

Good debt vs bad debt: A practical guide to smart business borrowing that actually works

Description

Debt has a bad reputation. But for the business owners who understand it, borrowing is one of the most powerful growth tools available.

Should you add debt to your business? Learn the difference between good debt and bad business debt, when borrowing makes sense, and how to decide what is right for your business.

Introduction

The word debt makes most business owners uncomfortable. It carries weight. It feels like a risk. And for many founders, the instinct is to avoid it completely and build everything from their own pocket.

But here is what that instinct often costs them.

The competitor that opened a second location last year. The supplier who bought new equipment cut production costs by 30%. The founder who hired three people ahead of demand and captured the market before anyone else could. In many of those cases, the fuel behind that growth was not profit. It was borrowed money used strategically.

Debt is not inherently dangerous. Unplanned, poorly structured, or unnecessary debt is dangerous. Understanding the difference between the two is one of the most important financial decisions a business owner can make.

This guide breaks down exactly what good business debt looks like, when borrowing makes sense, when it does not, and how to decide what is right for your specific situation.

Business Facts

According to the Federal Reserveâ??s 2025 Report on Employer Firms, **39%** of small businesses currently hold over **$100,000** in business debt, and **59%** of businesses applied for some form of financing in the prior year. Of those seeking capital, exactly **56%** were borrowing simply to cover operating expenses. This reliance on funding for daily costs is a clear sign that many businesses are using debt reactively rather than strategically.

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2. According to the Federal Reserveâ??s 2025 Report on Employer Firms, **29%** of small businesses report having zero outstanding debt, meaning that the remaining **71%** of small employer firms carry some degree of debt. This data clearly demonstrates that carrying debt is not the exception in business, but rather the norm.
3. According to PYMNTS via Canopy, over half of small businesses with more than **$1 million** in annual revenues are now using financing as a deliberate business strategy rather than just a necessity. The most successful businesses do not avoid debt. They use it intentionally.

Why It Matters: The Real Cost of Avoiding Debt Completely

Avoiding debt feels responsible. But for a growing business, refusing to borrow at the right moment can be just as damaging as borrowing at the wrong one.

Consider what happens when a business owner avoids debt completely. Growth slows to the pace of cash generation. Opportunities that require upfront investment get passed over. Competitors with access to capital move faster, hire earlier, and capture market share while the debt-averse business waits for the perfect financial moment that never quite arrives.

The question is never simply should I take on debt. The real question is: does this specific debt create more value than it costs? When the answer is yes, debt becomes a growth tool. When the answer is no, it becomes a burden.

What Is Business Debt and Why It Is Not Always Bad

Business debt is any money borrowed by a company that must be repaid over time, usually with interest. It comes in many forms, including bank loans, lines of credit, equipment financing, and business credit cards.

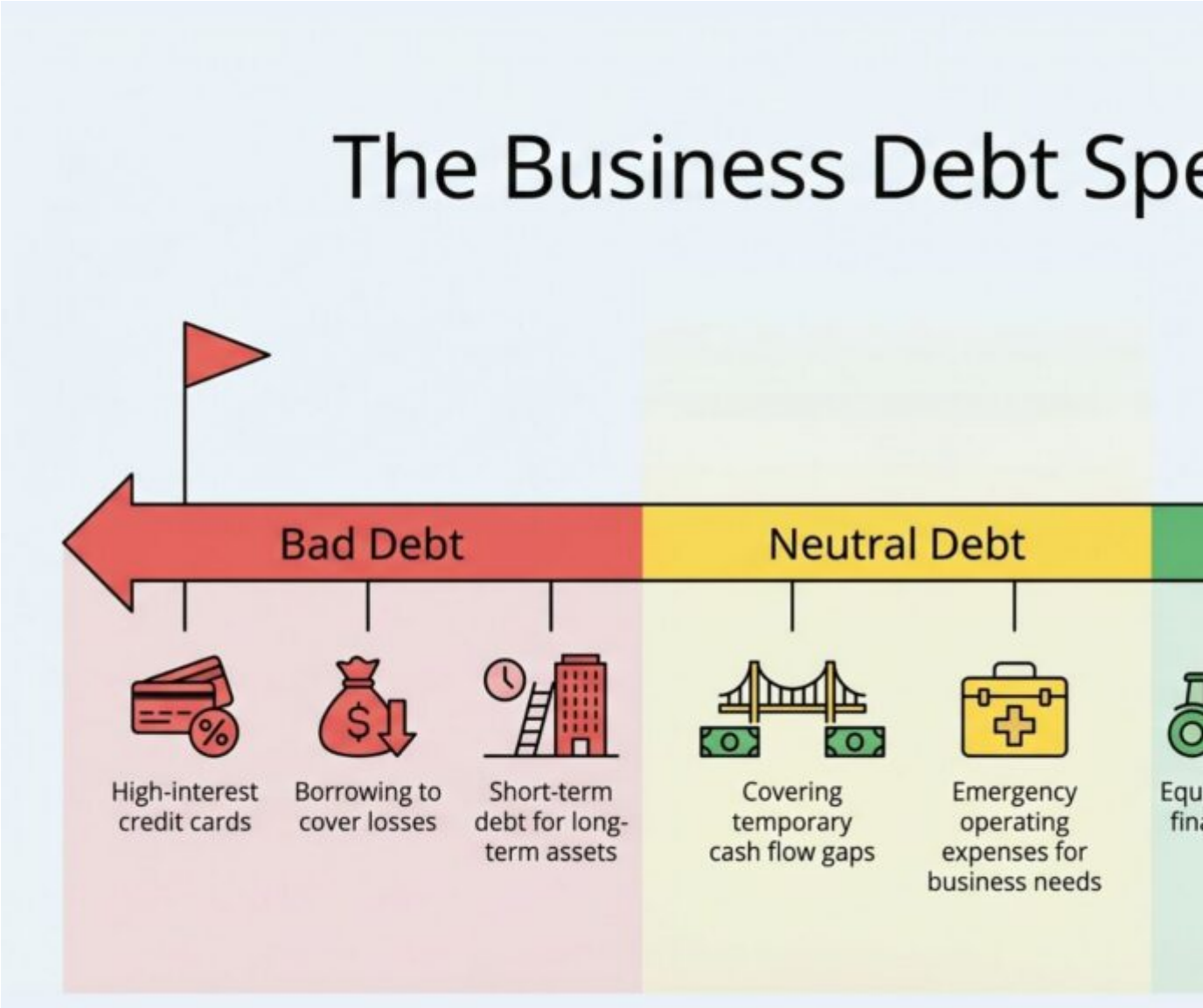
Not all debt is created equal. The most useful framework for thinking about business debt is simple: good debt creates value. Bad debt destroys it.

Good debt finances something that generates a return greater than its cost. A loan to purchase equipment that increases production capacity. A line of credit that allows you to buy inventory ahead of your busiest season. A business expansion financed at a low interest rate that opens a new revenue stream.

Bad debt finances something that does not generate a return. Borrowing to cover operational losses without fixing the underlying problem. Taking on high-interest debt to fund expenses that could be cut. Using short-term financing for long-term investments that will not

generate returns quickly enough to cover repayments.

The type of debt matters as much as the amount.



When Debt Makes Sense for Your Business

Borrowing makes strategic sense in four specific situations.

When it finances growth that pays for itself. If a loan to buy new equipment reduces your production cost by more than the monthly repayment, the debt is self-funding. The same logic applies to hiring, expansion, and technology investments. If the return exceeds the cost, the math works in your favor.

When it bridges a temporary cash flow gap. Many businesses experience seasonal revenue swings. A retailer buying inventory ahead of the holiday season or a construction company waiting on client payments may need short-term financing to bridge the gap

between expenses and income. Used carefully, a line of credit in this situation is not a sign of financial weakness. It is smart cash flow management.

When the interest rate is lower than your return on investment. If you can borrow at 7% interest and deploy that capital into a part of your business that generates a 20% return, the spread between those two numbers is pure value creation. This is exactly how financially sophisticated business owners think about debt.

When waiting would cost you more than borrowing. Sometimes the opportunity cost of not acting is higher than the cost of debt. A competitor entering your market. A supplier offering a bulk discount that expires. A key hire who will not wait three months for you to save enough cash. In these moments, strategic debt is not a compromise. It is a competitive advantage.

When Debt Is Dangerous for Your Business

Borrowing becomes dangerous in four equally clear situations.

When you are borrowing to cover ongoing losses. If your business is consistently spending more than it earns and you are using debt to fill that gap, you are not solving a cash flow problem. You are delaying a business model problem while making it more expensive to fix.

When the repayment terms do not match your revenue cycle. Short-term debt used to finance long-term assets is one of the most common and most damaging financial mismatches in small businesses. Always match the loan term to the investment timeline. Short-term debt financing a long-term asset means your repayments will be due long before the investment starts generating the return needed to cover them. That mismatch is one of the most common and most avoidable cash flow traps in small business

When the interest rate makes the math impossible. High-interest business credit cards and merchant cash advances can carry effective annual rates of **40% to 80%** or more. Unless your business generates extraordinary returns, debt at these rates is almost never a good strategic decision.

When you have no clear plan for repayment. Borrowing without a documented repayment plan is not a funding strategy. It is financial procrastination. Before taking on any significant business debt, you should be able to answer three questions clearly: where will the repayment money come from, what happens to the business if revenue falls short of projections, and what is the worst-case scenario if things do not go as planned.

The 5 Most Common Types of Business Debt Explained Simply

Understanding what you are borrowing matters as much as understanding why.

Term loans are the most straightforward form of business debt. You borrow a fixed amount, repay it over a set period with interest, and use the capital for a specific purpose such as equipment, renovation, or expansion. Best for planned, one-time investments with a clear return.

Lines of credit give you access to a pool of capital you can draw from and repay as needed. You only pay interest on what you use. Best for managing cash flow fluctuations and covering short-term operational gaps.

Equipment financing uses the equipment itself as collateral, which typically means lower interest rates than unsecured loans. Best for purchasing machinery, vehicles, or technology that has a clear productive life and return.

Business credit cards offer flexible short-term credit with rewards, but carry high interest rates if balances are not cleared monthly. Best for small, recurring expenses that can be repaid within the billing cycle. Dangerous when used for large purchases carried over multiple months.

Invoice financing allows you to borrow against outstanding invoices so you can access cash before clients pay. Best for businesses with strong sales but slow-paying customers, creating cash flow gaps.

How to Calculate If Your Business Can Handle Debt

Before borrowing, run these three simple checks.

Debt Service Coverage Ratio (DSCR): Divide your net operating income by your total annual debt repayments. A ratio above **1.25** means your business generates enough income to comfortably cover its debt obligations. Below 1.0 means it cannot, which is a clear warning sign.

Break-even on borrowed capital: Calculate how long it will take the investment financed by debt to generate enough additional revenue or savings to cover the total cost of the loan, including interest. If that timeline is longer than the loan term, reconsider the structure.

Worst-case scenario test: Ask yourself what happens if revenue drops by 20% for three consecutive months. Can the business still meet its debt repayments? If the answer is no, the debt load is too high for your current risk profile.



Good Debt vs Bad Debt Comparison Table

Type of Debt	Good Use	Bad Use	Risk Level
Term Loan	Equipment purchase, planned expansion	Covering recurring losses	Low to Medium
Line of Credit	Seasonal cash flow gaps, short-term needs	Funding long-term assets	Low if managed well
Equipment Financing	Machinery that increases production	Equipment with no clear ROI	Low
Business Credit Card	Small recurring expenses paid monthly	Large purchases are carried out long-term	High if misused
Invoice Financing	Bridging slow-paying client gaps	Masking ongoing cash flow problems	Medium

Merchant Cash Advance	Emergency only, last resort	Regular operational funding	Very High

> â??The most important thing about debt is to understand what it is for and whether it is creating value or consuming it.â?•
>
> â?? **Aswath Damodaran**,
>
> Professor of Finance at NYU Stern School of Business.

Final Thoughts

> Debt is not the enemy of a healthy business. Misunderstood, poorly structured, or unplanned debt is.
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> The business owners who grow fastest are rarely the ones who avoid borrowing entirely. They are the ones who understood exactly when debt creates value, structured it correctly, and used it to move faster than their own cash flow would have allowed.

The goal is not to be debt-free. The goal is to be financially intelligent. To know the difference between borrowing that builds your business and borrowing that burdens it. And to make that decision based on numbers and a clear plan, not fear or instinct alone.

If your business is already under financial pressure from existing debt, the first step is not to borrow more. It is getting clarity. Read our guide on Debt Management Consulting for Small Business Owners for practical steps to regain control and build a path forward.

For everyone else, the opportunity is still ahead. Use debt wisely, plan it carefully, and let it work for your business rather than against it.

Ready to build the financial foundation your business deserves? Download the Business Plan and Financial Plan Bundle from Excellent Business Plans and take control of your numbers today.

Next Steps: Before You Borrow, Do These Five Things

1. Calculate your Debt Service Coverage Ratio and make sure it sits above 1.25
2. Write down exactly what the debt will finance and what return you expect it to generate
3. Map your repayment timeline against your projected revenue to check the math works
4. Run the worst-case scenario test and make sure the business survives a 20% revenue drop
5. Compare at least three lenders before committing to any loan to ensure you are getting competitive terms

Debt is a tool. Like any tool, it works best when you know exactly what you are using it for before you pick it up.

FAQs

1. Is it better to grow a business using debt or using only your own money? Neither approach is universally better. Self-funding gives you complete control and no repayment obligations. Debt-funded growth allows you to move faster and capture opportunities that would take years to fund from profit alone. The right answer depends on the specific opportunity, the cost of the debt, and the expected return on the investment. Most successful businesses use a combination of both at different stages of growth.

2. How much debt is too much for a small business? A common benchmark is a Debt Service Coverage Ratio above 1.25, meaning your business generates at least 25% more income than needed to cover debt repayments. Beyond that, the right level of debt depends on your industry, your revenue stability, and your growth stage. A business with highly predictable recurring revenue can typically handle more debt than one with volatile or seasonal income.

3. Does taking on business debt affect my personal credit score? It depends on the type of debt and how it is structured. Sole proprietors and some partnerships may find that business debt affects their personal credit, especially if personal guarantees are required. Incorporated businesses with established business credit profiles can often borrow without a direct impact on personal credit. Always clarify this with your lender before signing.

4. What is the difference between a business loan and a line of credit? A business loan gives you a fixed lump sum that you repay over a set period with a fixed or variable interest rate. A line of credit gives you access to a pool of capital you can draw from and repay repeatedly, paying interest only on what you use. Loans are best for planned one-time investments. Lines of credit are best for managing ongoing or unpredictable cash flow needs.

5. Should I pay off business debt as quickly as possible? Not necessarily. If the interest rate on your debt is lower than the return you could generate by deploying that cash elsewhere in your business, it may make more financial sense to maintain the debt and invest the cash. However, if the debt carries a high interest rate or is creating cash-flow pressure, paying it down quickly is usually the smarter move. The decision depends on the specific numbers, not a general rule.

6. Can a startup take on debt before generating revenue? Yes, but with caution. Pre-revenue debt is higher risk because there is no proven income to service repayments. The most appropriate forms of early-stage debt are typically equipment financing, in which the asset serves as collateral; SBA microloan programs designed for startups; or revenue-based financing, in which repayments flex with income. Avoid high-interest unsecured debt before your revenue model is validated.

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