Capital Solutions

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Does your Revolving Line of Credit Truly Revolve?

One thing that will get your lender's attention today that may not have prior to the financial crisis is your use of the company line of credit.

Your line of credit is intended to finance working capital, and really nothing else.

Sure, you may use it to take advantage of opportunities, or to pay for a marketing initiative, or to meet payroll when cash is tight.

But over the course of spending to secure new clients, fulfill client orders, and then collecting for your work, your use of the line should go up and down in concert with that net activity.

It should rise when a lot of work is in the pipeline, and come down as that work converts to revenue and cash.

Simply put, the line of credit is intended to bridge the cash gap between when you spend money on customer work, and when you collect from that work.

Businesses can get into a couple of traps using their line of credit, some of which can be avoided, and others sometimes cannot.

One trap is to use the line to buy a long-term asset, which should instead be financed with a separate long-term loan. By doing this you have long term assets absorb a part or all of your line of credit, and you could subsequently need that availability under your line for an emergency, like payroll, only to have used it already on 2 new trucks and a forklift as an example.

Another trap is to rely on the line of credit to fund losses from the business. Sometimes this can't be avoided, but it will only work for a short period, before your lender will restrict the use of the line and demand principal repayment of it.

A quick and simple example of how the line of credit should be used:

> **You sell your service for $100, and it costs you $80 in supplies and labor to produce it.**
>
> **You have to pay the suppliers and labor before you get any client money, so you preserve cash and use your line of credit for the $80 to pay them.**
>
> **Then, when the $100 comes in from the client, you take $80 plus and interest fees associated and pay your line of credit back, and then the nearly $20 goes towards increasing cash.**

Banks and other lenders are cracking down on lines of credit that do not revolve over the course of the year. Businesses are being notified by their bank that if their line of credit does get paid to $0 for a 30-day period over the course of the year, then a portion or all of that line of credit will be converted to term debt.

That can be really distressing to company cash flow when mandatory principal payments on the line of credit are introduced without much warning. Better to recognize that you need to ensure your line of credit is managed properly, and that it ebbs and flows along with your business activity.

Thanks for reading. Let us know if you would like our help securing your next line of credit.

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