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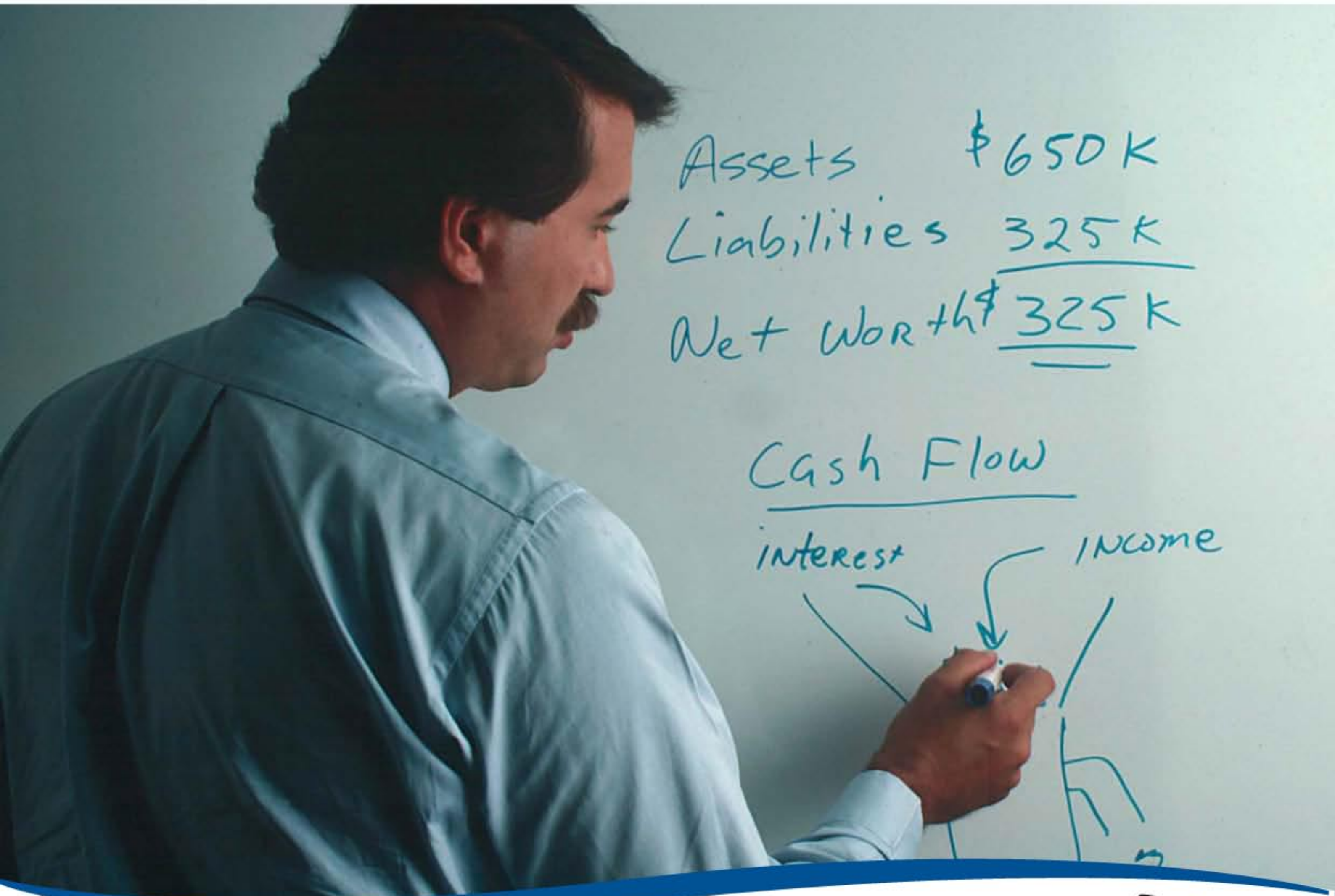
Financing your business

A guide for small business operators and those thinking about starting their own business in Tasmania.



Tasmania
Explore the possibilities

Department of Economic Development, Tourism and the Arts

Financing your business

DISCLAIMER

The information in this guide has been prepared with care, but no warranty, express or implied, is given as to the accuracy, correctness or completeness of the information, or for any advice given, or omissions from this guide. Therefore, readers relying on the contents of this guide do so entirely at their own risk and they should seek their own independent legal and financial advice. The information is provided to intended parties solely on the basis that they will be responsible for making their own assessment and undertaking such investigations as they see fit to verify all relevant information to enable them to come to their own conclusions.

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> *"Always work out the effective cost of a business loan, that is, base interest rate plus risk margin and fees payable and be prepared to negotiate".*
>
> Tim Laws, Partner, Animal Medical Centre Veterinary Hospital, Launceston

Overview

No business activity – whether it be marketing, sales, production, administration or planning – exists independently of the financial factors governing the operation. Finance is the ultimate business reality.

Careful preparation is essential when it comes to borrowing. It begins with a study of the financial requirements of your business and a matching of the appropriate loan facilities to those requirements.

Once the financial requirements have been identified, you need to 'sell' the business proposal to the financier. While a well-prepared business plan or loan proposal may be regarded as your passport to finance, your ability to obtain the loan on cost-effective terms that suit you will depend upon your negotiating skills in the loan interview.

Readers are advised:

- *The purpose of this guide is to provide general introductory information.*
- *The guide does not purport to contain all the information that would be relevant to any particular business opportunity.*
- *The guide is provided to interested persons on the basis that they will be responsible for making their own assessment of that opportunity with the assistance of the information provided.*
- *All figures contained in the guide should be regarded as estimates only based on general samples and may be subject to error.*
- *The information in the guide should not be relied upon in substitution for professional advice and individual investigation.*
- *Persons interested in pursuing any particular business opportunity are strongly advised to fully inform themselves by taking professional advice as to the extent of their rights and obligations – particularly in relation to any proposed investment.*
- *The guide is provided subject to the terms of the formal disclaimer, which appears on page 2.*

Determining financial requirements

The financial requirements of your business fall into two categories – fixed or permanent investment capital and working capital. Fixed or permanent investment capital is used to fund fixed assets such as land, buildings, plant, machinery, vehicles, fixtures and fittings. Assessing the requirements of a business for fixed capital therefore involves identifying all required items of expenditure in this category, determining when they will be required and totalling the cost of each.

The working capital requirements of most small businesses will revolve around five key elements – stock, debtors, cash, creditors and bank overdraft. The following checklist outlines the major considerations associated with each:

Checkpoint ?

Aspect	Amount required	How it should be estimated
Stock	Minimum necessary to support turnover	Relate to turnover by dividing annual sales at cost by the number of times stock is expected to turn over each year. (stock turnover)
Debtors	Minimum required to support credit sales	Relate to credit sales by multiplying estimated sales each month by percentage anticipated to be on credit.
Cash	Buffer for incidentals and emergencies	Relate to type of business and cash flow. e.g. if few cash transactions and ready access to short-term funds, cash on hand can be very low.
Creditors	Maximum possible, while maintaining good relations with suppliers	Relate to monthly purchases by multiplying estimated purchases at cost by credit terms allowed.
Bank overdraft	Realistic amount based on projected cash needs	Relate to cash flow – bank will expect facility to fluctuate fully from maximum utilisation to position when overdraft is not used and credit funds are in the bank account.

In the initial assessment of capital requirements and the resultant level of borrowing required, it may be that the borrowing necessary will be too high relative to the capacity of your business to service the debt.
This may make it necessary for the financial requirements and business strategy to be reassessed.
For example, second-hand equipment or a vehicle may have to be considered, the credit terms offered to customers may have to be reviewed, too much capital may be tied up in stock, an equity partner may have to be introduced or consideration given to contracting out certain functions.

Types of finance

The fundamental principle of financing a business is to match short-term finance with short-term needs, medium-term finance with medium-term requirements and long-term stable sources of capital to longer-term needs.

In many cases, this matching principle will result in a package of several different types of loans, tailored to the needs of the business. This could mean, for example, an overdraft for working requirements, leasing finance for plant and equipment and a term loan for stock.

The following checklist describes the most common types of debt finance available to small businesses and offers practical tips for their use.

Checkpoint ?

Type	Purpose	Tip
Overdraft	Short-term working capital needs or seasonal require-ments	Ensure it moves from overdrawn balance into credit regularly Do not use for long-term funding purposes Remember that an overdraft is repayable upon demand.
Commercial bills of exchange	Short-term, including seasonal requirements, bridging purposes and working capital needs	Interest is payable in advance Commercial bills are highly sensitive to interest rate fluctuations
Leasing finance	Lease of plant, equipment and motor vehicles	Working capital will not be depleted as deposit is not required Asset being leased becomes the "security" in most cases Negotiate repayment term up to five years, tailored to cash flow
Hire purchase and asset purchase finance	Acquisition of plant, equip-ment and motor vehicles	You will need to provide a deposit
Term loans	Purchase of land, buildings, plant and equipment; assist with set-up costs associated with new businesses etc	Negotiate fixed or variable interest rate and tailor repayments to the cash flow of your business
Personal instalment loans	Purchase of motor vehicles, equipment and any other worthwhile purpose	Are usually made available for modest amounts and are repayable by instalments May be secured or unsecured

Type	Purpose	Tip
Mortgage loans	Purchase of land, buildings and other fixed assets	Interest-only loans are obtainable from some lenders
Factoring	Injection of funds from sale of the receivables of a business at a discount	Usually only available to businesses with credit sales in excess of $200,000 per annum
Trade finance	Assist importers and exporters fund international transactions	Banks can also advise on the creditworthiness of overseas buyers Short-term and longer-term finance is available, tailored to need

Passport to finance - the loan application

The time, effort and expense incurred in preparing a well-researched and thorough business finance application are well worth it. There are four immediate benefits – it tells you where your business stands financially, it draws a quicker response from a lender, it is likely to result in a loan package which is tailored to the needs of your business and it helps to obtain the most competitive interest rate and fee structure available.

Many lenders have a standard form of application. While such pro-formas may not have to be used, the information provided should enable the lender to make an informed credit decision.

Checkpoint ?

Details required by a lender to assess a business loan proposal

- Short description of the business – history, past achievements, products and services, competition and market position, location and business structure.
- Brief details of your experience and background including trade and business references.
- Outlook for your business and the industry in which it operates.
- Amount and purpose of loan.
- Does the amount sought make allowance for unexpected events?
- What equity do you have in the business?
- Statement of your personal financial position.
- Balance sheet and profit and loss statement for the last three years.
- Analysis of major influences affecting operating performance over the last three years.
- Cash flow forecast for at least the next 12 months with a separate listing of the assumptions on which it is based.
- Listing of debtors and creditors dissected by age and amount outstanding.
- Repayment term desired.
- Security for borrowing.
- Names and contact details of key advisers to the business.

"Don't keep it in your head, put it down on paper. The more information you provide, the more effectively we can help you."

Tony Hastings, Commercial Business Manager,
Commonwealth Bank of Australia, Launceston

Are you a good risk?

If you understand what is being looked for by a lender, preparation of your finance application can be more effective and questions likely to be posed at the loan interview can be anticipated.

An easy way to remember the critical factors in a business loan assessment is the approach offered by the five c's – character, capital, conditions, capacity and collateral.

Checkpoint ?

Assessment factor	Issues addressed
Character	Honest, reliable, trustworthy Integrity Creditworthiness Track record, if any, in business Business skills and acumen
Capital	Financial strength Quality of assets Liquidity of assets Debt-equity ratio
Conditions	General economic outlook Conditions in your industry Implications for profitability and debt servicing capacity
Capacity	Ability to service the loan and meet other commitments Ability of your business to withstand a setback Your capacity to manage the business profitably
Collateral	Your willingness to pledge security Nature and acceptability of security offered Adequacy of security

Negotiating your business loan

Action	Tip
Be thoroughly familiar with your finance application or business plan	If you invite your accountant or business adviser to accompany you to the loan interview, answer all questions in the first instance. The lender will be seeking to appraise your business acumen and financial management skills.
Practise the language of the financier	By adopting and practising some of the more common terms, you will be seen as an experienced operator, well-versed in things financial and an able negotiator.
Develop a firm appreciation of the value of your business to the financier	Have, at your fingertips, full details of services utilised, services you may tap in the future and fee revenue generated by the lender as a result of its association with you. Use this information to win a point or obtain a concession when negotiations are under way.
Establish your negotiation strategy in advance	Determine what aspects of the financing arrangement are highly important to you (non-negotiable), what aspects you are prepared to deal on or seek trade-offs (negotiable) and what you are prepared to give up early to demonstrate a spirit of co-operation (negotiating issues of low importance).

Action	Tip
Determine the risk profile of your business	Identify the weaknesses of your business and where it may be vulnerable in the eyes of a financier.
Negotiate the interest rate payable	Choose between a fixed or variable interest rate. If variable, link the interest rate to a market indicator. Advance sound reasons to minimise perceived risk and seek lowest risk margin possible. Choose any fixed term with care. Seek ability to convert in future from variable to fixed or vice versa.
Negotiate the repayment schedule	Determine an appropriate repayment term suited to your cash flow. Consider interest-only finance where appropriate. Ensure repayment arrangement is flexible. Remember that the greater the frequency of payment of interest, the higher the return for the lender. Check whether repayments are required in advance or in arrears.
Negotiate the security arrangement	Is the loan to be fully secured, partially secured or unsecured? Where secured, ensure the security adequately meets the lender's requirements without being excessive
Negotiate the amount of fees payable	Determine once-only costs payable. Determine any recurring fees payable. Express fees as a percentage of the amount being borrowed to determine effective cost of borrowing. Be alert to prepayment fees if you repay a fixed-term loan early.
Negotiate other issues	Be prepared to negotiate the terms of settlement and covenants and restrictions such as future presentation of financial information, ability to borrow further etc.
Organise an interview with the financier	Be on time and be well-presented. Use the interview to demonstrate commitment, enthusiasm and business acumen.
Know where any deficiencies are in your proposal	Be prepared to acknowledge deficiencies but answer related questions in a positive manner.
Maintain effectiveness of negotiation at all times	Do not: - become aggressive or argumentative - be over-optimistic and disregard the fact that all businesses have weaknesses and are vulnerable to risks - expect the lender to have more faith in your business than you do.
Summarise the essence of your proposal at the conclusion of negotiations with financier	Indicate concisely the present and future financial needs of your business and demonstrate that you wish to build a relationship of mutual trust and confidence.

Maintaining a successful relationship with your financier

The financier to your business, whether a bank or some other financial organisation, plays a pivotal role in its operations and success. For long-term stability, an unofficial 'partnership' needs to be developed between you and your financier.

> *"Whether you are running an established business or just starting out, your banker will be one of your most important contacts. Regard your banker as an extension of your management team."*
>
> Tony Hastings, Commercial Business Manager, Commonwealth Bank of Australia, Launceston

The following practical tips are offered to help you maintain good relations with your financier:

Checkpoint ?

- Establish rapport and mutual confidence with the financier; if he or she is transferred, take steps to re-establish rapport.
- Conduct all business affairs professionally.
- Talk to the lender before making a formal application for loan funds; get to know the financier early before assistance is required.
- Do all homework necessary; determine precisely what the financial needs of your business are.
- Display initiative when applying for finance but avoid being aggressive.
- Keep your financier regularly informed on progress and developments with your business by providing accurate and timely financial information.
- Invite your financier to visit your business premises.
- Ensure your bank is competitive at all times; ask and shop around to make sure you are getting a good deal.
- Discuss important matters in person rather than over the telephone.
- If difficulties are encountered with a loan or a problem is foreseen, take the initiative and make an appointment to discuss the situation with the financier.

Summary

- Finance is the ultimate business reality.
- The financial requirements of your business are made up of working capital and permanent or fixed investment capital.
- The fundamental principle of business financing is to match short term capital with short-term needs, medium-term capital with medium-term requirements and long-term capital with longer-term needs.
- A comprehensive business plan or finance application is needed in support of any request for loan funds.
- The information provided in your loan application should be adequate for the lender to make an informed credit decision.
- A lender will assess your loan application having regard to character, capital, conditions, capacity and collateral.
- You can negotiate a cost-effective loan with a financier on terms and conditions that suit you with thorough preparation, knowledge of the financier's language, an appreciation of the value of your business to the financier and application of a skilled negotiation strategy.

Resources and contacts

- Australian Government Publishing Service, ***Presenting a Case for Finance*** (Managing the Small Business Series).
- Australian Government Publishing Service, ***Sources of Finance*** (Managing the Small Business Series).
- Talk to your nearest bank branch or telephone your bank's customer service or business customer enquiry line – refer telephone directory.
- Department of Economic Development, Tourism and the Arts
  Business Point
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  www.development.tas.gov.au