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# Understanding Term Loan



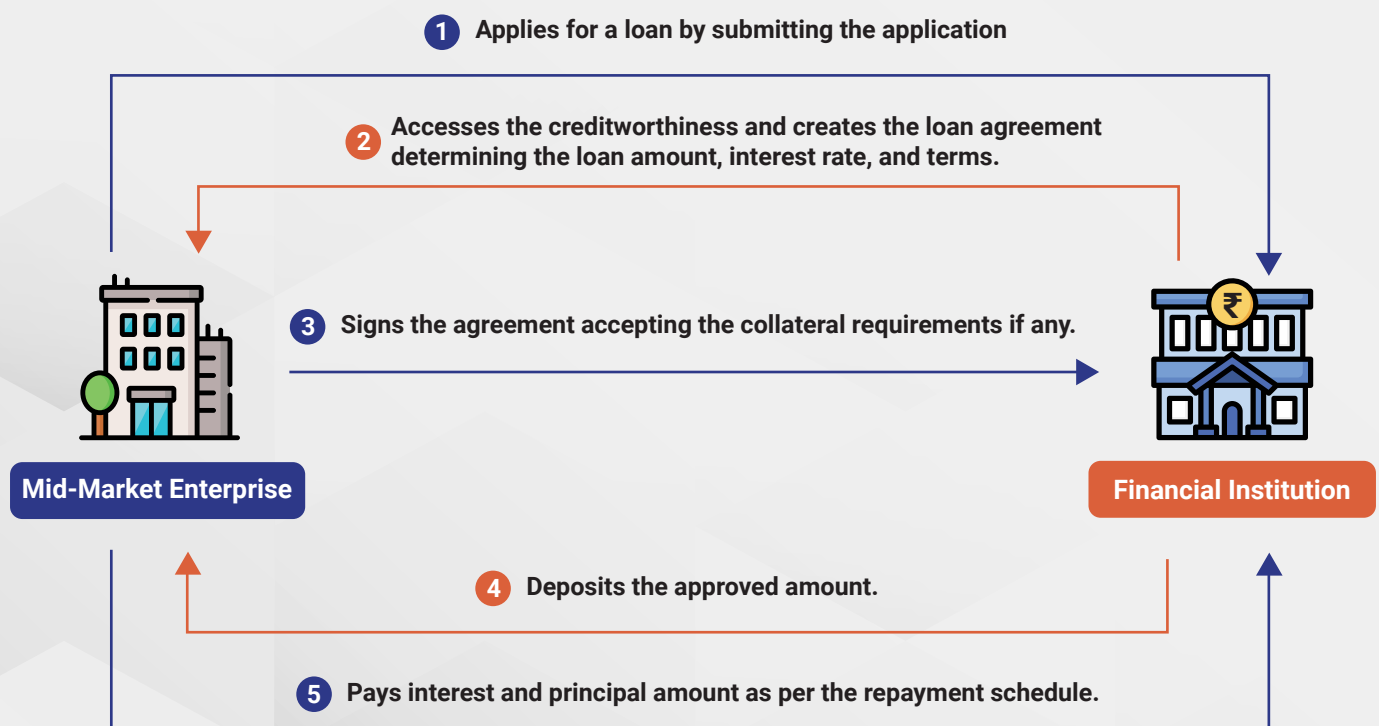
## What is Term Loan?

Term loan is a type of loan that provides lump sum amount to the borrower for a pre-determined time period at a fixed or variable interest rate. It's one of the most preferred forms of financing opted by businesses as it allows them to borrow large amount compared to other forms of financing.

Term loan offers borrowers flexibility in terms of end use of the fund, businesses can use the financing to fund their capital expenditure such as purchasing and upgrading equipment/machinery, business expansion or to meet their working capital needs and refinance their existing loans. Collateral may or may not be required depending on the agreement with the lender. The rate of interest can be linked to the external benchmark rate or can be fixed depending on the credit profile of the borrower.

The loan can be repaid through equated monthly instalments (EMI) depending on the terms of the loan agreement. Factors such as borrowers credit score, financial health and industry related risks can affect the acceptance of the loan application.

## How does Term Loan work?



## Categories of Term Loan

Term loans are broadly classified into two main categories:



**Secured Term Loan:** Here businesses provide collateral such as machinery/equipment, securities and property with the value equivalent or more to the loan amount. As the loan is backed by assets, it safeguards the lender against the risk of default, enabling borrowers to obtain loans at lower interest rate.



**Unsecured Term Loan:** Here businesses don't pledge an asset or a security to obtain the loan. Instead, the lenders approve the loan after evaluating the borrower's creditability. As there is no collateral, lenders usually charge high interest rate to compensate for the increased risk.

## Types of Term Loans

Depending on the repayment tenure, there are three types of term loans:



**Short-Term Loans:** Short-term loans are typically used to finance assets that have a lifespan of less than three years, such as inventory, accounts receivable, and working capital. They typically have higher interest rates than long-term loans, but they also have shorter repayment terms.



**Medium-Term Loans:** Where the loan is offered for three to five years for business activities such as purchasing machinery and improving working capital.



**Long-Term Loans:** Long-term loans are typically used to finance assets that have a lifespan of more than five years, such as buildings, equipment, and intellectual property. They typically have lower interest rates than short-term loans, but they also have longer repayment terms.

## How can term financing enable growth and progress of Mid-Market Enterprises?

Mid-market enterprises (MMEs) in India, despite contributing ~30% to national GDP and ~45% to total export, are often faced with the following challenges in traditional sources of term financing:

### Limited Solutions



While banks do extend loans to MMEs, their focus primarily lies on offering working capital solutions for day-to-day operations. But these businesses need more than just that - they require loans for long-term growth and managing their supply chains, which banks don't provide enough.

### The Complexity Conundrum



The intricate nature of MMEs is a challenge for banks providing term loans. With diverse financial structures, industry niches, and complex models, these businesses require more rigorous financial analysis and due diligence. This makes traditional risk assessment less favourable.



### Risk Aversion and Collateral Predicaments

Traditional lenders, governed by stringent risk practices, approach term loans for MMEs with caution. Also, mid-market businesses frequently lack the substantial collateral sought by banks, leading to a standstill in accessing necessary capital.

Given the limited availability and lack of flexibility of term financing from traditional sources, non-banking financial companies (NBFCs) focusing on the mid-market corporate segment emerge as an alternative route to consider for MMEs. Such NBFCs follow flexible lending approach, quicker loan disbursements, personalized solutions, and are adaptable to MMEs' unique needs, making them their go-to lender.