



Understanding Business Debt Funding

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Debt funding by a business should be used:

- to smooth seasonal and cyclical fluctuations in cash flow; and
- To fund planned development or expansion.

When debt funding for cash flow fluctuations or planned development or expansion, there must be an amortisation plan incorporated in the cash flow or capital sale to pay back the debt.

Furthermore there should be a plan ready in respect to contingent events such as death, disability or trauma of the Business Principal, to payout debt.

What follows is an overview of how banks operate together with a checklist of Business issues to consider when advising Business Principals of debt contingency funding.

Business Debt Funding Risks

Businesses that ignore the purpose of debt funding place themselves in a dangerous situation and they need to plan to urgently reduce debt.

Rather than doing all the right things—such as only taking on business which is profitable, using staff productively, attracting and retaining good staff but without paying them excessively, ensuring that prices keep rising to match costs and beyond, operating the business on the guiding principle of seeking maximum sustainable profit, ensuring that creditors are paid

promptly and that the billings and collections function is handled as it should be, and that growth is funded from cash flow—easy access to credit invariably leads to the wrong decisions being made by a business.

It is this exposure to unsustainable debt levels that ultimately becomes the trigger for the demise of many businesses. The unprecedented spate of capital raisings by iconic businesses in Australia in early 2009 emphasises how dangerous reliance on external debt funding could be. Equity was being raised at huge discounts, because debt levels had become too high.

Many public entities are likely to end up in liquidation because they are unable to tap the market for additional equity and will not be able to extend their debt facilities or meet demands from their bank to repay debt. All loans must be repaid and banks get very nervous if they form the view that they may suffer a loss.

What follows is an overview of debt funding and how financial institutions operate. Such an understanding will enable a business to fund growth. Furthermore contingent funding strategies can be put in place.

How Banks Operate

To understand how dangerous debt funding can be it is necessary to understand how financial institutions in particular how banks operate.



A bank's most important asset is its credit rating. If a bank's credit rating drops, its cost of funding increases and it becomes less profitable and ultimately less competitive in the marketplace. Banks such as Bank of America, Lehman Brothers and Royal Bank of Scotland ultimately failed because they were unable to borrow. That is to say their credit ratings were reduced substantially.

During the Great Financial Crisis Australian banks also faced reduced credit ratings. Without the Commonwealth Government Guarantee on all bank deposits, a number of banks faced the possibility of being unable to roll over their own debt. The credit rating of banks is determined by a variety of indicators, including their capital ratio, but primarily by the quality of their loan portfolio. For example, loans to owner occupiers of real estate where the loan-to-value-ratio is less than 70 per cent and which are performing (i.e. interest payments are up to date) would receive the highest rating.

Loans classified as being of higher risk would receive a lower rating. Loans to businesses which are unsecured by real estate are significantly riskier. By far the highest proportion of loan write-offs by banks over the last two years have been business loans.

When banks assess their own credit status, banks conduct a review of their entire loan portfolio and then plan to reduce exposure to riskier loans and riskier categories of loans. When this occurs, a directive will go out down the line to credit managers and then to relationship managers. For example, there may be a directive to reduce exposure to business loans within a certain

region or business category by 5 per cent. The result being no new business loans will be able to be granted within the particular market sector or region until after the reduction has been made. Furthermore, various individual loans will be picked out from the portfolio and the directive will go out to either arrange for the loan to be repaid in full or, to significantly increase the amortisation rate.

In such instances the real risk inherent in using bank finance for long-term funding of a business may occur. Hence in an environment where the lending competition from non-bank lenders and from overseas banks is all but disappearing, power has moved back firmly into the hands of the Big Four Australian Banks.

As such the Big Four Banks maybe far less interested in individual business than before. The Big Four Banks know that for several years to come, they will have more potential customers wanting loans than they have funds available to lend. A Business Principal must therefore take into account the change in the banking environment. To ignore such changes maybe fatal.

When a bank wants its loan repaid, it will do so on its own terms. If it assesses a business facility as being at risk, it is likely to move with great speed. A bank's power to recall or change the condition of its loan to a customer will inevitably be found in the Loan documents.

During a recession, particularly when the banking system itself has been at risk, decision-making power may move from a friendly relationship manager to faceless credit analyst and, potentially, to the Loan workout team.



Steps in Managing a Loan Portfolio

Firstly conduct a comprehensive review of all loan facilities, including equipment leases and corporate hire-purchase agreements. In many instances documentation may be a series of documents, not necessarily interrelated or easily understood. This is because the initial loan may have been made years ago and it may have been subject to possibly dozens of variations. In most situations, the variations may have been documented by letter and in other cases by formal agreements.

As a matter of prudence a request should be made to all financial institutions to obtain finance and security documents as well as variation letters they hold which currently affect the business facilities. Furthermore legal advice to fully understand the nature and extent of the exposure of the business and Business Principals should be sought.

Furthermore Loan facilities may be linked to mortgages held on properties owned by Principals. It may even be linked to properties owned by directors who retired many years ago. In many cases the security position of the bank will be alarmingly greater and more extensive than at first realised or exists in changing structures.

All "Monies" Guarantees

Many guarantee documents are 'all monies' guarantees. Rather than being linked to one specific loan, the more likely scenario is that the guarantee will extend to all facilities linked to that guarantor, including a spouse's credit card, vehicle leases, loans provided to the business, and all business debts. It is quite possible that the home mortgage

of a Principal, which may have been paid down over many years, may in fact be linked, in an oblique way but linked nevertheless, back to the business facility. Inevitably this could be a time bomb waiting to explode.

During good times, most people don't bother too much about the details. However, when times turn bad, the bank's legal team will start pouring over the fine print in the documentation and will ultimately take whatever action is required in order to protect the interests of the bank.

Most Business Principals would be shocked if they were fully aware of the degree to which the bank has secured their loans. For example, a wife or husband may have previously provided a guarantee to the bank in relation to the business loans and the guarantee has not been revoked. Hence in the event of the business loan going into a default position, the bank can, and almost certainly will, seize funds held in any personal accounts held by the spouse with the bank.

A business survival plan must provide for developing a comprehensive understanding of the level of exposure to the bank because only with this knowledge will it be possible to develop a pre-emptive strategy to deal with a problem loan. Waiting until the business hits troubled waters is far too late. The time to do this is when the business is travelling well. This advice applies to all businesses of all sizes.

Failure by many huge Australian businesses to understand the risks inherent in external debt has had devastating consequences for them. Such powerhouses as Rio Tinto, Wesfarmers and Pacific brands,



to name but two, have suffered immensely because of this failing. Other businesses such as, ABC Learning have disappeared because they had excessive debt and did not plan for the inherent risks of having such levels of debt. Strategies can be undertaken in order to lessen and even ultimately remove the risk.

Next week we review how a Business Principal can mitigate their situation in respect to Debt Funding.

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