Is a Business Line of Credit Wise for Your Small Business?

A local small business owner asked me last week if “it is wise to have a business line of credit”. My answer was, quoting from Warren, a friend of mine, “that depends”. Let me explain why as I share some ideas from Brian Smith, a freelance writer and entrepreneur with over 30 years of experience in the field. He regularly writes for several digital platforms on subjects related to starting and running a small business. SCORE includes his content in its Resource Library.

Smith states that “Business lines of credit are a successful financial product because they can provide valuable assets to a growing company like yours. But they come with disadvantages and risks”. So, let us consider a look at both sides of this coin to see if a business line of credit is right for you.

What Is a Business Line of Credit? Of the financial products you're probably familiar with, a business line of credit is the most like a business credit card. You receive a maximum balance and take money from that balance as you need it. Each month, you make a minimum payment based on the current balance of the loan.

A business loan, by contrast, works more like a mortgage or car loan: A bank lends you a lump sum one time, and you make regular payments each month until it's paid off.

Consider some “pros” of business lines of credit: There's a reason small business lines of credit are popular. They can provide distinct and valuable advantages to your business. Among the most important are:
1. They Even Out Cash Flow: All businesses, but especially small business, sometimes need to engage in a juggling act when income lags slightly behind expenses. A business line of credit lets you pay your bills on time and take advantage of automatic payment discounts.

2. Similarly, seasonal businesses can benefit from a line of credit when the cash influx from peak times isn’t quite enough to make it through the leaner months. You can draw from the line when it's slow, then pay it down when the crowds return.

3. They Allow You to Pay for Only What You Need. A business loan gives you a lump sum based on what you think you need for your business. It's rarely precisely the right amount. If you guess low, you have to scramble to find the extra capital to accomplish your goals for the business. This quick credit tends to be expensive and time-consuming to get. With a line of credit, your maximum balance is your highest estimate of the costs you need to cover. However, you use only what you need, meaning you only pay interest on what you need.

4. They Enable You to Seize Opportunities. Sometimes your business has an opportunity to advertise, participate in an event, open a new location, or take advantage of bulk price points for supplies and inventory. If your cash flow is weak at the time, you miss that opportunity. With a line of credit on hand, you can take advantage of those opportunities every time they're the right decision.

5. They Help You Build a Relationship With the Lender. Lines of credit are similar to credit cards in many respects, but they often require extra steps to access the balance. Those steps usually put you in contact with a decision-maker or customer service representative at the bank or credit union that issues the loan.

Now let us look at the “cons” of business lines of credit: Nothing in life is perfect and business lines of credit are no exception. Though they have some strengths, they also come with weaknesses, hassles and risks. Consider the following carefully as you make up your mind about taking one on.

1. They Can Be Expensive. Although they’re not usually as expensive as a business credit card, business lines of credit have high interest rates.
These are generally in the double-digit APR range, sometimes over 20%. In addition, many business lines of credit carry hidden initiation, processing, and maintenance fees — not to mention non-sufficient funds (NSF) and late payment penalties — that increase the cost significantly. Read the fine print carefully before accepting one.

2. There Are Wolves out there. To be clear, not all business lines of credit are a bad deal run by predatory institutions who want nothing but to milk your business of its hard-earned revenue. Many are legitimate, fair business deals, especially those from established banks and credit unions. But some are offered in bad faith, with extreme rates of interest and predatory policy details. Be wary, especially of offers that come to you rather than waiting for you to come to them.

3. Applying Is Time-Consuming. To apply for a legitimate business line of credit, you will usually need to provide: Business bank statements, Personal bank statements, Personal and business tax returns, Recent profit and loss (P&L) statements, etc. It's a long process with lots of moving parts, far more complicated than applying for a secured installment loan or credit card.

4. They Can Lead You into Temptation. One of the “pros” was that a business line of credit lets you act on opportunities? Not every opportunity is a good one, and if you act on too many at once, you may not leverage any of them as much as you should.

1. Limits Can Be Low. Business lines of credit usually have limits higher than a credit card but much lower than an installment loan. If the line has a limit lower than your needs, it's not a very good solution. It just sets you up to accumulate debt without accomplishing your goals.

So, as my friend Warren says, the answer is “that depends”. There is no universal yes-or-no answer to whether or not your business will benefit from taking on a business line of credit. Each business is unique, and each situation is different.
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