THE BUSINESS FINANCE YOU DIDN'T KNOW ABOUT

XENIUM

CONTENTS

BUSINESS FINANCE

There are many types of business loans available, however most of them can be sorted into two categories: unsecured loans and secured loans.

If your loan is secured by an asset (either residential or commercial property, or some type of equipment or asset) to obtain the finance, then the lender will consider this as a secured loan. If the loan does not require security over an asset, then it is considered an unsecured loan.

Unsecured loans

As mentioned, an unsecured loan is a facility that does not require an asset to be offered as security to obtain the finance.

Examples of unsecured loans are:

- overdrafts
- lines of credit
- short term loans (under 3 years)
- multi-use supply chain facilities

In addition, facilities like debtor finance and trade finance might also be described as unsecured, even where assets (such as equipment, stock being purchased or your debtors with outstanding payments) could be considered to provide security to the lender.

Did you know that an unsecured loan can be used to purchase a business?

Example:

A business is for sale for $1M. The purchaser only has $600,000 in cash (or property equity) for the purchase. The remaining $400,000 may be provided as an unsecured loan based on the estimated profit performance of the business instead of taking security over the property.

This type of funding is available from selected financial institutions, however is subject to certain criteria being met. The loan is considered to be 'unsecured' as the security is being provided against the cashflow of the business itself rather than against the property. This type of finance can also apply to purchasing franchises.

While unsecured lending options have increased significantly in the past few years (making it easier for businesses to obtain capital), the key is to know the range of lending institutions (and the conditions) offering the facility you need.

Secured loans

Secured loans take the form of any facility provided to your business where an asset is taken as security for the loan. The security could be a residential or commercial property, a motor vehicle or other equipment. Secured loans can be obtained to start a new business, expand an existing business or simply for the asset being purchased.

Example:

A business premises could be used as security for a piece of machinery or equipment (forklifts, trucks, vans, cold-rooms) that will be utilised by the business.

Interest rates are typically lower for secured loans due to their perceived lower risk.

WORKING CAPITAL

TRADE FINANCE, DEBTOR FINANCE, SUPPLY CHAIN FINANCE

Trade finance

Trade finance is utilised both domestically and internationally. Businesses typically use trade finance to purchase stock from suppliers and then repay this facility when they have sold their stock.

Example: A retailer may purchase its goods overseas. The goods are manufactured over a six-week period and then shipped to Australia taking another six weeks to arrive.

The supplier of the goods may require 50% of the order amount paid upfront with the remaining 50% paid when the goods are loaded on to the ship. As the business has not yet sold the goods, they require financing to help pay for the stock.

Trade finance facilities allow a business to pay for the goods and then have around 180 days to repay the loan. This provides enough time to have the goods manufactured, shipped and sold.

Trade finance can also be used when a business requires equipment, but it is built either by an overseas or domestic supplier who allows progress payments while the equipment is produced. A trade finance facility is used to draw down multiple progress draws to pay the manufacturer (just like a house construction facility). When the equipment arrives, a chattel mortgage facility is then used to repay the trade finance loan.

Debtor finance

This facility is used by businesses where they borrow against the value of their customers' outstanding invoices. In other words, funds are drawn against money that is owed. Debtor finance is useful for growing companies and those that operate in a business environment with short term operating costs but long collection cycles.

Example: A labour hire company must pay its employees on a weekly basis, however their

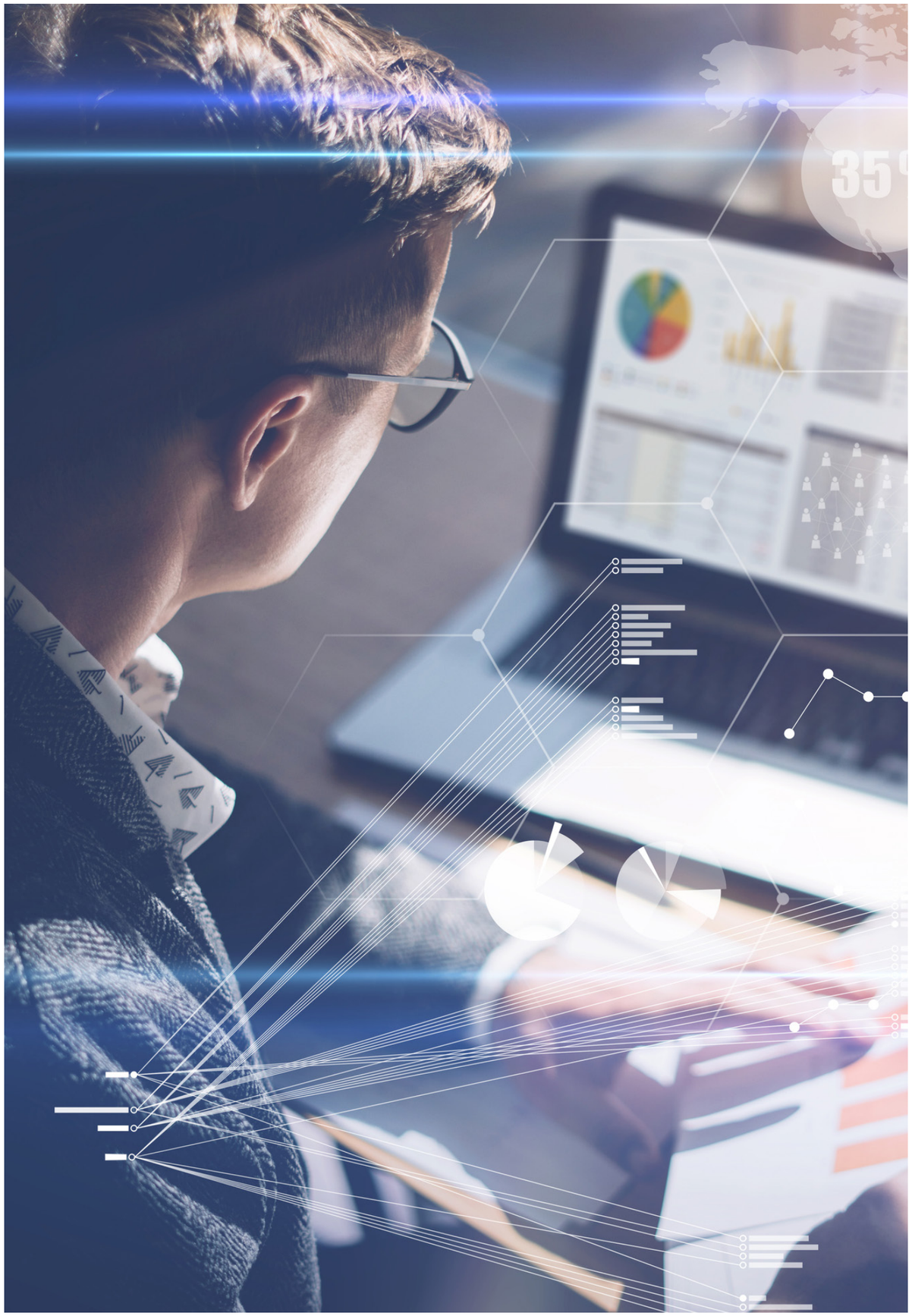
clients have 30 or 60 day payment terms. By accessing debtor finance, the company can issue an invoice of say $100,000 with payment due in 30 days and draw down up to $80,000 of this money within 24 hours to pay its operating costs.

On average, debtor finance is provided at 80% of the face value of the invoice. Debtor finance is also known as invoice finance, invoice factoring and line of credit against debtors.

This type of finance is a simple way to advance money to a business against any money owed.

Supply chain finance

This can take the form of a multi-use facility. Businesses can take on loans to extend their own creditor supply terms. Facilities such as these offer limits based on the business's turnover and are split between different types of loans. These include the ability to pay creditors' invoices (money you owe) and then repay this loan over six or nine months. Part of your credit limit can be used to draw down against your own invoices (debtor finance) and the residual is a cash advance limit which can be used for any expense – think credit card cash advance.



DEVELOPMENT FINANCE

Property development finance refers to a **short-term loan type that provides funding for the development of property.** Development of property extends to construction projects, land purchase, property renovation and much more. Development finance can be used to construct a small project, like a duplex, or an apartment block of up to 25 units. For each type of project, the rules of lending remain relatively the same.

To check if a development project qualifies for finance, there are some basic rules of thumb.

Rule 1

The finance provided will most likely be 65% of the Net Realisable Value (NRV) of the project or up to 80% of the cost of the land and the construction. The NRV is usually the gross value (25 units multiplied by average sale price of $700,000) less GST on the project. Sometimes the cost of marketing the project is also deducted from the Gross Realisable Value (GRV) as well.

Rule 2

If the applicant owns the land unencumbered, it is likely there is enough equity. The land value in most projects is typically 30% of the total cost. If the applicant owns this land, they generally have sufficient equity, however they may still need to have extra cash available.

Rule 3

If you pre-sell 60% of the product, it will often cover 100% of your debt. Pre-sales are important in a project. They de-risk the project from both the financier and the developer's perspective. Lenders will always expect pre-sales, however private and non-bank lenders don't always need them. 100% debt coverage is a general rule to be applied by financial institutions.

Assuming a project meets at least Rules 1 and 2, then an application for finance with a non-bank lender could be put together.

Banks vs non-bank lenders

A non-bank lender is simply a finance provider that isn't a bank. This means that since they aren't a deposit-taking institution, their loans aren't funded by customer deposits. Instead, their loans are funded through securitisation and capital raising.

If the developer applying for finance is looking for the cheapest interest rate and fees,

then the conditions of the loan will be much higher. If the developer is willing to pay more for their finance, the conditions will be less.

Explanation:

Let's say that to be approved with a major bank at the lowest rate available, the applicant must pre-sell 60% of their 25 unit development. A non-bank lender may offer finance at what appears to be a much higher interest rate, however does not require pre-sales so the project can start immediately.

To obtain the bank's finance at the lower interest rate, the developer may need to drop their prices by say $40,000 or more to get their 14 presales. This will cost them up to $560,000 in lost revenue. If the cost of discounting is more than the difference between the bank low rate and the higher non-bank rate, then it is not worth comparing interest rates.

Many developers like to commence their projects with non-bank lenders who are willing to risk their money in particular marketplaces. Bank finance will always be much less expensive, however the conditions that sit alongside cheaper money may not be worthwhile in the overall equation.

To qualify for development funding, a finance company or bank will always consider the following:

The project/sales risk: Does it make sense? Can it make more than 15% IRR (internal Rate of Return)? Are there pre-sales and is the location attractive?

The sponsor: Has the applicant previously developed, delivered on time and on budget, and are they credit-worthy?

The construction: Is it a fixed price contract? Have trades been locked in? Can this builder complete?

Providing as much information about these three risks as well as the feasibility will be the start of a good proposal.

Gross Realisable Value	25 @ $700,000	$17,500,000
Less GST		-$1,750,000
Net Realisable Value		$15,750,000
@ 65% Borrowing on NRV		$10,237,000
Land value		$5,250,000
Construction costs		$8,500,000
Total		**$13,250,000**
@70% of construction costs		$9,275,000
Financier will fund the lower		$9,275,000
Equity contribution if land is unencumbered	Land value is equity	$3,975,000
Number of presales required to cover debt	($9.275M / $700K)	14 (approx 60%)

FINANCING RENT ROLLS

A rent roll is the term used to describe the income generated from a property management business. A real estate agent manages an investment property on behalf of a client and will charge the investor a percentage of the rental income for this service. While many agents charge a range of fees, a figure of 8% per annum could be considered average for individual residential properties.

Example: If a property is rented out at $30,000 pa, the agent will collect a fee of $2,400 pa. If an agent has 100 properties, this income will be $240,000 in gross revenue for their business. Rent rolls are considered a stable business with obvious recurring revenue.

Many agents want to purchase other rent rolls to expand their own business. Alternatively, they may wish to borrow against the value of the rent roll to expand their business organically with increased marketing, a larger office and new staff salaries.

Given the recurring nature of the revenue, rent rolls are usually valued at market rates by professional valuation firms prior to finance being provided. For well run businesses, a valuation could be in the range of $2.50 to $2.80 per dollar of rental commission.

The value of a business in the example above with 100 properties generating $240,000 in commission would be assessed at $600,000 ($2.50 x $240,000).

The rent roll business owner may be able to access between 65% to 70% of this value ($390,000 to $420,000) for the purchase of a second rent roll or for expansion purposes.

Rent roll income	$240,000
Multiple	$2.50 per $1 of gross revenue
Total value	$600,000
70% of value available	$420,000

However bear in mind that other tests can apply to this number. For example, it's likely that a bank will not want to lend more than 2.5 times the EBITDA of a business even though they may lend 'up to' 70% of the valuation.

For example, let's say that the firm above has an EBITDA of $150,000.

This means that the maximum borrowing for the business will be $150,000 x 2.5 = $375,000.

So despite $420,000 being available, this business would only be able to borrow a maximum of $375,000.

When applying for rent roll finance, there will be a range of requirements from a lender including understanding any arrears and management programs, location of properties, experience of the team, the software systems being used for rental management and payments as well as the overall financial performance of the business compared to industry norms.

FINANCING ACCOUNTANCY PRACTICES

Accounting practices are one of the many professional services firms that can be financed based on the business goodwill. Accountants operate businesses by providing a range of services including taxation returns and compliance work, business advisory and taxation planning. They also provide bookkeeping services and keep their clients updated with the latest in regulations from the ATO and other regulators.

There are several ways that lenders will provide finance to a practice depending on the size of the firm.

For smaller firms with one partner, usually the maximum debt available is no more than 50% of the annual fees generated by the firm, but it cannot be more than 2.5 times the EBITAPR[1].

Where there are between 2 and 20 partners in a firm, this amount can be up to 3.5 times the EBITAPR.

They key item here is 'standard professional remuneration'. This amount provides an allowance for a 'standard salary' to employ an accountant.

Example: Let's say a small firm is generating $1M in fees, has one partner and has a profit of $200,000. This profit is after the partner draws his salary of $170,000 pa. By adding the $170,000 to the profit of $200,000 we have an EBITA of $370,000.

However, we must deduct the 'standard professional remuneration' to turn this number into EBITAPR. In a small firm, $100,000 pa could be expected to be a reasonable remuneration for an accountant. As such, $100,000 is deducted from the previously calculated $370,000 = $270,000.

We then multiply this by 2.5 times ending with $270,000 x 2.5 = $675,000. This is the amount available to this practice for borrowing purposes. The firm may wish to borrow this amount to pay out other partners or purchase another accounting business.

Existing fees	$1,000,000
Earnings before interest and tax	$200,00
Existing partner salary	$170,000
Sub-total	$370,000
Less standard professional remuneration	$100,000
Total adjusted	$270,000
Multiple	2.5
Total borrowing available	**$675,000**

1: EBITAPR = Earnings Before Interest and Tax After Partner(s) Remuneration, ie net profit before tax + interest + depreciation + amortisation + salaries and fees paid to partners – LESS standard professional remuneration.

FINANCING FINANCIAL PLANNING FIRMS

Financial planning firms have multiple sources of income including their annual recurring revenue from the fees charged to clients. This is different to any upfront fees they may charge for statements of advice relating to investment options or the set-up of self managed superannuation funds.

As a result of the recurring revenue within the business, many financial institutions are willing to fund financial planning 'books' for the purpose of organic expansion or the purchase of other financial planning businesses.

As with any lending on an 'unsecured' (no property security) basis, there are a number of tests the business needs to undergo prior to a loan being approved.

Aside from the experience of the operator, a well recognised dealer group membership and a lack of complaints against the business, the following boundaries should be examined.

The proposed debt for the business:

A) should not be more than 1.75 times the annual operating revenue
B) EBITAPR must cover at least 2.5 times the interest cost
C) the total loan should not be more than 3.5 times the EBITAPR

In a similar fashion to accounting practices, the EBITAPR is calculated as follows:

EBITAPR = Earnings Before Interest and Tax After Partner(s) Remuneration,

That means, net profit before tax + interest + depreciation + amortisation + salaries and fees paid to partners – LESS standard professional remuneration.

How does this work in a practical sense?

Let's say that the recurring revenue is $500,000 and there is one financial planner in the business. The profit for the business is $150,000 and the planner takes $160,000 as salary.

EBITA is $150,000 profit plus $160,000 salary = $310,000. Revenue is $500,000.

A financial planning salary may be deemed at $110,000 by

the bank. The EBITAPR is then $310,000 less $110,000 leaving $200,000.

Using the a, b and c tests:

a) $500,000 x 1.75 = $875,000
b) Interest cost must be a maximum of EBITAPR divided by 2.5 : $200,000 ÷ 2.5 = $80,000
c) Total loan not more than $200,000 (EBITAPR) x 3.5 = $700,000

At an interest rate of say 5%, if this business borrowed $700,000 then the interest cost would be $35,000.

The loan is less than a) ($875,000) and equal to c) ($700,000) and the interest cost is less than b) ($80,000).

On the basic numbers, this firm could be financed up to $700,000.

Of course, there are other factors such as the demographics of the clientele, the business strategy and the types of products sold that will still need to be investigated.

1: EBITAPR = Earnings Before Interest and Tax After Partner(s) Remuneration, ie net profit before tax + interest + depreciation + amortisation + salaries and fees paid to partners – LESS standard professional remuneration.

Recurring revenue (a)	$500,000	x 1.75	$875,000
Profit	$150,000		
Addback salary	+ $160,000		
EBITA	$310,000		
Deduct planner salary	- $110,000		
EBITAPR (b)	$200,000	Interest cost (maximum)	$200,000 / 2.5 = $80,000
Total loan (c)	No more than EBITAPR x 3.5	$200,000 x 3.5	$700,000
Interest rate	5%	Of $700,000 borrowed	Interest cost = $35,000

FINANCING LEGAL SERVICES FIRMS

Legal firms take many forms and the financing of each is different according to the strategy of the firm.

In the main, financiers separate them into three categories:

A) commercial firms
B) mixed services (commercial/ liquidation/ personal injury)
C) liquidation/personal injury

Each of these businesses has a different stream of revenue, and as such they represent different levels of risk to a financier.

Example: A commercial firm may be involved in contract reviews, shareholders' agreements, commercial litigation and other services of a commercial nature. The income from this firm is based on its billing to business and commercial clients and expects to be paid.

On the other hand, a personal injury lawyer may only rely on insurance claims and winning court cases for its income.

The risk for this firm is the length of time it can take for cases to be finalised and the possibility that cases may be lost and income is not received.

As a result, the debt available for commercial firms is higher than for both mixed services firms and those that rely on liquidation and personal injury claims for business.

Some of the same rules as other professional services firms apply with loans of up to 50% of revenue available for one partner firms.

Larger firms are tested on their business mix in addition to a test of interest coverage of 2.5 times the business EBITAPR.

For each of the firms, the landscape is as follows:

- commercial firms – a maximum debt of 2.25 times EBITAPR
- mixed firms – a maximum debt of 1.5 times EBITAPR
- liquidation and personal injury – a maximum debt of 1 x EBITAPR

Of course there will be variables based on the experience of the principal partner and the reason for the loan. The most favourable loan purpose is expansion. Using an existing business to help fund the purchase of a second firm increases its revenue and ideally its mix of clients. It also provides depth to the business structure and presents as a stable risk to a lender.

Table outlining each type of legal services firms and the amount that can be borrowed if EBITEAPR is $200,000

Type of firm	Max debt of # times EBITAPR	Revenue	EBITAPR	Maximum debt
Commercial only	2.25	$500,00	$200,000	$450,000
Mixed	1.5	$500,00	$200,000	$300,000
Liquidation and personal injury	1	$500,00	$200,000	$200,000

NON-RECOURSE FEE FUNDING FOR PROFESSIONAL SERVICE FIRMS

Many professional services firms charge fees to clients and then spend months trying to collect them. In some cases the fees were unknown to the client until the work was completed, the services may have taken longer to prepare or they were more detailed than initially expected.

Accounting and legal works are good examples of fees that can escalate. Further follow up requests by the client may be made without reference to the possible final amount on completion.

To help the cash flow of the business and to reduce the heavy administration of following up client debt, non-recourse fee funding is available for professionals such as accountants and lawyers.

The amount of funding available is determined by the firm's annual turnover and a limit set based on this amount. The firm may then offer up to $15,000 **per client** in fee funding.

A client can apply for this funding via the firm, and when approved have payment terms of six or nine months. This means the accountant or lawyer is paid all their money upfront, while the client now has longer to pay their fees than initially expected. Normal terms would be 30 to 60 days if invoiced by the firm itself

Non-recourse means that should the client fail to pay their debt, there is no recourse to the accountant or the lawyer. The lender will pursue the client for the unpaid loan, not the professional service provider.

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