

There are really two approvals that must take place when applying for an SBA loan.

1. The bank where you apply will review your application to determine whether or not you meet their qualifications, subject to SBA approval. (NOTE: The lender is required to observe the "credit elsewhere" rule, meaning that if your company is qualified for a loan from another source without the credit insurance provided by the SBA, you should be sent there.)
2. The SBA must approve your application for the loan guarantee.

Processing a 7(a) application can take several weeks. There are banks with what the SBA calls "delegated authority, which can make the process faster. Once approved, it can take between 30 to 60 days to close the loan and receive the funds. As a result you'll need to evaluate how quickly you need the funds to meet your loan purpose. It's possible the length of time it takes to apply, have your application reviewed, and receive the funds might take too long to accommodate some business loan purposes.

Interest Rates, Terms, and Fees on a 7(a) Loan[1]

The most a small business can borrow within the 7(a) loan program is $5 million, but the average loan amount is between $350,000 and $450,000. There is really no minimum loan amount and the SBA has removed fees on loans under $150,000 to encourage its lenders to make more loans to smaller businesses.

On loans over $150,000, the small business will pay a one-time up-front fee that is determined by the size of the loan. On loans between $150,000 and $750,000 the fees are lower than those over $750,000. Also, the

SBA does not allow other fees to be assessed by the lender unless there are extreme circumstances, such as a higher-than-normal servicing required by the loan.

Loan terms are generally negotiated with the individual lender, within the following parameters:

- Fixed and variable interest rates are available
- Lenders are limited to how much they can add to the prime rate based upon the size of the loan
- Maximum loan terms are determined by the use of loan funds; for example:
    - 25 years for real estate and improvements
    - 10 years for equipment
    - 7 years for working capital
- Personal guarantees are required for all owners with 20 percent or more ownership
- Monthly loan payments are required
- Borrowers will have to pay for all costs associated with the lender's due diligence on collateral—this may include attorney's fees, appraisals environmental assessments, etc.

When most people think of an SBA loan, they're thinking of the 7(a) loan, but there are other SBA loans that are designed for specific loan purposes.

The CDC/504 Loan

A 504 loan is administered through a non-profit organization called a Certified Development Company (hence the CDC designation). These non-profits work with both the SBA and a participating lender. The process may feel a little more complicated because there are more players involved with a 504 loan

To qualify, the business must have a net worth of less than $15 million and an average net income of less than $5 million after taxes. Many of the same restrictions described above for the 7(a) loan program also apply to a 504 loan.

Like a 7(a) loan, the maximum loan amount is $5 million, but the actual amount will be determined by how the funds are used. 504 loans are typically tied to some kind of community development goal with job creation the underlying objective. The metric for a 504 loan is to create one job for every $65,000 borrowed. With the exception of small manufacturers that have a different goal of creating or retaining one job for every $100,000 borrowed.

Interest Rates, Terms, and Fees for a 504 Loan[2]

Loan terms vary from 10 years (for equipment) to a 20-year term (for real estate), making it possible for business owners to repay the loan over the expected lifetime of the asset. Interest rates are pegged to an increment above the current market rate for 5-year and 10-year U.S. Treasury issues. A 504 loan may include a fee of approximately three percent, which may be financed with the loan.

SBA Microloans

A microloan, as defined by the SBA, is a loan amount of $50,000 or less. The average SBA microloan is $13,000.

Microloans are a good choice for businesses that can leverage a relatively small loan amount into a bigger impact. An SBA microloan can't be used to pay debts or purchase real estate.

Unlike a 7(a) loan or a 504 loan, which are only offered to for-profit businesses, microloans are also available to non-profit businesses like child care centers—although there are ineligible non-profit businesses that are excluded.

Unlike other SBA loans, microloans come direct from government funds and are administered by a local non-profit lender. Therefore, unlike the standardized loan terms and requirements of a 7(a) loan, eligibility requirements, terms, and interest rates are determined at the local level. However, you should expect a shorter loan term, with a maximum of six years.

Small Business Loans From an Online Small Business Lender

In addition to traditional bank loans and the SBA a new breed of online lenders are offering small business loans. In many ways, online loans are similar to their traditional counterparts. The difference is in the way they leverage technology, their approach to the small business loan process, and the paradigm they use to evaluate a business borrower's creditworthiness.

As traditional lenders shied away from the smallest small businesses, loans to those businesses have been in decline and slow to recover[3], online lenders are making more capital available to small businesses by adding a financing option that didn't exist previously.

In the same way companies like Amazon, AirBNB, and Uber have changed the way we shop, stay in a hotel, or hail a cab, these lenders are using technology to match loan purpose with the right loan product to help them fuel business growth and meet other capital needs. According to a survey of 592 Main Street small business owners conducted by the Electronic Transactions Association (ETA) in early 2016, the average business owners in the survey anticipate a 5x return for every dollar they borrow. What's more, 94 percent of those same business owners perceive that having more options helps them do that.

Although many online lenders share some of the same characteristics, they are not all the same. Some lenders tend to focus on either long-term loans or short-term loans. Nevertheless, there are lenders that do both. As a result, depending upon your loan purpose (what you're borrowing the money for), you'll likely need to know before your search begins what terms might make the most sense for your loan purpose. For example, the loan term when purchasing short-turnaround inventory and a large piece of manufacturing equipment could be very different.

Applying for an Online Business Loan

The application process for an online loan is very different from a traditional loan at the bank or an SBA loan. Applications are usually a simple online form that only takes a few minutes to complete and the business will often receive an answer to their application within and hour—sometimes as quickly as within a few minutes.

The documents required for an online business loan will vary from what is required by the bank and may include:

- The borrower's Social Security Number
- The business' Tax ID Number
- Several months of business bank statements
- Financial statements

Although the requirements might vary from lender to lender, most online lenders don't require specific types of collateral to secure a loan. Rather, they apply a general lien to business assets during the loan term and require a personal guarantee (a common practice also used by many banks).

Interest Rates and Fees for Online Business Loans

Interest rates and fees will vary from lender to lender. And, because it can be confusing to compare loans with different loan terms, it's important to ask any potential lender for some of the following information:

- The total cost of capital (or total cost of the loan)
- The fees associated with the loan
- APR (which includes an annualized interest rate plus any fees)
- Prepayment policies

This information will make it easier to compare loans from different lenders who might express the costs associated with their loans in different ways. For example, 57 percent of those who participated in the ETA survey chose a shorter-term loan option with a higher APR for a hypothetical short-term business opportunity because it offered a lower overall dollar cost when compared to a longer-term loan with a lower APR.

Although loans for consumers are commonly expressed in terms of APR, thdeat is only one way an online lender might express the costs associated with a business loan since dollar cost is important to consider in relation to an investment opportunity. And, use of APR may be most helpful when comparing loans of similar term, but it's always a good idea to also ask about the fees, the total dollar cost of the loan, and prepayment policies. In many situations, the total dollar cost might be be a more important metric than the APR to a small business borrower.

Repayment Terms and Other Considerations

The advent of daily and weekly periodic payments is a departure from a more traditional monthly payment schedule; nevertheless, many lenders (including online lenders) have adopted a more-frequent-than-monthly payment schedule. Not the least of these reasons is that it tends to smooth out the cash burden throughout the month and helps the lender control the risk associated with the loan.

If your lender requires a more frequent periodic payment, it's important to make sure your business has the appropriate cash flow to accommodate the payment schedule. This type of payment schedule might not be a good choice for a business that relies on a month-end influx of cash flow to maintain business operations or infrequent inward deposits.

There are several situations where an online small business loan could make sense:

1. **Your business doesn't meet the rigid credit criteria at the bank:** Because many online lenders consider dozens of other metrics that demonstrate a healthy business, beyond just your personal credit score, they will often accept a lower personal credit score (provided other metrics demonstrate a healthy business).
2. **You need to fill a short-term business need:** As described above, there are situations where a long-term loan will include a total dollar cost that is too high for the loan purpose. An online loan with a six- to 12-month term could be a better fit.

3. **You need an answer regarding your application quickly:** Online lenders are typically able to respond with an approval or a decline of your credit application within the same day—sometimes within a few minutes.
4. **You need the capital quickly:** There are times when opportunity costs are high enough that paying a premium for 24- or 48-hour access to capital is worth the extra expense. For example, the opportunity to purchase quick-turnaround inventory at a steep discount, could justify paying a premium for the funds.

The qualifying criteria for an online business loan will vary depending upon your lender, but are typically less strict than a traditional loan.

- Required Time in Business: Usually between 1-2 years
- Minimum Annual Revenue: $75,000-$250,000
- Minimum Personal Credit Score: 500-650
- Industry: Industry requirements vary by lender, but restricted industries sometimes include financial services, homebuilders, real estate investors, etc.

The Devil is in the Details

Regardless of whether you opt for a loan at the bank, and SBA loan, or an online business loan, it's important to understand any and all fees and charges that could be applied to your loan down the road. In addition to late fees, are there other fees or policies you need to be aware of?

The fine print isn't always fun to read, but it's important to make sure you understand what's included in there. For example, you should understand how frequently you might expect rate changes with a variable rate loan.

If there are financial terms you don't understand, make sure they are explained to you by the lender or have a trusted advisor like your accountant or lawyer review the document and explain the terms to you before you sign it.

There are more options available for small business owners than ever before, but it's important that small business owners become savvy about their choices to determine the financing option that will make the most sense for their business.

[1] https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/general-small-business-loans-7a/7a-loan-amounts-fees-interest-rates

[2] https://www.sba.gov/loans-grants/see-what-sba-offers/sba-loan-programs/real-estate-equipment-loans-cdc-504/cdc-504-loan-amounts-interest-rates-fees

[3] http://www.hbs.edu/faculty/Publication%20Files/15-004_09b1bf8b-eb2a-4e63-9c4e-0374f770856f.pdf