

Tutorial Notes

Class: M.Com, Semester IV (MC 4.3 / EC3)

Subject: Financial Institution & Market

Topic: Working Capital and Term Loan

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Working Capital Loans

Working capital is a really important funding source for businesses. The working capital for them is the immediate cash they receive for the daily expenditures that the business encounters. Usually, the need for working capital shows up when businesses have to pay the monthly rent, or pay the salaries to the employees or cover some seasonal demands that have shown up in the last minute. The assistance they get from these types of external funding sources helps them to get back on track and continue with their work. A type of assistance that you can get for working capital is a working capital loan.

You need to know that you cannot use the working capital loan for new investment, to start a new project or expand the business that you already have. These are liquid loans with a short term. The period for which these loans are given is usually a year or less.

The positive side is that they are really easy to get, especially in situations where your credit score is at a good level. The paperwork is not huge since it's a short-term loan. But, the interest rates are high.

You can use a loan calculator to estimate the requirements for working capital. The calculator will help you to analyse the inventory that has been built up, to add all of the cash that you already owe and also take in consideration the amount that you are supposed to pay to the suppliers. This helps in easier repayment of the loan that is taken.

Working capital loans, in comparison with terms loans, are relatively easier to get, especially with a good credit score. A working capital improvement is the main goal of such loans.

Term Loans

Term loans, as the name suggests, are loans that take more time, from one to ten years. These term loans are taken when you need funds for larger investments, for expansion of your business or for purchasing new machinery or tools. These loans usually involve higher sums of money than the working capital loan, and this is the reason why they are paid off during a longer period.

We mentioned that the interest rates for working capital loans are high, and this can lead people to think that it's an expensive loan. But, with the term loans, the interest rates keep growing with the years, so in the end, you pay more in interest for the term loans when compared to working capital loans.

You have a business loan calculator which can help you in estimating the total of the repayment, along with the interest and the principal.

Because this is a long-term loan, it requires a lot of paperwork and many procedures. So, it's not that easy to get it. Financial institutions need to check everything before approving or denying the loan request.

WORKING CAPITAL vs TERM LOAN

WORKING CAPITAL LOANS are short term loans which are availed for running working capital requirements of an entity

TERM LOANS are the long term loans which are availed for primarily financing for expansion, buying new assets, or other capital expenses.

DIFFERENCES

| WORKING CAPITAL LOAN | TERM LOAN |
|---|---|
| Availed for <u>short-term</u> with repayment period of two months. | Can be availed for <u>short, medium or long term</u> for duration between one to ten years. |
| Purpose is to <u>meet short term working capital requirements</u> | Purpose is to finance <u>expansion, buying of new asset, machinery</u> etc. |
| There are <u>limited number of instalments</u> here | There are <u>multiple instalments</u> spread across years |
| <u>Does not</u> consist of <u>lots of paperwork / procedure</u> | Contains <u>lot of paperwork</u> and procedure compliance |
| <u>Interest rates are high</u> as these loans can be unsecure | <u>Interest rates are lower</u> as compared to the other. |
| Loan <u>amount</u> is usually <u>small</u> | Loan <u>amount</u> is usually <u>high</u> . |
| May or <u>may not require collateral</u> | Term loans (being secure) <u>require collateral</u> |
| Has <u>less chance</u> to improve <u>credit score</u> | Has <u>better chance</u> of improving <u>credit score</u> . |
| Types : Account receivable Loans, Business credit line, Factoring or Advances | Types : Short Term, Intermediate Term, Long Term Loans |