# BUSINESS FINANCE STRATEGIES

A GUIDE TO COMMERCIAL LENDING
FOR BUSINESSES & ADVISORS

MCP FINANCIAL SERVICES

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## APPENDICES

# INTRODUCTION

Business Finance is a highly specialised area where relevant skills and experience are required to succeed. Overall, business finance is a more qualitative process than mortgage or consumer finance.

The Business Finance Strategies Guide offers an insight into Australian best practices for obtaining commercial finance.

**Section One - Guidance For Businesses & Advisers** aims to provide the information needed to optimally manage business banking and commercial debt.

### Where to start?

In accessing the services of a Finance Broker or Banker, it may raise awareness of characteristics that are relevant to your circumstances including:

- How you present as a Borrower - including the "5 C's of Credit"
- Different Interest Rate Options
- Basis of Loan Repayment and Loan Term
- Desired Loan Features
- Credit Providers that may be relevant to your circumstances

The general information in this guide may prove helpful in making decisions or raising questions to be discussed with your Finance Broker, Adviser or Banker.

### Disclaimer

*The information in this Guide is general information only. It is not intended to be a recommendation or constitutes advice.*

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# SECTION ONE

## Guidance for Businesses & Advisers

# A: YOUR CREDITWORTHINESS

**Overview**

An understanding of the guiding principles involved when obtaining credit and the associated risks as seen by the lender will afford your application the highest change of success.

**The Five C's of Credit**

Banking credit and scoring models can be complex. In essence, they relate to financial fundamentals. A credit provider will typically follow the "Five C's of Credit". These are:

*Character, Capacity, Capital, Collateral, Conditions*

**TIP:** For more detailed information on the 5 C's of Credit, you can visit our blog here


## The Five C's of Credit

### 01 Character

*"Lending is not based primarily on money or property. No sir, the first thing is character." J.P. Morgan*

Character is best summarised as a borrower's willingness to meet their credit obligations. In other words, how trustworthy and reliable are they?

- Character is strongly weighted by your credit report, which is becoming increasingly sophisticated.
- A new credit reporting process (CCR), has replaced the old "negative" credit reporting, where only adverse credit events such as defaults and judgements appeared on credit searches.
- Since CCR, banks include information about your credit conduct, including repayment history, to credit reporting bureaus. Going forward, your "character" will be measured in a less subjective manner via a score.

## 02 Capacity

*"If you would know the value of money, go and try to borrow some." Benjamin Franklin*

Capacity measures your historical, current and forecast cash flow, and the ability to repay your debt obligations from these sources.

Capacity is an area where borrowers become frustrated. "I have so much collateral and security, so what is the issue for the lender?" they often ask.

- Lenders want the option of multiple sources for retiring debt - cash, cash flow from business, asset realisation, or money from an external source. The "first way out" through free cash is always the most desired.
- Lenders do not want to be forced to draw on assets or guarantors given the increasing level of compliance, uncertainty and adverse public relations. All lenders have responsible lending guidelines that they need to cover, even for unregulated credit.
- These guidelines are increasing levels of bank speak or descriptive covenants in business loans.
- Measures of capacity include terminology such as DSR, ICR, Debt to EBITDA.

**TIP:** Refer to the *Acronyms* section in the appendix for definitions of terms such as DSR, ICR and EBITDA.

## 03 Capital

*"Capital is that part of wealth which is devoted to obtaining further wealth." Alfred Marshall and Mary Paley Marshall*

Capital is often confused with Collateral. Capital is the value of assets that a borrower owns, which may include assets that are pledged as collateral for a loan. "Capacity is King, Capital is Comfort."

- Lenders like to see some contribution or "hurt" or "skin in the game" from the borrower and this is where a contribution of capital is desired.
- An example of capital is a material level of deposit for a property purchase.
- As an example, a business or mortgage loan may be supported with a property given by a third party (guarantor) of considerable value but without any contribution of capital from the borrower. In this instance, there is a lot of collateral (second way out) but a lack of borrower contribution.
- The exception here would be if the guarantor derives a direct benefit.

## 04 Collateral

*"One of the great responsibilities that I have is to manage my assets wisely, so that they create value." Alice Walton*

Collateral is often confused with Capital. Collateral represents the assets pledged to support the loan — the "second way out" for the lender.

- Included in collateral are the traditional and tangible forms such as property or cash along with specific or general cover over a business and its assets.

- The quality of the collateral provided does in turn drive risk and in turn, pricing.

TIP: It is vital to understand collateral in detail when dealing with a financier.

## 05 Conditions

*"Finance is not just about lending, it is about recovering loans also." Raghuram G. Rajan*

After meeting the other "C's", the Conditions of your loan, such as the interest rate, the repayment term and the purpose of the money, are also critical factors.

The updated Banking Code of Practice talks of using more "plain English" and aims to help borrowers understand their obligations or any covenants that apply to their lending after it is funded.

Covenants are restrictions or requirements that lenders place on a borrower, to provide a structure to monitor the performance of the borrower over the loan term. See page 28 for examples.

## SUMMARY

### YOUR CREDITWORTHINESS

*The 5 C's of Credit: Character, Capacity, Capital, Collateral, Conditions.*

| | |
|---|---|
| **Character** | reliability and willingness to meet credit obligations and includes credit score |
| **Capacity** | a measurement of past, current and future cashflow in the context of debt repayment and includes responsible lending guidelines |
| **Capital** | the value of assets owned by the borrower, available to pledge as collateral if required |
| **Collateral** | the traditional and tangible assets pledged to support the loan, includes risk and drives pricing |
| **Conditions** | such as interest rate, repayment term, and covenants, and form the critical factors of the loan |

# B: SECURITY PROVIDED FOR DEBT

**Overview**

**Security** or **Collateral** are the assets that an individual or entity borrower provides to a lender, as security for credit. For the credit provider, this serves as a protection against potential loss of capital.

There is no simple formula for security, yet it is a material part of the process for the credit provider and borrower.

## Tangible vs Intangible Security

**Tangible Security**

usually takes the form of acceptable property security or cash. This is the most common form of commercial lending especially in the small to medium business market. A registered first mortgage is taken over property and is commonly supported by personal and directors' guarantees, and a General Security Agreement (GSA) over the borrowing entity and other entities in the group that directly or indirectly provide serviceability support for a loan.

**Intangible security**

is sometimes referred to as "Cash flow Lending" and is more difficult to obtain especially in the small business market. Businesses that can demonstrate strong balance sheets and future cash flows may be able to obtain lending facilities without the provision of property or cash security.

Financiers support these types of lending arrangements by developing policy criteria across specific industries (e.g. Pharmacy, Accounting, Franchises) that outline the general parameters of these arrangements.

**TIP:** Most SME lending in Australia is secured by tangible collateral.

## Consider the Loan Complexity

As a very general principle, the greater the risk or complexity of a transaction, the greater the security that will be required by a credit provider to approve new lending.

Commercial loans are more complex than mortgage lending. It is therefore important to work through all the components of security offered by the customer in support of existing arrangements.

The loan complexity will determine the type and foundation of security required for any lending application put forward by the customer.

# Six Types of Security

## 01 Property Security

Most people are familiar with a registered real property mortgage. In Australia, this is usually a Torrens title mortgage, which operates as a statutory charge on the relevant lot or interest in the land for the amount of debt or liability secured. It may also be over a lease.

The type of property needing security can be diverse and will have a material impact on the appetite of the credit provider. Considerations include:

- Type and Usage
- Best/Alternate Use
- Liquidity/Saleability
- Location
- Variability of Valuation

## 02 Guarantees & Indemnities

In most cases, an individual guarantee and indemnity will be required from the natural person(s) that support the borrowing entity.

For example, Jane Smith provides a "guarantee and indemnity" in respect of the obligations/conduct of the borrowing entities, Smith Group Pty Ltd & Smith Holdings Pty Ltd.

This potentially means the personal assets of the borrower, Jane Smith are at risk. A certificate of independent legal advice is generally required for each individual guarantor.

## 03 Supported versus Unsupported Personal Guarantees

Supported Guarantees are secured against an asset that you own; typically a property. Unsupported personal guarantees aren't secured against assets.

For example, Smith Group Pty Ltd & Smith Holdings Pty Ltd provides a "corporate guarantee and indemnity" in respect of the obligations of the borrowing entities, Smith Group Pty Ltd & Smith Holdings Pty Ltd.

## 04 General Security Agreements & "PPSR"

The Personal Property Securities Act 2009 (PPSA) is a law regarding security interests in personal property. The PPSR is a register of security interests in personal property. This was a significant shift that changed how security interests were termed and registered.

The requirements include:

- A General Security Agreement (GSA) over the general assets of a guarantor, including tangible movable property and other property such as intangible property.

- A specific security agreement over specified goods.

For example, Smith Group Pty Ltd & Smith Holdings Pty Ltd provides a "General Security Agreement" over all present and after-acquired property.

## 05 Financial Position & Background of the Principals and Directors

In most instances, the personal financial position of the borrowers will be reviewed, as supporting guarantees or security are usually required. The capital base accumulated by the individual borrower should indirectly reflect their business life. A lender will look to connect that to some extent.

Often, marginal performance by the business in a period can be mitigated by the borrower's capital base.

In all cases, financiers will request a completed Asset & Liability Statement for all individual borrowers and/or guarantors. This will help assess the viability of the guarantor to meet obligations in the event the obliger is not able to do so.

The other key determinant is the applicants' experience in their industry. This must be evaluated in considerable detail to ensure that the necessary business expertise is present to support future goals and objectives.

## 06 Retirement of Debt

The financier will want to show a demonstration of the way the debt will be retired. Typical strategies they look for are:

- Full payment over the term of the loan out of current cash flow
- A forecasted increase in earnings, demonstrating capacity to retire debt in the future
- The acquisition of new contracts or revenue streams that are recurring in nature
- The divestment of non-core assets

**TIP:** The sale of the primary security is not a sufficient debt strategy in most instances. Credit providers want to see the "first way out".

# SUMMARY

## SECURITY PROVIDED FOR DEBT

### TANGIBLE VS INTANGIBLE SECURITY

Tangible

- Most common form in SME commercial lending – usually property or cash
- Supported by personal and directors' guarantees plus a GSA

Intangible

- Also called cash flow lending
- More difficult for SMEs unless they meet industry policy criteria
- Requires strong balance sheet and future cash flow

### SIX TYPES OF SECURITY

- Property
- Guarantees & Indemnities
- Supported vs Unsupported Personal Guarantees
- General Security Agreements & PPSR
- Financial Position & Background of the Principals or Directors
- Retirement of Debt

# C: REPAYMENT STRUCTURE & AMORTISATION

**Overview**

Setting a loan term can be one of the most challenging aspects of structuring commercial lending.

Loan term is a topic that drives significant negotiation between lender and borrower. Often SME borrowers in particular, are conditioned to residential property lending that allows extensive interest-only periods or long periods of amortisation.

The bank is seeking to have more money out for longer, but they need to satisfy their internal risk parameters and have the loan repaid as quickly as possible.

TIP: The key is to match the loan term with the period in which the assets being acquired provides the maximum benefit.

## Three Common Repayment Types

### 01 Principal & Interest (P&I)

Principal and Interest or "P&I" repayments are designed to ensure after a specified term (usually 15 years for commercial property) that the balance of the loan is fully repaid. Therefore, each repayment is paying interest and principal.

Initially, the P&I repayment is mostly paying interest, but as the loan term progresses and principal reduces, the interest component will reduce also. Or more simply, as the loan balance decreases, so does the interest.

The P&I repayment is a contracted ongoing repayment, based on the outstanding loan limit (not balance), the interest rate and term remaining. The repayment can change over time as interest rates move as a result.

Repayment basis will vary on the type of facility. As a rule, there is less flexibility on the timing of commercial loan repayments compared to home loans.

- **Pros**: Generally a lower interest rate; assists retirement of debt without any active engagement.
- **Cons:** A set loan repayment regardless of utilisation (additional amounts repaid won't reduce the P&I repayment required).

## 02 Interest Only (IO or I/O)

Interest Only or "IO" repayments do not require the repayment of principal for a period of time (usually a maximum term of 5 years). These loans typically attract a higher interest rate.

Generally, the overarching maximum term is 15 years for a commercial loan, so upon the IO term maturing, the P&I term will be based on the total period, less the IO period. As a consequence, borrowers will usually find themselves with higher residual repayments.

For example: *If your loan term was 15 years with 5 years interest only, the residual term is 10 years P&I.*

IO may suit businesses that want to preserve cash flow. However, Principal & Interest from the outset can be desirable in many cases. The best option will ultimately come down to the opportunity cost of the "saving" and borrowers need to be aware of this.

- Pros: Lower repayments may assist with tax strategies; minimise cash flow from your business.
- Cons: Higher interest costs; more aggressive P&I repayments when the IO term matures; more costly over the loan life (ignoring opportunity cost).

## 03 Interest Capitalisation (ICAP)

Interest capitalisation is when no repayment is required until the end of the term. Instead, the bank adds interest charges to the loan balance over time.

This option usually exists only for construction and property development financing.

- Pros: Allows for preservation of cash flow that is better employed in other areas.
- Cons: It does not test the capacity to make commitments during the loan term.

# Determining Loan Term

The loan term and the repayment type offered will depend on both the **Security** and the **Purpose** for which the funds will be utilised.

**Loan Term - Based on Security**
As one of the Five C's of Credit, lending products are increasingly available that accommodate for different availability of security.

Interest rates and terms are driven by the risk and capital requirements imposed by regulators; so sometimes it is not the credit provider's fault!

The following table is a very simplified overview of key loan terms available based on different types of security or collateral provided:

| Collateral Type | Loan Term | Interest Rate | LVR |
|---|---|---|---|
| Residential Property | Up to 30 Years | Lowest | 80% |
| Commercial Property | Up to 25 Years | Low | 70% |
| Business Equipment | Up to 5 years | Low | n/a |
| Business - Trading (GSA) | Up to 10 years | Higher | 50% |
| Unsecured | Up to 2 years | Highest | n/a |

# Five Types of Collateral

## 01 Residential Property

According to APRA around 50 of the $420 billion of total outstanding lending to SMEs is secured by residential property. This is partly attributable to the strength of Australian house prices, which enables business owners to borrow more against the value of their property.

Using a home as security for a business loan enables borrowers to access "better" terms.

**Pros:** Generally a lower interest rate; offers the most flexibility; with property growth can mean access to "walkaround" funding. (Without it - this author for one would not have started out in business.)

**Cons:** The extended loan term and "easy" access may mean funding for purposes that do not match the benefits derived. Be careful.

## 02 Commercial Property

Lending using commercial property as collateral is diverse. Security types are broadly defined as Standard or Non-Standard. Standard security generates more lending options and terms.

### Standard commercial properties

are usually preferred and the best terms can generally be extracted. Zoning is another factor to consider - whether the property is residential, commercial, industrial or mixed-use.

Examples include:

- Commercial Offices
- Industrial Warehouses & Factories
- Retail Premises & Shopfronts
- Residential Development Stock

### Specialised commercial properties

are generally a higher risk to credit providers, as they have a smaller available market on exit.

Examples include:

- Specialised Accommodation (Motels, Hotels, Caravan Parks)
- Aged Care Facilities
- Child Care Facilities
- Agri/Farms/Rural properties

**Pros:** A lower interest rate. A loan term that incentivises repayment within the term that the asset provides benefit. There could also be SMSF benefits – read more here.

**Cons:** Generally less flexible terms than residential.

### Commercial Property and WALE

When financing a commercial property with multiple tenancies you will need to know about the "WALE" or weighted average lease expiry.

WALE measures the average time period in which all leases in a commercial property expire. It is a key measure for assessing the certainty of rental income streams and is a standard assessment tool for commercial property financiers, especially in determining the initial loan term offered.
*For more on WALE, please review our blog here*

03

## Business Equipment

When purchasing or leasing a new physical asset, often it can be used as security for financing. The terms of asset finance will depend on the asset's expected useful life and valuation.

Like commercial property, credit providers prefer non-specialised assets that can be easily liquidated. Assets purchased from established vendors are new and have a common usage that will drive appetite from lenders.


**The types of funding arrangements are diverse and include:**

- Finance Leases
- Operating Leases
- Novated Leases
- Commercial Hire Purchase (CHP)
- Chattel Mortgage
- Rental Agreements

These structures all generate different outcomes for borrowers from a taxation and ownership perspective. As such, professional advice should be sought in all cases when considering this type of financing structure.

For more, please read our equipment finance blog here

**Pros:** Generally a competitive interest rate for non-specialised goods; a loan term that matches repayment within the term that the asset provides benefits; no property security required.

**Cons:** Generally less flexible terms than other categories in respect of additional repayments.

04

## The "Business" as Security

Borrowing secured with a GSA but without property collateral, is a sign that a business has performance and processes that allow them to be distinguished from others in their industry.

**Pros:** Removes tangible security, such as the family home, out of direct sight of the borrowing arrangements.

**Cons:** The pricing and terms of the lending may be less advantageous.

05

## Unsecured

A lending arrangement that does not require any type of collateral. The lender instead draws comfort from the borrower's capital position or credit strength.

This is less common in business lending, in fact, it is more prevalent in personal lending where unsecured loans include personal loans and credit cards.

## SUMMARY

### COMMON REPAYMENT TYPES - PROS AND CONS

| Payment Type | Pros | Cons |
|---|---|---|
| **Principal and Interest (P&I)**<br>• Each repayment is paying interest and principal<br>• As the loan balance reduces, so does the interest<br>• Repayments change with interest rates | Lower interest rate<br>Assists retirement of debt | Set loan repayment - additional amounts repaid don't reduce P&I |
| **Interest Only (IO)**<br>No repayment of principal for a period of time (max 5 years) | Lower repayments for initial period<br>Possible tax and cashflow advantages | Higher interest rate<br>Higher P&I repayments when IO term matures |
| **Interest Capitalisation (ICAP)**<br>No repayment of interest required as added to the balance over time | Allows for preservation of cash flow | Does not test capacity |

### TYPES OF COLLATERAL - PROS AND CONS

| | Pros | Cons |
|---|---|---|
| **Residential Property** | Generally a lower interest rate<br>Offers the most flexibility<br>Can mean access to "walkaround" funding | The extended loan term and "easy" access may mean funding for purposes unmatched to benefits |
| **Commercial Property** | Lower interest rate<br>incentivises repayment within the term that the asset provides benefit<br>Possible SMSF options | Less flexible terms<br>Need to allow for WALE in determining loan term |
| **Business Equipment** | Competitive interest rate for non-specialised goods<br>Loan term matches repayment within the term that the asset provides benefits<br>No property security required | Less flexible terms<br>Additional repayments don't reduce loan term |
| **Business - Trading** | Removes tangible security, such as the family home, out of direct sight of the borrowing arrangements | The pricing and terms of the lending may be less advantageous |
| **Unsecured** | No collateral required | Not common in business lending |

# D: LOAN RATES, TYPES & FEATURES



**Overview**

In this section we consider the difference between loan rates, types of commercial loans and common loan features.

## Loan Rate Options

01

### Variable rate loans

It is variable because the interest rate resets at each roll. These can be packaged by lenders in a variety of ways. For simplicity, we also include bill facilities, even where they are technically fixed during their 30,60,90 or longer terms.

Unlike mortgages, which typically move in the same direction as the Reserve Bank cash rate, commercial rates are market-driven, correlated to changes in funding costs.

Variable rate loans are most popular with borrowers as there are generally few or no restrictions. Most variable loans are flexible, and they allow unlimited extra repayments.

You can split loans if required, and this is common where you have loans for different purposes. Although don't expect the same flexibility that you would on a home loan package for example.

- **Recommended for:** Borrowers wanting flexibility, have good business cash flow to retire debt and can absorb interest rate rises.
- **Pros:** Extra repayments without penalty or restrictions; an easier loan type to refinance; benefit from interest rate falls.
- **Cons:** Exposure to interest rate rises which increases loan repayments.

02

### Fixed rate loans

The interest rate is fixed usually for a term of 1 to 5 years. Fixed rates can be restrictive, extra repayments can trigger "break costs".

Break costs occur when you repay more than what is allowed under the product. A larger prepaid amount and a longer fixed period can potentially mean a more significant break cost. If interest rates continue to decrease after fixing, your break cost liability increases.

Some short term fixed commercial facilities can be combined with scheduled principal reductions at each rollover, allowing the borrower to choose a structure to suit cash flow.

- **Recommended for:** Borrowers who have a firm plan for the future, like to budget or are sensitive to interest rate rises.
- **Pros:** The business can budget with repayments set for a period of time; protecting against rate rises.
- **Cons:** The product has break costs if you prepay debt by more than what is allowed, or discharge the facility.

### 03 Hybrid loans (part fixed, part variable)

As the name suggests, you can have part of your loan fixed and another part variable over two or more loan splits. You may be able to have multiple fixed splits (e.g. for different fixed terms).

Recommended for: Borrowers who want flexibility but also certainty around interest rates.

## Caps and Collars

For larger or more complex debt needs - there are additional products that support a tighter ongoing management of interest obligations. Examples of these are Caps and Collars.

A Cap is a maximum interest rate that will apply.

A **Put** is the minimum interest rate that applies.

A **Collar** is designed to have interest rates operate between these two points.

Generally, rates will vary between the Cap and the Collar, but will stay within the bands. This type of interest rate mechanism gives a borrower more certainty while retaining flexibility. At a cost of course.

## Loan Types

### BUSINESS TERM FACILITY

- A term loan that is suitable for many business purposes, including acquisitions or expansion
- The loan term will generally depend on the purpose of the funding, aligned to the period in which the asset will provide a benefit
- The facility may be either secured against real estate property and/or the business assets
- These loans are generally offered with variable or fixed interest rates

### COMMERCIAL PROPERTY FACILITY

- A structured term facility used for the purchase or refinance of commercial property
- Normally have a term of 15 years
- Repayment options with an initial interest-only period followed by principal and interest repayments

### OVERDRAFT

- As a revolving ongoing credit limit, an overdraft does not require minimum regular repayments
- Interest can be capitalised as long as the balance owing is within its credit limit
- Typically has a higher interest rate

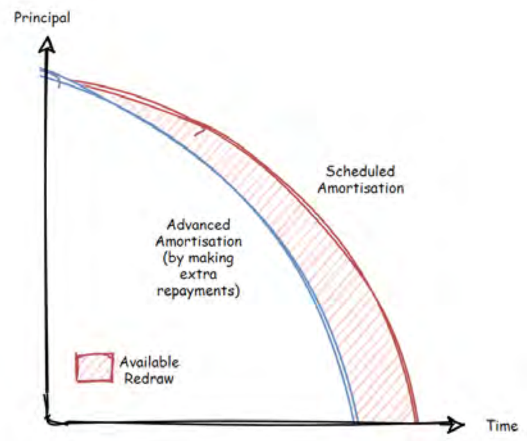
### COMMERCIAL OR BANK BILLS

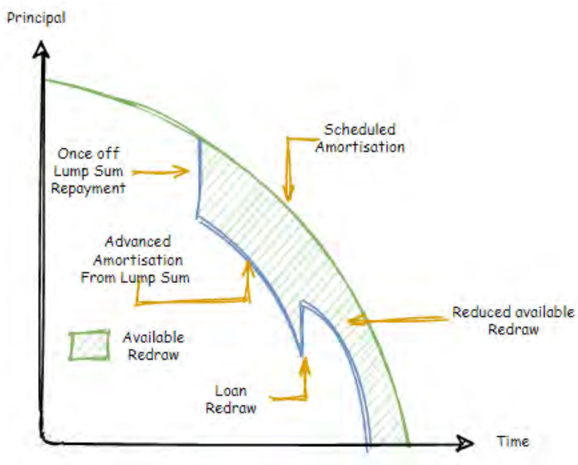
- A traditional lending facility, especially for business lending over say $3M
- A Bill is an unconditional written order by one party addressed to a bank to pay a fixed sum at a fixed date to the bank
- The term of the Bill (typically 30, 60 or 90 days) may be renegotiated by drawing a fresh Bank Bill for an agreed period at each rollover
- Technically it is a fixed rate facility, but given its short term nature it is used as part of a variable rate strategy

# Loan Features

## Redraw Facility

Redraw is a facility providing access to funds prepaid in advance. Debt is retired from lump sum repayments or by making regular extra repayments over time. These prepayments become available to redraw.




- As a rule, redraw is usually only available on "fully secured" business loans
- Typically, redraw should be unlimited but some products have costs to redraw or restrictions
- Usually limited or unavailable for fixed-rate products
- Your available redraw and your loan balance will form your loan limit

TIP: It is important to view redraw as effectively "reborrowing" repaid money. Every time a redraw is accessed, the life of the loan extends, unless P&I is set on the limit not the balance.

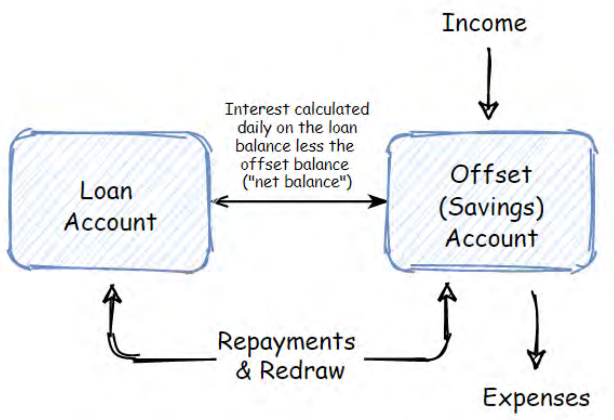
**Pros:** You can access money you repaid in advance. Surplus funds can be put into redraw to save on interest costs.

**Cons:** Temptation of easy access may delay your debt retirement strategy. To combat this you can call your lender to cancel your available redraw at any time.

## Offset Accounts

First offered in the residential mortgage market, offset accounts can isolate your savings from your loan, but whether it works for you depends on your circumstances.

- An offset is linked to a loan, and the bank works out the daily interest on the net balance (the loan balance less the offset balance)
- As a rule, offset is only available on "fully secured" property loans
- Sometimes offset accounts can add to the overall product cost so consideration should be given to their value




TAX CONSIDERATIONS: If you make an extra loan payment you have retired debt, alternatively if you credit your offset account you have not. In either case, interest is not charged. Should the amount you repaid be "redrawn" you are reborrowing it.

Do you need an offset account? You should seek tax and financial advice if you are unsure.

**TIP:** The ATO has published a tax ruling on the topic of redraw and reborrowing of funds. https://www.ato.gov.au/law/view/document?docid=TXR/TR20002/NAT/ATO/00001.

1. The ATO states "Where a loan facility allows for redraws of extra repayments, we consider those redraws constitute new borrowings of funds that cannot be traced to the extra repayments. In this regard the term 'redraw' is a misnomer. It is in effect a new borrowing of funds."

2. The ATO States "We consider a draw-down from a line of credit account or sub-account, or a redraw from a loan account, is a separate borrowing. Therefore, the deductibility of the interest on that separate borrowing ends on whether the interest is incurred in gaining or producing assessable income or is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income"

**Pros**: Isolates your savings from your loan; good for temporary cash; Tax considerations; creates more discipline - your cash flow might offset your loans.

**Cons**: May add to the cost of the product; often a similar outcome could be achieved with a basic loan.

# SUMMARY

# LOAN RATES, TYPES AND FEATURES

## LOAN RATE OPTIONS

### VARIABLE RATE

Recommended for: Borrowers wanting flexibility, have good business cash flow to retire debt and can absorb interest rate rises.

Pros: Extra repayments without penalty or restrictions; an easier loan type to refinance; benefit from interest rate falls.
Cons: Exposure to interest rate rises which increases loan repayments.

### FIXED RATE

Recommended for: Borrowers who have a firm plan for the future, like to budget or are sensitive to interest rate rises.

Pros: The business can budget with repayments set for a period of time; protecting against rate rises.
Cons: The product has break costs if you prepay debt by more than what is allowed, or discharge the facility.

### HYBRID

Recommended for: Borrowers who want flexibility but also certainty around interest rates.

## LOAN TYPES

- Business Term Facility
- Commercial Property Facility
- Overdraft
- Commercial or Bank Bills

## LOAN FEATURES

Redraw facility vs Offset accounts
Do you need one? Consider costs, tax, temptation to easy access funds and cashflow needs.

# E: CAPACITY & COVENANTS - THE FIRST WAY OUT

**Overview**

*How much can I borrow?* *How do I stay out of trouble?*

These are the two most frequent questions asked by business owners when dealing with credit. We consider how Capacity and Covenants help provide answers.

## Capacity and Serviceability

**Capacity** or **Loan Servicing** is often mis-understood by borrowers. Gaining clarity on this can help build greater financial literacy.

Importantly, there is no one "right" approach to assess borrowing capacity of the business borrower. Both the nature of the assets being funded, and the type of lender you are approaching, will drive the specific measurements used for servicing.

### So where to start?

*"Revenue is Vanity, Profit is Sanity, but Cashflow is Reality"*

This saying is a great reminder, as ultimately, cash flow will provide the ability to repay debt. In assessing capacity however, the critical aspect is to understand your business and how the financial performance flows from that point.

### 1. Understanding Revenue & Gross Margin

STEP 1

#### REVENUE FACTORS

**Revenue** may be vanity in one sense, but the quality of the revenue is still critical to its flows into profit and the ability to generate cash of course. Factors that financiers will look for:

- What is the quality of the Revenue?
- Are the customers consistent from year to year?
- Are there any dependencies on one or more customers?
- Are customers paying on time? (A review of Debtors Ageing will help to clarify)

STEP 2

### GROSS MARGIN FACTORS

Next to consider is how competitive is the industry sector? One litmus test will be **Gross Margin** performance. Factors to consider here are:

- Are there supply constraints moving forward?
- Is Margin being sacrificed to pursue Revenue Growth?
- Can suppliers be paid on time? (A review of Payables Ageing will help here)

STEP 3

### FINANCIAL STATEMENT REVIEW

After this we can review the Financial Statements, starting with the Operating Profit as per the example below:

| PROFIT & LOSS EXTRACT | 30/6/2020 | 30/6/2021 | 30/6/2022 |
|---|---|---|---|
| Operating Revenue | $4,000,000 | $5,000,000 | $6,000,000 |
| Cost of Goods Sold | $1,250,000 | $1,875,000 | $2,650,000 |
| Gross Margin | $2,750,000 | $3,125,000 | $3,350,000 |
| Net Profit before Tax | $670,000 | $780,000 | $930,000 |
| Tax Paid | $130,000 | $175,000 | $265,000 |
| Net Profit after Tax | $540,000 | $605,000 | $665,000 |

| PROFITABILITY RATIOS | 30/6/2020 | 30/6/2021 | 30/6/2022 |
|---|---|---|---|
| Revenue Growth % | 15.00% | 25.00% | 20.00% |
| Gross Profit Margin % | 68.75% | 62.50% | 55.83% |
| Net Profit Margin % | 16.75% | 15.60% | 15.50% |

## 2. "Normalising" Earnings

It is essential to review the Profit & Loss to adjust for any abnormal or non-recurring incomes and expenses. This holds true not just for satisfying your financier, but also to provide a realistic profile of the business and its ultimate value.

In most SMEs, adjustments may include an assessment of the owners' salary. Ensure that the personal exertion contributed by the owner to the business is costed at a market rate.

STEP 1

## OWNER CONTRIBUTION

The process of normalising earnings may raise many issues, including the dependency on the business for the contribution of the owner. Factors to consider here are:

- Can the business be deleveraged from the owners' contribution?
- Are the owners' paying themselves a market salary for personal exertion contributed to the business?

STEP 2

## OTHER ADJUSTMENTS

Other adjustments may include:

- Owners personal expenses (motor vehicles, etc.)
- Rental Expense Foregone
  (i.e. when purchasing owner-occupied property)
- Non-Recurring Income
  (project or one-off revenue not sustaining)
- Bad Debts
  (if not part of the normal risk of business)
- Government Subsidies, Grants or Benefits

For the example above it might look like this:

| LEVERAGE RATIOS | 30/6/2020 | 30/6/2021 | 30/6/2022 |
|---|---|---|---|
| Net Profit before Tax | $670,000 | $780,000 | $930,000 |
| Tax Paid | $130,000 | $175,000 | $265,000 |
| Net Profit after Tax | $540,000 | $605,000 | $665,000 |
| Interest Paid | $80,000 | $82,000 | $78,000 |
| Depreciation & Amortisation | $6,432 | $12,544 | $14,500 |
| Total Income/(Expense) Adjustments* | $80,000 | -$23,000 | -$10,000 |
| Owners' Salary Adjustment (+ / -) | -$150,000 | -$150,000 | -$150,000 |
| EBITDAO | $686,432 | $701,544 | $862,500 |

## STEP 3 TOTAL AVAILABLE FOR SERVICING

In the example above, the owner was working fulltime in the business, (actually 60+ hours), and not paid a salary or otherwise expensed anywhere in the P&L. On reflection, the cost to replace their personal exertion contribution - a salary of $150,000 - needed to be inserted into the P&L to reflect the value of the owner's contribution and the cost to replace them.

Other adjustments included removing personal owner expenses, and adjustment for one-off Government payments.

We can process these adjustments over both historical, current year and forecast income for consistency.

In simplistic terms, and after "cleansing" the P&L, we arrive at "**Total Available for Servicing**".

| LEVERAGE RATIOS | 30/6/2020 | 30/6/2021 | 30/6/2022 |
|---|---|---|---|
| EBITDAO | $686,432 | $701,544 | $862,500 |

As a starting point, regardless of the method applied by the lender, identification of whether there is a surplus remaining after all commitments is important.

## STEP 4 CURRENT AND FUTURE FINANCIAL PERFORMANCE

Make sure that you understand the current state of the business.

As Business Owners, or indeed people assessing financial performance of a business, there can be too much focus on historical performance compared with what is happening now.

Questions to explore here are:
- Has the current customer mix changed?
- Are Margins changing for the business or the industry?

If so, show workings of what this will look like for financial performance moving forward.

## 3. Components of Servicing

Again, all banks apply different logic and scoring models so what follows is a lot simpler than the reality. However, the components of loan serviceability are supported by key fundamentals – explained by applying the data in the example above.

### FOUR KEY MEASURES OF SERVICEABILITY

#### 1. Interest Cover Ratio (ICR)

ICR is a measure of how easily a business can pay interest on its outstanding debt. Most lenders will not add back depreciation and amortisation when looking at this measure. Using the example this is calculated as:

*Total EBITO ($848,000) / Total Interest ($78,000) = 10.87*

When a trading company's interest coverage ratio is 2.0 or lower, its sustained ability to meet interest commitments may be questionable, especially if there is uncertainty around the reliability of future income.

ICR is commonly applied for assessing consistent yield assets. For example, rental income on a commercial investment property. Expect ICR to be lower in instances where there is no trading income to support servicing.

#### 2. Debt Service Ratio (DSR)

A measure of how easily a business can pay total debt repayments on its outstanding debt. Using the example this is calculated as:

*Total EBITDAO ($862,500) / Total Repayment Obligations ($700,000) = 1.23*

Where this ratio is 1.0 or lower, cash flow will be negative! So how close it goes to 1.0 times depends on the quality and certainty of the income of the business.

**TIP:** DSR can be a more relevant measure of liquidity, unlike ICR it includes the actual cash commitment to reducing debt. Where strong amortisation is needed, the gap between DSR and ICR can be wide.

#### 3. Payback (Debt) Ratio

A measure of how quickly total debt can be repaid out of EBIT and cash reserves. Using the example this is calculated as:

*Total Debt ($3,520,000) - Cash ($120,000) / Total EBITO ($848,000) = 4.01*
Consider the actual Payback Ratio result, but also the variation from period to period.

**TIP:** The greater the uncertainty around future earnings, the sooner the business may want to retire debt. This is mitigated by the price of the debt, where there could be better returns from deploying cash elsewhere.

### 4. Multiple of Earnings

A less commonly communicated but valid test of borrowing capacity is to apply a multiple limit to the adjusted EBITDAO.

This has become increasingly popular in assessing borrowing capacity for service firms in particular. Using the example EBITDAO is calculated as:

*Total EBITDAO ($862,500) x Maximum Multiple of 3.0 = $2,587,500 (Indicative Borrowing Capacity).*

TIP: Usually an appropriate method where consistency of EBITDAO is evident. It is increasingly relevant where the lending is not supported by tangible security.

# Covenants

Covenants in a banking context are restrictions or requirements that lenders place on the borrower.

These restrictions can be many and varied, both quantitative and qualitative, positive and negative and provide a structure for monitoring the performance of the borrower.

In the past, covenants were seen "as a guide" rather than a rule. In other words, as long as repayment commitments are maintained the noise between lender and borrower wasn't "loud".

In fact, our experience is that many business borrowers either are not aware or do not understand the basis of their ongoing covenants. Business owners need financial literacy in this area to prevent covenant breaches.

TIP: A savvy businesses will review performance regularly to maintain compliance with covenants.

Quantitative performance measurements include:

- Debt/EBITDA Ratios
- Interest Coverage Ratios
- Debt/Equity
- EBITDA

*Example in Bank Speak:*

*Aggregated Actual EBITDA of ABC Pty Ltd will not for any Relevant Period be less than the respective Relevant Amount. Relevant Period and its respective Relevant Amount mean: A. 1 July to 31 December each year, $300,000; and B. 1 July to 30 June each year, $600,000.*

**Qualitative performance measurements include:**

- Ensure assets are maintained and kept in good working order
- Dividend/Distribution Payout Ratio
- Limitation on new acquisition and/or merger activity

*Example in Bank Speak:*
*ABC Pty Ltd will ensure that the sum of the Distribution and all other Distributions made in respect of each financial year does not exceed 100% of the NPAT.*

## SUMMARY
## CAPACITY AND COVENANTS

What financiers look for

### CAPACITY AND SERVICEABILITY

### 1. UNDERSTANDING REVENUE & GROSS MARGIN

Step One: Revenue factors: as a measure of cashflow into profit

- Revenue quality
- Annual customer consistency
- Uneven customer dependency
- Consistency of receivables (ageing debtors)

Step Two: Gross Margin factors: as a measure of sector competitiveness

- Supply constraints
- Margin sustainability
- Supplier serviceability (aged payables)

Step Three: Financial Statement Review

- Determining Operating Profit and Profitability Ratios

### 2. 'NORMALISING' EARNINGS

Step One: Owner contribution

- Business dependency on owner
- Salary – at market rate comparable to contribution

Step Two: Adjustments

- Owners' personal expenses
- Rental expense foregone
- Non-Recurring Income
- Bad Debts
- Subsides, grants, or benefits

Step Three: Total available for servicing

Step Four: Show the current and future financial performance

## 3. COMPONENTS OF SERVICING

### FOUR KEY MEASURES OF SERVICEABILITY:

1. Interest Cover Ratio – ICR

- Measures if a business can pay interest on debt
- Factors include income reliability and consistency of yield assets

2. Debt Service Ratio – DSR

- Measures if a business can pay total debt repayments
- Speaks to quality and certainly of income
- A more relevant measure of liquidity

3. Payback (Debt) Ratio

- Measures how quickly debt can be repaid
- Factors include EBIT, cash reserves, future earnings
- Price of debt - Can redeployment of cash generate better returns?
- Look at period to period variations

4. Multiple of earnings

- Measures borrowing capacity
- Applies a multiple limit to adjusted EBITDAO
- Popular for service firms where EBITDAO is consistent
- Relevant in absence of tangible security

## COVENANTS

- Restrictions/Requirements placed on borrower
- Place a structure for monitoring borrower performance
- Important for businesses to understand the basis of ongoing covenants

Quantitative measures include

- Debt / EBITDA Ratios
- Interest Coverage Ratios
- Debt / Equity
- EBITDA

Qualitative measures include

- Asset maintenance
- Dividend/Distribution Payout Ratio
- Limits on acquisition/mergers

# F: CHOICE OF LENDERS

**Overview**

Business lending has evolved. Credit rules are less technical than consumer credit, and several innovations have helped new lenders compete in the segment.

These include Government initiatives to promote data sharing, such as comprehensive credit reporting, which provides lenders with better access to data to make faster credit assessments.

In real estate and property development, the risk aversion and regulation imposed on major and second tier banks have opened the door for a range of non-bank financial institution (NBFI) lenders to enter the market with increased sophistication.


## Bank and Non-Bank Lenders

### 01 Major Banks (Big Four)

The Big Four refers to CBA, Westpac, NAB & ANZ. They have a majority market share (over 60%) of the Australian SME lending market.

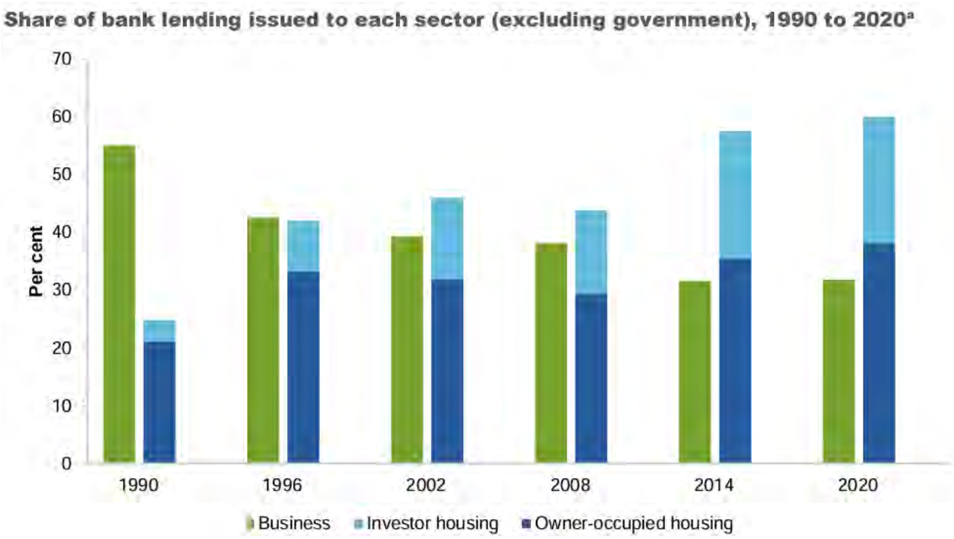
The Major Banks offer the most extensive branch and business centre networks. As deposit-taking institutions, their loans are funded mainly by their customers through bank deposits (plus funding sourced through other markets).

In the overall mix of their total lending, their business lending has been declining for a long time (see diagram below). This is due to the higher capital requirements for SME loans and the complexity in assessing the 5 C's of SME borrowers compared with residential mortgages.

Perhaps even more materially, the introduction of the National Consumer Credit Protection Act 2009 (NCCP), means that business lending that was previously done using residential property is now caught by this law.

At times, this change has delivered unintended consequences for borrowers. This includes where a personal use asset (owner-occupied property) is used as security or where the predominant purpose of the business borrowing is viewed as being for investment or personal purposes.

In recent times, and under the threat of competition, the majors are looking to bounce back. This is best evidenced in small businesses - say up to $1M of borrowings - where there are simplified assessment criteria, longer loan terms and higher LVRs, to compete better against Fintech, Neobanks and other providers.




*Source: Small business access to finance - Productivity Commission 2021*

## 02 Second Tier Lenders

Second tier lenders are authorised Australian Deposit Taking Institutions and are regulated by APRA and other governing bodies. Participants include Macquarie, ING, Bankwest, Bendigo & Adelaide Bank, Suncorp and Bank of Queensland.

As major banks have retreated (in relative terms) from SME lending, one of the expectations was that second tiers may fill the void. On the whole, they didn't, with a credit appetite that sat alongside or behind the majors. Significantly, they just didn't have the underwriting skills.

TIP: **One exception has been the development of policy niches for certain industries such as Medical, Professional Services and others. This is where second-tier lenders are looking to have a point of difference.**

## 03 Neobanks

This growing segment of SME banking includes Up, Volt, Revolut, Judo, Hay, Tyro and 86 400. They usually operate via a website and mobile application, without physical business centres and generally offer fewer products and services than larger banks.

Appealing too, is the perceived lack of bureaucracy found in traditional banking, as Neobanks can operate under reduced regulatory supervision and capital requirements.

## 04 Fintech Lenders

There are different definitions of the "Fintech" segment. As a broad description, we define these as lenders that rely on technology and automation in making credit decisions. Fintech uses "AI" as a processing hub that gathers data from information sources to help with credit scoring algorithms.

The "tech" can be supported by several manual processes, so the lines are often blurred. However, they are generally accessed by an online application process, with automated decisions and funds transfers. They have no physical business centres, and most are not full banking services providers. They do need to hold an Australian Financial Services Licence.

B2B fintech companies include Stripe, Square, Prospa and Moula. Better known B2C fintechs are Athena, BeforePay, Flare, Raiz and Nimble.

To understand the impact of Fintech on B2B and B2C Finance, read our blog here

## 05 Private Funders

The "Private" segment has undergone massive growth since the GFC. With the major banks restricting credit appetite, and second tiers not willing to fill the void, this segment has seen unprecedented growth.

The funding base is varied. It is supported by sources including larger institutions or high net worth individuals. These loans are delivered and packaged in a variety of ways. The investor can provide debt directly to a borrower as a mortgagee (known as on a contributory basis) or via a structure of debt securities or similar where the funding is "pooled".

As the segment has matured and become more competitive, so has the appetite and understanding of risk. We have seen a significant reduction in the "gap" between private lending costs and traditional lenders.

Therefore, it is very important to use reputable private funders with structures that can back the loans they approve. If you need Private Funding, this is one area where you should seek the assistance of a finance professional.

Private Funders may be potentially more sensitive to borrowing costs triggered by local or global economic conditions. More aggressive credit policies may carry more portfolio risk, which investors could deem risky.

TIP: A reminder that the Financial Claims Scheme (FCS), an Australian Government scheme that protects deposit-holders with Australian incorporated banks, building societies and credit unions, does not apply to this category.

# Funding Costs For Lenders


While it may not appear directly relevant for borrowers, where credit providers get their money can be very impactful over the longer term. At a simplistic level, we can draw comparisons between Approved Deposit Taking Institutions (ADIs) and Non-Bank Lenders.

ADIs obviously attract deposits that form the basis of lending. They have other sources (which were tested in the GFC), and currently, deposits represent about 60% of their overall funding mix.

This is not technically a secure platform from which to draw for lending, as it can vary significantly and impact key funding ratios as below:

The **Net Stable Funding Ratio** (NSFR) is a liquidity standard requiring banks to hold enough stable funding to cover the duration of their *long-term* assets.

The **Liquidity Coverage Ratio** (LCR) measures the proportion of highly liquid assets held by financial institutions to ensure their ongoing ability to meet *short-term* obligations.

In a low-interest rate environment, ADIs can hurt a little as their Net Interest Margin (NIM) shrinks. Therefore, we have seen innovation and development over recent years, with investors seeking higher yields and alternative investment classes, providing a source of funds for various lenders.

In simple terms, NIM is the difference between what it costs to raise money and what borrowers are charged for lending. Or in banking terms, the interest income from earning assets and the interest cost of funding those assets.

Typically, this is due to the material amount of monies on deposit that cost little or no interest payments (think business trading accounts as an example). Since the Reserve Bank cut rates consistently post GFC, these rate cuts savagely eroded bank margins.

Non-bank lenders have to look at other funding sources as they cannot generate deposits from the public. As a result, funding is derived from other sources that may be less consistent and generally at a greater cost.

## SUMMARY

## CHOICE OF LENDERS

- Business lending is evolving
- Five Types of Commercial Finance Lenders
  - Major Banks (Big Four)
  - Second Tier Lenders
  - Neobanks
  - Fintech Lenders
  - Private Funding
- Banking is impacted by NSFR for long-term assets and LCR for short-term obligations
- Traditional banking draw funding from deposits (60%) and other sources
- Non-bank lenders look to other funding sources that are less consistent and possibly more expensive

# G: BASIS OF RECOMMENDATIONS

**Overview**

Structuring Business Finance is more complicated than many, including some accountants, realise.

In the most primitive sense, money is a commodity, and in that regard, the product offerings between credit providers in some market segments have become increasingly homogenous.

Reputable finance brokers and bankers will always strive for good customer outcomes and be cognisant of laws and guidelines that provide the necessary framework to support borrowers.

In our experience, the structure and subsequent conduct of borrowings is more material than the credit provider selected. Therefore, it is critical to focus on identifying the needs of the business first, rather than jumping straight to a credit solution or provider.

## Six Factors For a Basis of Recommendations

Feedback from business borrowers shows that the following six factors are most critical when forming a basis of recommendations. A basis of recommendations is a best practice step in the commercial lending process.

It is best to take these six factors into account at varying levels depending on the customer's needs:

**01**

**Term**
How long is the initial loan term, and the basis for repayment? Short-term P&I or Interest Only? What does the new cash flow position look like?

**02**

**Pricing**
How much will it cost? What is the interest rate? Be careful here - it isn't always simple.

**03**

**Flexibility**
As things change or the business grows, is there future borrowing capacity to meet needs?

**04**

**Covenants**
Covenants are important - but some lenders can frustrate with qualitative demands or a thirst for endless paperwork.

**05**

**Services**
Treasury, Foreign Exchange, Trade Facilities, etc. Are there specific additional services needed from a banking relationship?

**06**

Relationship
Quality of people is a critical factor for many businesses at the front and back end. Other borrowers may be "low touch", so this is less of a factor for them.

# SUMMARY

# BASIS OF RECOMMENDATIONS

- Be customer focused - Identify needs of business first, then find best credit provider to suit
- Critical Borrowing Factors to consider for business owners
    - Terms
    - Pricing
    - Flexibility
    - Covenants
    - Services
    - Relationship

# H: UNDERSTANDING INTEREST RATES

Overview

Determining the interest rate on commercial loan facilities can be complex, as outlined below.

All prospective lending terms depend on the borrower's relative risk of default, combined with a "score" calculated by bespoke risk grading systems that capture both qualitative and quantitative measures.

This also presents a required Return on Equity (ROE) for the business, which forms the ultimate basis of the lender's rate pricing and fee model. So it takes into account the probability of default based on risk grade and then calculates the "loss given default", which generates the capital cost requirement based on the lender's cost of funds.

## Risk Grading and Pricing

Impacts include:

- The primary purpose of the funding
- The quality of the collateral provided for the loan (i.e. if funding is "unsecured" the pricing model will automatically throw up a high interest rate)
- An LVR based on the collateral provided (a higher LVR will place upward pressure on pricing)
- The strength of the capacity to service the debt (using a range of measures)

Consider the following two scenarios:

**Scenario 1 - Fully Secured**

| Collateral Type | LVR | Capacity | Capital |
|---|---|---|---|
| Standard Commercial Property | Low | Marginal | Weak |

**Scenario 2 - Unsecured**

| Collateral Type | LVR | Capacity | Capital |
|---|---|---|---|
| Unsecured | n/a | Strong | Strong |

Scenario 1 will "model" better from a pricing perspective as it is fully secured and will have a minimum ROE for the financier.

Scenario 2 is often more preferred, and the lender will be looking to identify the risk and mitigants that can put downward pressure on the model produced interest rate.

## Interest Rate Structure

Unlike getting a mortgage, business customers are often not sure of the interest rate they are paying for their commercial finance.

SME loans are typically packaged as a simple all up interest rate. However, larger loans will usually be linked to a "market" base interest rate with margins and costs added to that rate.

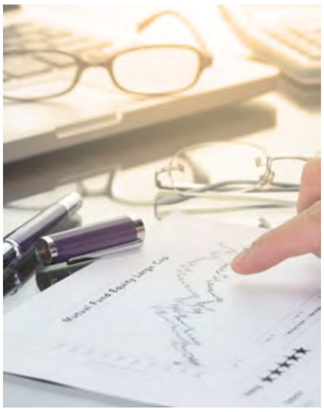
**Interest Rate Components include:**

### BASE RATE

In simple terms, a commercial loan will be based on a Bank Bill Swap Bid Rate (BBSY) interest rate or a similar benchmark at which the financier borrows money. To be technical, Bank Bill Swap Rate (BBSW) is calculated first and is a short-term money market benchmark interest rate. BBSY bid is a bid rate reference and is usually five basis points higher than BBSW.


### BASE MARGIN

Customer margin is determined by the 5 C's as explained above. On a bill facility, the interest rate is rolled over every 30, 60, 90 or 180 days. At rollover, the interest rate is reset to the current base rate plus the margin. As an example, this may be quoted as 2.0% over BBSY.



### TREASURY MARGIN

Raising money to lend is expensive. Some financiers will separate a cost (called a treasury margin) built into "their" bespoke base rate or identified as a separate cost component. This might be anywhere from 20 to 40 basis points.

### LINE FEES

A line fee is payable to keep credit available for the borrower to use. A line fee is charged on the loan facility limit. Interest is only paid on the balance of a loan.

Take the following example:

| **Loan Option 1** | | **Loan Option 2** | |
|---|---|---|---|
| Principal Limit ($) | $2,000,000 | Principal Limit ($) | $2,000,000 |
| Loan Term (Years) | 5.0 | Loan Term (Years) | 5.0 |
| Base Rate + Margin (% p.a.) | 2.85% | Base Rate + Margin (% p.a.) | 2.60% |
| Line Fee Component (% p.a.) | 0.00% | Line Fee Component (% p.a.) | 1.00% |
| Total Fees | $12,000 | Total Fees | $12,000 |

| Ongoing Costs | | Ongoing Costs | |
|---|---|---|---|
| Monthly Fee | $120 | Monthly Fee | $0 |
| Total Fees over Term | $22,200 | Total Fees over Term | $12,000 |
| Total Repayments & Fees | $2,167,453 | Total Loan Repayments | $2,146,979 |
| Interest & Fees Paid | $167,453 | Interest & Fees Paid | $146,979 |
| **Comparison Rate** | **3.23%** | **Comparison Rate** | 2.84% |

On face value, Option 2 is more cost-effective. On review however, it was determined that the average balance of the loan facility over the loan term was only $500,000.

Adjusting for the fact that in Option 2 - a line fee of 1.0% is charged on the $2M limit, the results are now very different.

| Loan Option 1 | | Loan Option 2 | |
|---|---|---|---|
| Interest & Fees Paid | $131,006 | Interest & Fees Paid | $146,979 |

TIP: When making extra repayments, it is vital to understand what interest rate components are charged on the loan limit and the true cost of borrowing.

# SUMMARY

# UNDERSTANDING INTEREST RATES

A businesses Return on Equity (ROE) is basis for the lender's rate pricing and fee model. ROE is net profit after tax divided by total equity to determine efficiency of equity to generate profit.

**Lender's Cost of Funds determined by:**

Risk Grade > Probability of Default > Loss Given Default > Capital Cost Requirement

**Impacts on Risk Grading and Pricing**

- Primary purpose of funding
- Quality of collateral
- LVR based on collateral
- Capacity to service debt

## INTEREST RATE COMPONENTS

| | |
|---|---|
| Base Rate | based on Bank Bill Swap Bid Rate (BBSY). Is usually 5 basis points higher than Bank Bill Swap Rate (BBSW) |
| Base Margin | determined by the 5 C's of Credit. May be quoted as a % over BBSY (base rate) |
| Treasury Margin | can be built into a bespoke base rate, or as a separate cost. Could be 20-40 basis points |
| Line Fees | loan facility limit fee charged on total loan amount (outside of interest rate) |

# I: DOCUMENTATION REQUIREMENTS

Overview

On face value, collating documentation to support a lending application should be easy.

However, documentation to support business lending is more comprehensive than most borrowers anticipate. Broadly, documentation can be classed as either a pre or post conditional offer stage.

## Pre-Offer Stage

### Financial Data (Capacity)

- Latest two (2) years' Individual Taxation Returns & ATO Notices of Assessment for Owners
- Latest two (2) years' Business Taxation Returns (All Entities where acting as Director/Trustee)
- Latest three (3) years' Business Financial Statements (All Entities where tax returns exist)
- Interim Financial Statements for all trading entities
- Aged Receivables & Aged Payables Listings
- Details of any key supplier or customer contracts (if applicable)
- Corporate Structure Overview
- Forecast Cash Flow Statement

### Background (Character)

- Corporate and Personal Background verification
- Background Description of Owners/Key Persons
- Last 6 months Loan Statements for all debts being refinanced
- Last 6 months Trading Statements to show "run of business"
- Current ATO Tax Portal Statement for all registered entities

### Borrower Contribution (Capital)

- Completed Statement of Financial Position for all Directors/Borrowers/Guarantors
- Evidence of funds to contribute to asset purchases

### Property or Business Security (Collateral)

- Executed Contract of Sale (Signed Page and Sale Particulars Page / Contract Note)
- Lease Agreements for existing business interests/locations
- Independent Valuation of the Security Property (always) or Business (sometimes)

## Post-Conditional Offer

Once capacity, capital, collateral and character are verified - there is still work to do to bring funding to the line. This may include, though not limited to:

- A certificate of independent legal advice for each individual guarantor
- A certified copy of fully executed trust deeds (and any deeds of amendment) for borrowing entity
- Confirmation that adequate insurance is maintained to protect collateral and/or the owner

TIP: Be Prepared. Applying for or having commercial finance facilities can be onerous. However, it is an opportunity for the business to organise financial matters in a more orderly way. Most of the information requested by credit providers should be available in the normal course of being in business.


## SUMMARY
## DOCUMENTATION REQUIREMENTS

### TWO STAGES OF DOCUMENTATION

| | |
|---|---|
| Pre-Conditional Offer | required to prove Capacity, Character, Capital, Collateral |
| Post-Conditional Offer | additional docs needed to meet Conditions |

*The Key is to Be Prepared!*

# APPENDICIES

# APPENDIX 1: CREDIT OBSTACLES: BORROWER FAQs

As a borrower, the pendulum can swing both ways. On one hand, we want stable, compliant, financially robust financial institutions that do the right thing in our society.

On the other hand, sometimes, these same processes don't work for us as potential borrowers.

Here are the most common pain points from borrowers, the financier's perspective, and what you can do to improve next time.

*I have offered so much security/collateral, why can't I have the money?*

Capacity.

Yes, offering good collateral reduces the risk for the credit provider in lending money. Collateral, like property, can be repossessed and sold if a repayment default occurs to recover monies. However, banks do not want to be in this position. They have legal responsibilities (NCCP) to ensure borrowers have the ability to repay debt. It is also bad public relations when they have challenges and need to recover debt from the forced sale of security.

TIP: Be prepared to demonstrate the income to service loan repayments, or otherwise provide an exit strategy that doesn't involve a forced sale of assets.

*I make money, so why does the bank need so much collateral?*

Collateral.

If you read a business letter of offer, it usually includes a property mortgage, a charge over business assets, and guarantees and indemnities for all connected entities of the borrowers.

Isn't the property enough? Sometimes, but the bank will always want to control the cash flow. This means "having a foot on" all the structures within the borrowing group and multiples avenues of recovery when looking to exit a debt.

TIP: Think carefully about the ideal borrowing structure. Is there a benefit of not providing a certain collateral item? If so, test the tension with the lender. Be aware, this will impact overall risk grade and pricing.

*I make repayments on time, then why am I bombarded with ongoing requests for Information?*

Covenants.

The same laws and guidelines that protect us also place a responsibility on lenders to monitor borrowers.

TIP: Understand the loan covenants, or get help if needed. Use them as a driver of positive actions in your business.

*I have offered security and can show a capacity to make loan repayments - why won't the bank support me?*

Yes, sometimes we provide the collateral we need and can show the ongoing income to service the debt. If the bank still says no - this may be due to Character or Industry:

If Character.

Credit history and score may be below the bank minimum thresholds. With the advent of open banking, conduct is now more transparent, so maintaining good conduct with credit is essential.

TIP: Manage credit conduct carefully. With new reporting and technology in place, there is more visibility of credit conduct.

If Industry.

Through no fault of the borrower, it might be that the bank has too much exposure to the specific industry or is otherwise taking a macro view that the industry is not one they want to support moving forward.

TIP: Talk to a finance partner who understands lender views in regards to industry funding.

# APPENDIX 2: BUSINESS FINANCE ACRONYMS

Below are common words & acronyms we will use in conversation and communications. It is beneficial for a borrower to have a basic understanding of what they mean.

| | |
|---|---|
| APRA | Australian Prudential Regulation Authority. An independent authority that supervises institutions across banking, insurance and superannuation and promotes financial system stability in Australia. |
| BCOP | "Banking Code of Practice." Sets out the standards of practice in the banking industry for individual, small business customers, and their guarantors. |
| BBSW/BBSY | Bank Bill Swap Rate (BBSW) is a short-term money market benchmark interest rate. Along with Bank Bill Swap Bid Rate (BBSY), it is a key base rate used for commercial lending. |
| Collateral | The Assets given by a borrower to a credit provider in order to secure a loan. It serves as an assurance that the lender will not suffer a significant loss. |
| DSR | "Debt Service Ratio". A measure of how easily a business can pay total loan repayments on its outstanding debt relative to EBITDA. Not just interest, principal too. |
| EBITDA | "Earnings before Interest, Taxes, Depreciation and Amortisation". Perhaps a more precise measure of performance; shows earnings before the influence of accounting and financial deductions. |
| EBITDAO | Goes one step further than EBITDA, with the 'O' being a + or – adjustment for Owner market salary costs. Evaluates performance beyond the stated Operating Profit. |
| LVR | Loan to value ratio. This is the loan amount divided by the property or sometimes by the business valuation. Always expressed as a percentage. |
| Fintech | As a broad description, we define these as lenders that rely on technology and automation in making credit decisions. |
| G&I | "Guarantee & Indemnity" A guarantee means answering for debt after default of another party. An indemnity is a direct liability for another party to compensate for a loss occurring, caused by a third party. |
| GSA | A General Security Agreement (GSA) which is offered over the general assets of a business. In the past, this would be solely represented as a "Charge over the business assets". |
| IO or I/O | Interest Only. Where repayments are only covering the interest on the amount borrowed (the principal) for a set period of time. Repayments will vary due to the utilised balance, number of calendar days in a month. |
| Loss Given Default | The amount a bank loses when a borrower defaults on a loan, after taking into consideration any recovery, represented as a percentage of total exposure at the time of loss. |
| MFAA | Mortgage & Finance Association of Australia. Has 14,000 members and contributes to the finance industry through advocacy, education and business-building support. |
| NBFI | Non-Bank Financial Institution. In other words, a credit provider that does not hold a banking licence. |
| P&I | Principal & Interest - this is the most common repayment type and requires a payment towards loan principal along with interest. Repayments are set based on the interest rate. |
| NPAT | Net Profit after Taxation. Also after interest and depreciation. |
| ROE | "Return on Equity." Divides Net Profit after Tax by Total Equity to measure how efficiently a business is using its equity to generate profit. |
| Serviceability | Capacity. This is a calculation, based on the overall net income position, that lenders use to determine what level of debt can be serviced without reasonable risk of default. |
| Basis Points | A basis point is one hundredth of a percent or equivalently one percent of one percent, or one ten thousandth. 50 basis points is equivalent to 0.5%, as 1 basis point is one hundredth of 1%, or 0.01%. |

# APPENDIX 3: KEY FINANCIAL TERMS EXPLAINED

Below are common words & acronyms we will use in conversation and communications, It is beneficial for a borrower to have a basic understanding of what they mean.

## a) Profitability Terms

| Measure | Calculated | Used For? | Comments | Optimal |
|---|---|---|---|---|
| EBITDAO | Operating Profit + Interest + Tax + Depreciation + Amortisation +/- Owners' Salary Adjustment | EBITDAO is a metric used to evaluate operating performance beyond the stated Operating Profit. | Goes beyond Profit - adjusts for taxes and interest paid, and critically the "O" means a + or - to adjust for owners' market salary costs. | High |
| Gross Profit Margin | Gross Profit<br>Revenue<br><br>Gross Profit is (Revenue - Cost of Goods Sold) | Gross profit margin ratio shows the percentage of sales revenue maintained after all direct costs associated with running the business. | Gross Profit Margin is generally one of the most critical aspects for businesses with products or direct selling costs. Understanding its industry is important, and elasticity to price generally goes to sustainability. Are there threats to margins in the future? | High |
| Net Profit Margin | Net Profit<br>Revenue<br><br>Net Profit is (Revenue - COGS - Operating Expenses) | The net profit margin ratio compares a company's operating income to its net sales to determine operating efficiency. | A good initial reflection of performance, especially when reviewed over multiple years. Need to assess & explain the key drivers for Profit, taking into account all layers of the P&L. Benchmark to Industry where appropriate. "Normalise" the result by adjusting (+ / -) for any abnormal/personal/non-recurring P&L items. | High |
| Return on Total Assets | Net Profit Before Tax<br>Average Assets<br><br>Average Assets = (Current Period Assets + Prior Period Assets) / 2 | The return on assets ratio measures how efficiently a business uses its assets to generate profit. | Profit is Sanity but is generally relevant to the level of Assets used in the business. e.g. A profit assessed in isolation may or may not be optimal relative to risks or if there are higher levels of assets needed in the business to generate the profit. | High |
| Return on Total Equity | Net Profit After Tax<br>Shareholders' Equity | The return on equity ratio measures how efficiently a business uses its equity to generate profit. | Consider along with the Return on Assets. In larger businesses, this measure is always considered after-tax; however, in smaller businesses, tax circumstances can vary so it can also be calculated on a pre-tax basis. | High |

# b) Liquidity Terms

| Measure | Calculated | Used For? | Comments | Optimal |
|---|---|---|---|---|
| Current Ratio | Current Assets<br>Current Liabilities | The current ratio measures the ability to pay off short-term liabilities with current assets. | A relatively simple measure of liquidity. The critical aspect is to also consider the quality of the assets and how efficient they are. e.g., a current ratio of 3.0 may not be optimal if Receivables Turnover is 180 days. This will bias towards a higher (better) result. | High |
| Quick Ratio | Current Assets - Inventory<br>Current Liabilities | The quick ratio measures the ability to pay off short-term liabilities with quick assets. | A simple and quick measure of liquidity, this time adjusting for inventory which generally takes longer to turn into cash. The critical aspect is to consider the asset quality assets and the relevance of liabilities, along with how efficient they are in being turned over. | High |
| Cash Ratio | Cash or Cash Equivalents<br>Current Liabilities | The cash ratio measures the ability to pay off short-term liabilities with cash and cash equivalents. | Relevant consideration, especially where assets held are "inefficient". Consider both cash, availability of credit, and the financial support available outside the business. A relevant consideration is the dividend payout ratio. | High |

## c) Leverage Terms

| Measure | Calculated | Used For? | Comments | Optimal |
|---|---|---|---|---|
| Debt to Assets | Total Debts / Total Assets | The debt to assets ratio measures the relative amount of assets provided from debt. | Firstly, look at the quality of the assets. This ratio can be misleading if there are intangible assets, such as capitalised expenses or Goodwill. Also look for intercompany loans, unpaid dividends etc., that may be considered "quasi equity". | Low |
| Debt to Equity | Total Debt / Shareholders' Equity | The debt to equity ratio calculates the weight of total debt and financial liabilities against shareholders' equity. | A good initial measure, though perhaps not the most relevant measure for SMEs where retained earnings and other equity components are less material. Consider the results between comparable businesses. The lower the ratio, the better. | Low |
| Debt Service Coverage Ratio | EBITDAO / Total Debt Commitments | The debt service coverage ratio reveals how easily a company can pay debt obligations - both interest & principal repayments. | Must be considered in the context of the assets it is funding. For example, if assets are depreciating or income is less recurring, the ability to generate free cash now is important. The higher the ratio, the better - e.g. a DSCR of 0.80 means only sufficient EBITDAO to cover 80% of annual debt payments. Many businesses show strong ICR, but weak DSC. | High |
| Interest Cover Ratio | EBITO / Interest Paid | The interest coverage ratio shows how easily a business can pay its interest expenses. (ignores any principal reduction) | Similar to DSCR (does not add back depreciation/amortisation). Only considers the interest commitment instead of total interest & principal payments. Again, must be considered in the context of the assets it is funding. Typically used for assessing recurring income assets with longer useful lives (e.g. Property). The higher the ratio, the better e.g. a ICR of say 1.25 to 2.0 can be a minimum requirement for financiers. | High |
| Debt to EBITDAO | Total Liabilities / EBITDAO | Debt to EBITDA ratio measures the amount of income generated and available to pay down debt before covering interest, taxes, depreciation, and amortisation expenses. | A common servicing assessment, especially for service industries or businesses with consistent performance. For example, lenders may be comfortable to provide gross lending of up to 2.5 - 3.0 times a normalised EBITDAO. | Low |

## d) Working Capital Terms

| Measure | Calculated | Used For? | Comments | Optimal |
|---|---|---|---|---|
| Receivables (Debtors) Days | Average Accounts Receivable<br>Total Revenue<br><br>x by 365 to be expressed in days | Debtor days measure how long on average it takes for a business to get paid after an invoice has been issued. Can also consider using Average Debtors. | Firstly, look at the quality of the Customers and the Ageing analysis. This will tell you a lot about the business. Is there any economic dependency or concentration risk? This ratio can also be misleading if there are "Other Debtors" non-trade related. The lower the "Days" the better, which means there are higher turns per annum. | Low |
| Inventory (Stock) Days | Inventory<br>COGS<br><br>x by 365 to be expressed in days | Inventory days measure the average number of days a business holds on to inventory before selling it to customers. Can also consider using Average Inventory. | Look at the quality of the inventory, including the ageing analysis for slow moving or obsolete items. This ratio can be misleading if it includes items that are not moving. Consider the results between comparable businesses. The lower the days, the better. | Low |
| Accounts Payable (Creditors) Days | Accounts Payable<br>COGS<br><br>x 365 to be expressed in days | Creditor Days show the average number of days the business takes to pay its suppliers. | This ratio often shows both the culture and the performance of a business. The higher the days, the better for cash flow, but at what cost to the reputation of the business? Best business practice is to negotiate fair payment terms and stick to them. Delaying payments to suppliers (after taxes) is one of the first symptoms of cash flow strain. | Depends |
| Working Capital Days | Accounts Receivable Days + Inventory or WIP Days - Accounts Payable Days | Working capital days describes how many days it takes for a business to convert its working capital into cash. | Can tell a real story, particularly when assessing between accounting periods. Increasing investment in Inventory & Accounts Receivable can explain why a business may have Cash Flow issues and is requesting working capital finance. e.g. if Working Capital days are 100+ (80 days until inventory is sold - 40 days until the supplier is paid + 60 days to collect the invoice) this can place ongoing pressure on cash flow. | Low |

# APPENDIX 4: QUICK BUSINESS CHECKLIST FOR CREDIT PROVIDERS

When communicating with credit providers for the first time, it is vital to offer initial insights that give them an immediate sense of the business opportunity and its match to the Five C's.

These 15 quick questions can provide sharp insights before analysing business performance.

TIP: Communicate to the lender, in the simplest terms, what the business actually does!

| | | |
|---|---|---|
| 1 | Trading Business/Name | ABC Industries Pty Ltd |
| 2 | Primary Industry | Computer and Electronic Office Equipment Manufacturing |
| 3 | Business Location | 100 Collins Street Melbourne 3000 |
| 4 | No. of Offices/Locations | 1 |
| 5 | Years in Current Industry | 17 |
| 6 | Company Directors | Alan Smith, John Smith |
| 7 | Shareholders | Alan Smith (50%), John Smith (50%) |
| 8 | No. of Employees | 58 |
| 9 | Current Primary Bank | ANZ Bank |
| 10 | Tenure with Primary Bank | 12 |
| 11 | Financial Conduct | Excellent |
| 12 | Other Lenders | Westpac |
| 13 | ATO Conduct | Excellent |
| 14 | Description of Primary Need | ABC seeks a full review of its banking interests, and to also fund the purchase of a new commercial property in the South-East of Melbourne where a custom-built manufacturing facility will be constructed. Total funding requested for this expansion is $7.5M. |
| 15 | Brief Customer Background | ABC is an award winning and market leading manufacturer of computer products for all large participants. It has customers locally and across Asia and Europe, supported by long term supply contracts. |

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