Business Debt Part 1: Understanding Debt

DECAL
Thriving Child Care
Business Academy

Learn how to make informed decisions about business debt

Taking on debt can help people achieve significant milestones like buying a home, funding their education, or expanding a business. However, there is more to taking on debt than just gaining access to the money you need to reach your goals. It can have severe downsides if you're not prepared. This guide will help you understand how debt can impact your business and whether it is the right financial tool for your goals.

What's the big deal about debt?

Whether for personal or business reasons, nearly everyone encounters debt at some point in adulthood. Because it's so commonplace, it can be easy to focus more on its advantages, sometimes overlooking the potential risks of borrowing money. While debt can be a tool that supports resiliency, sustainability, and growth when used properly, there are two notable issues that are important to recognize.

First, when you borrow money, you will usually have to **pay interest**, which means you'll ultimately be paying more than the total amount you owe. Even if this is a worthwhile investment, if you don't really know the terms of your agreement or don't have a good plan for paying back what you've borrowed, you could end up losing a lot more money than you realize, or worse yet, finding yourself in a cycle of debt that is difficult to escape.

Second, depending on your current circumstances and the type of debt you are taking on, borrowing money may come with **great risk**. Committing to debt repayment can strain your finances, especially if you're already on a tight budget. High monthly payments can limit your ability to save, invest, or cover unexpected expenses, leading to increased stress and financial instability. In addition, some types of debt, like mortgages and home equity lines of credit (HELOC), are secured by your property. If you're unable to make payments as agreed, you risk foreclosure and losing your home.

Is debt the right financial tool for me?

Debt can be a great tool that assists in accomplishing many things; — but like any tool, if not used properly, it can cause problems for your business. Before taking on debt, it is

important to consider the benefits, the true cost of borrowing, and your ability to repay the amount borrowed.

Is there a benefit?

Before you do anything, it's important to make sure there's a clear benefit. To get started, ask yourself the following two questions:

- **What is the purpose of the debt?** Clearly define why you need the debt. Is it for expansion, purchasing new equipment, managing cash flow, or another specific purpose? Understanding the purpose will help determine if the debt is justifiable.
- **How will the debt improve the business?** Assess how the borrowed funds will impact your business. Will it increase revenue, improve efficiency, or provide other significant benefits?

As you answer these questions, think about how the impacts will help you in the long term. For example, debt might be a good choice it if will help you with:

1. **Expansion and Growth:** Debt can provide the necessary capital to expand your child care facility, whether it's opening new locations, renovating existing ones, or investing in additional resources and equipment.
2. **Investing in Quality:** Borrowing money can enable you to invest in quality improvements for your child care business, such as hiring staff with specialized expertise, enhancing educational programs, upgrading facilities, or obtaining certifications and accreditations.
3. **Financial Relief or Resilience:** Debt can provide financial relief or resilience by offering a safety net to cover unexpected expenses or navigate through periods of lower profit margins.

The key is that the responsibility of the debt repayment, the experience of keeping up with them, and the money lost to interest are outweighed by the benefits of what you're buying. So, for example, a loan to renovate a room in your child care facility that will allow you to take on additional children might provide you with enough revenue to quickly repay the money you've borrowed and also lead to a permanent increase in revenue.

What is the true cost of borrowing?

Understanding the real cost of borrowing goes beyond just looking at the amount you borrow. You'll need to also consider the interest rate, the duration of repayment, the consequences of not being able to pay back what you borrowed as expected, and the money lost versus the money saved.

- **Interest**
  There are two types of interest: **simple and compound interest:**

  - **Simple interest** is calculated only on the principal amount of a loan or investment. You might see simple interest when you take out straightforward loans, such as short-term loans from family or friends or some auto loans, where interest is calculated only on the initial amount borrowed and not on any additional interest accrued over time. For example, you take out a $1,000 loan from your Aunt. She charges you 10% interest monthly. In this case you would add $100 of interest a month (that is, $1,000 x 10% = $100).
  - **Compound interest** occurs when the interest on a loan or investment is calculated not only on the initial principal amount but also on the accumulated interest from previous periods. You might see this type of interest on long-term loans such as when purchasing property or major equipment. Compound interest can add up quickly. If you take our example of a $1,000 loan at 10% interest, the first month will be the same: $1,000 plus $100 in interest. But next month if nothing is paid, the interest will be calculated off the total of $1,100. So that month's interest is now $110 (that is $1,100 x 10%) which gets added to the $1,100 for a total owed of $1,210. Again, if this isn't paid is $1,210 x 10% = $121.

  Regardless of the type of interest you're dealing with, make sure you understand the total amount you may be expected to repay over time – because it can look very different from the amount you originally borrowed.

- **Duration**
  The duration of repayment may be fixed, as with a traditional loan, or it may extend indefinitely, as with a credit card. Here are some important considerations regarding duration:

  - Longer repayment times often mean lower monthly payments but can end up costing more overall because of interest.
  - Shorter repayment times might mean higher monthly payments but could save you money in the long run.

  Make sure you know how long you have to pay off your debt, but also remember that the longer you take, the more interest you'll have to pay.

- **Risk**
  When considering borrowing money, it's important to recognize potential consequences if for some reason you end up unable to repay what you owe:
  - **Late fees:** These fees for missed payments can quickly add up, cutting into your budget. It's crucial to know the amount and frequency of these fees.
  - **Collections:** If you fall behind on payments, your account may be sent to collections. This can lead to persistent calls from debt collectors, which could disrupt your business operations.

    - **Credit impact:** Late payments can harm your credit score, affecting your ability to secure future financing or favorable terms. Maintaining a good credit score is essential for the financial health of your business.
    - **Legal Action:** If you default on your loan, creditors may take legal action, including filing a lawsuit, wage garnishment, bank levy, placing liens on collateral, or seizing assets to recover the debt.
    - **Repossession or foreclosure:** If your loan is secured by collateral, such as property or equipment, failure to repay could result in repossession or foreclosure. This could disrupt your business operations and lead to significant financial losses.
- **Opportunity Cost**
  A final consideration when determining whether borrowing is right for you is understanding the opportunity cost — the money lost versus the money saved by using borrowing as a tool. Consider this: when you borrow, you're essentially paying interest to another party. However, if you were to invest that same sum in savings for yourself, it could generate returns for you instead. The length of time you spend losing money in interest could instead be significantly impacting your overall savings. Also, rather than increasing risk for your business, you'd be safeguarding your business from unforeseen financial challenges. So, while debt can be an impactful financial tool, it's equally important to recognize the opportunity cost of investing in debt versus savings. Take the necessary time to evaluate which financial approach best suits your business needs and objectives.

Can I repay what I am borrowing?

Whenever taking on debt, whether you have a choice or not, it's important to think through whether you are going to be able to pay it back easily, and what you will need to do to make sure you're successful in repayment. This will mean you need to understand your minimum monthly payments in comparison to the accumulation of interest because the longer you wait to pay the more you may end up paying.

- For example, say you've taken out a loan of $100,000 with a 5% fixed interest rate (meaning the interest rate will not change during the loan period) to purchase real estate for your child care business. In this case, if you paid steadily throughout a 30-year term, or length of the loan, you'd have paid a total of approximately $193,000 – **nearly double the original cost of the purchase price.**
- It's also important to note that the interest rate is typically much higher for credit cards – often around 21-22%. Imagine that you've made a purchase on a credit card for a play structure that costs $10,000. With these higher interest rates, the $10,000 balance on your credit card could **double in less than 4 years**, meaning you're paying double on your original purchase.

To prevent this from happening to you, start by creating a debt repayment plan that factors in the maximum amount you can afford to pay each month while aiming to minimize interest costs. You can create your debt repayment plan in 5 simple steps:

1. **Do a Cash Flow Forecast:** Start by creating a cash flow forecast to understand your monthly income and expenses. This will give you a clear picture of your financial situation and help you determine how much you can allocate towards debt repayment.
2. **Calculate Affordability:** Based on your cash flow forecast, determine how much you can realistically afford to allocate towards debt repayment each month.
3. **Set Your Repayment Goal:** Decide on a specific goal for debt repayment, such as paying off a certain amount by a particular date or repaying what you've borrowed within a certain timeframe.
4. **Make Extra Payments When Possible:** Whenever you have additional funds available, consider making extra payments towards your debt. This will help you pay off the debt more quickly and save on interest charges.
5. **Monitor Progress:** Regularly track your progress towards your debt repayment goal. Adjust your monthly payments as needed based on changes in your financial situation.

Taking on business debt is a significant decision, but if you prepare for the responsibility, it can be a great tool for your business. By doing so, you can leverage the borrowed funds to drive growth, improve operational efficiency, or anything else that will help you reach your business goals.

Additional Resources

If you have questions or need help, assistance is available.
GaPDS Website
DECAL Thriving Child Care Business Academy Website
To Find Other Study Guides: Click on Resources on the Academy home page
To Find Training: Click on Trainings on the Academy home page
To Register for Training: Click on Schedules & Registration on the Academy home page
To Sign Up for Study Groups: Fill out the Intake Assessment
For questions about coaching or study groups: Email GAcoaching@civstrat.com
To Find Other ECE Resources: Visit the DECAL Website
For General Questions about the Academy: Email thriving@decal.ga.gov
For More Information:
Family Child Care Learning Home Rules and Regulations
Child Care Learning Center Rules and Regulations

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