

Golden Rules for Finance in Tough Times

LOOKING BEYOND EXISTING BANKING ARRANGEMENTS CAN LEAD TO MORE EFFECTIVE FINANCIAL STRUCTURES. STORY | **CRAIG MICHIE**

Typically the directors of Australian small to medium sized enterprises consider only one option when it comes to providing finance for the business – ask the bank manager! Management practices in terms of financing the business often reflect an over reliance on one source and style finance, this being finance provided by their existing bankers which is secured by property (often the director's private home).

Whilst a company's existing bankers may represent an important and valuable resource, often by looking beyond one source for finance and improving the utilisation of balance sheet assets, a more effective financial structure can be developed.

All businesses require access to key resources. Resources such as customers, suppliers, staff and importantly – finance. In the same way a well managed business will investigate strategies to maximise the return to stakeholders from customers, suppliers and staff, management should be reviewing its strategies in terms of financing the business effectively to meet the desired outcomes of the business.

Generally there are two fundamental outcomes that should be taken into consideration when reviewing businesses finances.

- Provide for the capacity to whether adversity.
- Ensure the level of finance available supports current trading levels and the capacity to grow when the opportunity presents itself.

Both of the above desired outcomes involve maximising access to cash, other parts of the overall strategy should correlate with its objective.

DIVERSITY

In nearly every aspect of business diversity is considered to be an integral part of risk management. Most businesses try to have a spread of customers, they try to have a range of key suppliers and may even have



strategies to diversify key management functions or put in place key man insurance. The one area that Australian businesses have typically not diversified in is financing the business.

There are several benefits of diversifying finance providers.

Different institutions maintain differing lending approaches and underwriting standards. These are often affected by the lender's existing balance sheet and exposure to particular industries or even geographical areas.

From time to time lenders make decisions to exit relationships with its borrowers. If

refinance is not able to be achieved then the results can be devastating for the business. Lenders may choose to implement accelerated amortization programs which can place additional pressure on the business. This can often lead to a greater deterioration in the overall solvency of the business and ultimately lenders may choose to take possession of its security – often the director's residence.

Refinancing is a difficult task to achieve

quickly. Often a business is asked to refinance by its lenders at a time when the business is experiencing trading problems and accordingly the business will be a less attractive proposition for new lenders. The more facilities with the one lender the more difficult the complete refinance can be to achieve. Any one business may have a range of facilities including working capital lines (overdrafts and trade finance), property finance,

equipment and vehicle finance and usually the director's personal home loans. Having a range of lenders in place will mean that there is less that needs to be refinanced. Hopefully it will also present some options for refinancing as new potential lenders may already have relationships in place. Therefore potential to refinance is significantly enhanced.

Diversifying the companies' lenders can also assist in achieving another key strategy SME managers should be considering – leveraging balance sheet assets and preserving real estate equity.

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USING THE BALANCE SHEET AND PRESERVING REAL ESTATE EQUITY

Most start up businesses will require significantly more support from directors and shareholders in terms of cash contribution or security. It is reasonable that a lender be provided with a position of comfort when requested to support as yet untried ventures.

However, as the business develops, greater opportunities are presented for the business assets to support business borrowings. Bearing in mind the varying costs of finance, ideally personal property should be excluded from securing business borrowings. Whilst this is not always feasible, it is an ideal that should be worked towards. Unencumbered real estate is widely considered the preferred security for lenders, accordingly having access to real estate that can be leveraged to raise cash provides for a strong fallback position in the case of an unforeseen adversity such as a bad debt.

Changes in the home loan market over the last 20 years have seen home loan products become much more flexible. Many smaller business people use home loans with redraw facilities or Lines of Credit to fund assets such as vehicles and machinery. This can be a practice fraught with danger as there are no regimented principal reductions associated with these types of loans, however, often the assets that have been acquitted using the funds depreciate significantly.

Accordingly, the business is not servicing the true cost of the assets and may not be in a position to pay for a replacement assets at the end of its effective life.

Generally speaking established businesses that are showing a profit should be able to fund these types of assets using equipment finance products such as finance leases and commercial hire purchase. Where the assets being acquired are not highly specialised and are saleable, these facilities should not

require additional security in terms of real estate, and finance can often be raised for the full cost of the asset's purchase price.

In terms of working capital, different businesses will have different requirements. Traditionally directors of SME's have offered mortgages over their homes to secure bank overdrafts in order to fund working capital

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requirements. This can be an effective way to fund working capital and is often the most economic. However, the practice does mean that personal real estate assets are encumbered and, therefore, not available to secure a fall back position etc. This practice does limit the working capital available to the equity in the property. Those businesses that have to acquire and hold stock and those that give credit terms to customers will generally need to have access to more cash to meet their working capital needs.

Those companies that sell on credit terms may have the opportunity to utilise debtor finance. Debtor finance provides access to a working capital line against the company's outstanding debtors, and can be very effective in terms of linking supply of cash to the asset which is driving the demand for the cash. That is, as sales increase the company's debtors would be expected to increase.

Accordingly, the company has more cash tied up in debtors, however, as the debtors grow the company is able to draw more funds from the debtors finance facility. Debtor finance will be more expensive than real estate secured overdrafts, and cost is, of course, an important consideration. However, the cost should be weighed against the potential benefits of freeing up real estate and linking the business with a more flexible source of working capital.

The funding of stock purchases can represent an even greater challenge

for companies. Many businesses have moved towards Just in Time (JIT) inventory management with a view to minimizing the funds tied up in stock. This practice involves limiting the amount of stock on hand and, where possible, obtaining a customer order up front for the stock being acquired. If terms can be obtained from suppliers, this can be

a major advantage in terms of managing cash flow and, where possible, should be maximised. However, with the continued decline of the manufacturing sector in Australia, SME managers are now importing product more than ever. Importing can place even more strain on a company's cash flow as the supplier often requires payment up front.

Funding stock purchases can be a harder proposition without the support of real estate security. Traditionally this has been funded by trade finance facilities (letters of credit and bills), and again often these facilities are secured by real estate.

There are a number of niche finance providers that can assist in this area and, as it is the case with debtor finance, the benefits in terms increased cash availability and flexibility should be weighed against the additional cost of the facility

Managers and directors should observe the following five basics when developing a finance strategy for the business.

1. Maximise cash availability.
2. Consider having more than one banking / finance relationship .
3. Leverage against balance sheet assets where possible.
4. Preserve equity in real estate assets.
5. Consider cash flow not just profitability when planning. ■

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