



Bank of St. Helena Ltd.

www.sainthelenabank.com

Understanding Overdrafts

18 July 2016

Head Office: Market Street · Jamestown · St. Helena · South Atlantic · STHL 1ZZ Tel:

+290 22390 · Fax: +290 22553 · e-mail: info@sainthelenabank.com · Web: www.sainthelenabank.com

Established and regulated in St. Helena under the Financial Services Ordinance, 2008 the Company Ordinance, 2004 and the Company Regulations, 2004



CONTENTS

1: A tool for business financing.....	3
1.1 So what is an overdraft?	3
2: How does it work?	4
2.1 Cash Flow Forecast, Before Financing.....	4
2.2 Financing With An Overdraft.....	5
3: About Interest and Repayments	6
3.1 Interest.....	6
3.2 Repayments.....	6
4: When to use overdrafts	7
4.1 General Principles	7
4.2 Responsible use of overdrafts.....	7
5: What If?	8
5.1 The overdraft is not cleared by the expiry date?	8
5.2 The business attempts to draw more than the overdraft limit?.....	8
5.3 The business persistently breaches the limit.....	8
6: How do I apply for an overdraft?.....	9

1: A tool for business financing

This is a brief guide to overdrafts and their uses for business financing.

It is intended to give businesses some ideas about how projects could be more flexibly financed, using an overdraft.

Please read this document carefully. Overdrafts are not for every business or for all borrowing situations.

This guide assumes that you, the reader understands the basic concept of lending and interest calculation and is familiar with conventional bank loans.

1.1 So what is an overdraft?

A bank overdraft gives someone the ability to spend more than what is actually available in their bank account. Obviously the money doesn't belong to you but belongs to the Bank so this money will need to be paid back; which makes it similar to a bank loan as the money is technically borrowed.

Overdrafts are available to businesses for working capital purposes only and can be considerably cheaper and are more flexible than conventional bank loans.

Working capital is the money needed to fund the normal, day to day operations of your business. It ensures you have enough cash to pay your debts and expenses as they fall due.

Understanding Overdrafts

2: How does it work?

The best way to understand how an overdraft works is to look at a simple example.

Let's imagine a business is going to undertake some development work on behalf of a customer. The contract will take 12 months to complete and the customer has agreed that it will pay 20% of the total contract amount at the end of the first three quarters, with the remainder on completion. The business needs to pay for labour and materials from Month 1, so it needs to borrow some money which will be paid back in stages as income is received from the customer. In this scenario the working capital features are the labour & materials. Before starting the project, the owner has drawn up a cash flow forecast, which is shown below.

2.1 Cash Flow Forecast, Before Financing

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7	Month 8	Month 9	Month 10	Month 11	Month 12	Total
Receipts													
Stage Payments			£40,000			£40,000			£40,000				£120,000
On Completion												£80,000	£80,000
Total Receipts:	£0	£0	£40,000	£0	£0	£40,000	£0	£0	£40,000	£0	£0	£80,000	£200,000
Outgoings													
Materials	£10,000	£9,000	£500	£200	£200	£200	£200	£200	£200	£200	£200	£0	£21,100
Labour	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£7,000	£84,000
Total Outgoings:	£17,000	£16,000	£7,500	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,200	£7,000	£105,100
Net Cash Flow	-£17,000	-£16,000	£32,500	-£7,200	-£7,200	£32,800	-£7,200	-£7,200	£32,800	-£7,200	-£7,200	£73,000	
Opening Balance	£0	-£17,000	-£33,000	-£500	-£7,700	-£14,900	£17,900	£10,700	£3,500	£36,300	£29,100	£21,900	
Closing Balance	-£17,000	-£33,000	-£500	-£7,700	-£14,900	£17,900	£10,700	£3,500	£36,300	£29,100	£21,900	£94,900	

Understanding Overdrafts

It can be seen that this is potentially quite a worthwhile project, but that a significant amount of cash needs to be put in to keep the business solvent in the first five months.

2.2 Financing With an Overdraft

Using an overdraft solves the problem of insufficient cash if projected accurately. The business would request an overdraft facility to be placed on their account, which enables it to borrow money as it needs it, up to a maximum borrowing amount (called the 'overdraft limit') and for a limited period of time (currently 12 months). At the end of the period the overdraft must have been cleared (i.e. all borrowing must have been repaid), but until then the business can borrow as much or as little of the overdraft limit as it needs.

The following amended cash flow forecast assumes that the borrowing is handled using an overdraft.

Net Cash Flow before financing	-£17,000	-£16,000	£32,500	-£7,200	-£7,200	£32,800	-£7,200	-£7,200	£32,800	-£7,200	-£7,200	£73,000	
Balance	-£17,000	-£33,085	-£665	-£7,703	-£14,939	£17,825	£10,700	£3,500	£36,300	£29,100	£21,900	£94,900	
Interest (charged monthly in arrears, see Section 3.1)		-£85	-£165	-£3	-£39	-£75	£0	£0	£0	£0	£0	£0	
Cost of financing													-£367

In this case the overdraft limit would be £34,000 for a period of at least 6 months.

Interest payable

It can be seen that the total amount of interest paid is £367. This is because the business only pays interest on the amount of overdraft it uses from month-to-month, not on the total amount it needs to borrow up front i.e. the £34k.

3: About Interest and Repayments

3.1 Interest

Interest on an overdraft is calculated at the end of each month and is added to the overdraft at the beginning of the following month. This is illustrated by the following example:

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6	Month 7
Net Cash Flow From Project	(£9,000)	£2,000	£2,000	£2,000	£2,000	£2,000	£2,000
Interest (charged monthly in arrears)		(£53)	(£41)	(£30)	(£18)	(£7)	£0
Overdraft Balance	(£9,000)	(£7,053)	(£5,094)	(£3,124)	(£1,142)	£851	£2,851

The interest due on Month 1's overdraft (£53) is taken from the account in Month 2. So, although the business has cleared its overdraft in Month 6, there is still interest to be added (from Month 5). This must be remembered when drawing up cash flow forecasts that include overdraft financing.

3.2 Repayments

With a conventional loan, a fixed amount is borrowed and regular repayments have to be made. If interest rates remain constant, the repayments will be the same each month until the loan is repaid.

With an overdraft there are no fixed borrowing amounts and no requirement for regular repayments. All that is required is that the total outstanding remains within the overdraft limit, and that the overdraft is repaid in full by the time the limit expires.

In the following example, a business goes overdrawn by £90,000 in Month 1 and then does not receive any further cash until Month 6 (the overdraft limit is £95,000):

	Month 1	Month 2	Month 3	Month 4	Month 5	Month 6
Net Cash Flow From Project	(£90,000)	£0	£0	£0	£0	£100,000
Interest (charged monthly in arrears)		(£525)	(£528)	(£531)	(£534)	(£537)
Overdraft Balance	(£90,000)	(£90,525)	(£91,053)	(£91,584)	(£92,118)	£7,345

Though no 'repayments' are made in months 2-5, even with the addition of interest the business remains within its overdraft limit, so there is no problem.

It should be noted, however, that this is a relatively risky financing strategy. In general the bank would prefer to see some income being set against the amount borrowed each month.

4: When to use overdrafts

4.1 General Principles

In general, overdrafts are most useful where the cash flow forecast shows that there will be months in which there is a net negative cash flow and other months in which there is a net positive cash flow, intermixed. Good examples are businesses where sales will begin or income is generated before the investment is completed, such as the one shown above.

In situations where the business is borrowing to purchase an asset which will be written off over time, you will be advised to borrow using a conventional loan.

4.2 Responsible use of overdrafts

When used properly, overdrafts can be a flexible and cost-effective form of business financing, but when misused they can present real dangers.

The business is not forced to make regular repayments, and if the situation is not properly managed it is easy for the business to find itself approaching the expiry of its overdraft limit with insufficient cash flow to repay the borrowing.

For this reason Bank of St. Helena does not offer overdrafts in all situations. For an overdraft to be offered it is necessary for the bank to be satisfied that the business will be in a position to clear its overdraft within the limits of the overdraft expiry date, as evidenced by the submitted cash flow forecast.

Similarly, the business needs to make sure that the assumptions it makes when drawing up its cash flow forecast are realistic. If the business fails to generate enough cash it can find that its overdraft is growing each month. In an extreme case, where the interest on the overdraft becomes greater than the amount of cash the business is generating, the business is clearly heading for disaster.

Although Bank of St. Helena will not offer overdrafts in situations which are apparent to the bank as being overly risky, the bank's decision to lend should not be taken as a confirmation of your plan. It remains your responsibility to run your business in such a way that it can meet its commitments, including the need to repay any borrowings.

5: What If?

5.1 The overdraft is not cleared by the expiry date?

If there is an overdraft balance outstanding on the date that the overdraft limit expires, the business will be expected to make immediate repayment of that balance plus applicable interest.

If it fails to do so Bank of St. Helena will treat this as a default and will follow its usual procedures for dealing with borrowers that are in arrears with loan repayments, which could include taking court action and the seizing of assets.

If a business believes it may not be able to completely clear its overdraft by the expiry date it is advised to contact the bank as soon as it becomes aware of the situation, so that a mutually acceptable way forward can be found.

5.2 The business attempts to draw more than the overdraft limit?

In general the bank's systems should prevent a business from exceeding its overdraft limit, and should refuse to make further payments that would take the overdraft beyond the agreed limit.

However, managing the overdraft remains the responsibility of the business, not the bank.

In the event that a payment is made that takes the business beyond its limit, the bank will contact the business and require it to make immediate payment such that the overdraft is brought back within its agreed limit.

If the business fails to do so the bank may treat the situation as a default, as described above.

5.3 The business persistently breaches the limit

Bank of St. Helena reserves the right to cancel any overdraft limit and demand immediate repayment of any amounts outstanding. The bank will not take such action lightly, but may do so if a business is, in the bank's opinion, persistently misusing the overdraft facility.

6: How do I apply for an overdraft?

If you think your business could benefit from having an overdraft facility please contact the bank.

You will need to fulfil the bank's requirements for lending and accept its terms and conditions.

In particular, to support your application, you will need to draw up a business plan for the project or investment you are planning to make and submit with supporting documentation. Please see our "Business Loans – A Guide for Applicants" which will define the documentation required

If you need help in preparing your application, sources of external assistance are available.

Notes:

- It is assumed throughout this document that the commercial lending interest rate remains constant at 6%, and that the business can offer appropriate security to support the amounts of borrowing. Our current commercial interest rates for secured loans/overdrafts is 2% above our Base Rate (4%) equating to 6% interest per annum; for unsecured loans/overdrafts the interest rate is 3% above our Base Rate (4%) which equate to 7% interest per annum.
- Red figures in parenthesis indicate an overdrawn balance. Black figures indicate a credit balance with no overdraft.