

banking on debt finance

Debt financing for small business can be a tough process, so it pays to know what makes the banks tick.

Story Ben Power

During the GFC there was a widespread belief among small and medium-enterprises (SMEs) that banks had shut their doors to their business. Many SMEs also felt the banks were being unfairly tough with many demanding they put up their homes as extra security.

Global markets are reeling again, but banks are more happy these days to lend to SMEs. Yet while the banks are open for business, many SMEs are reluctant to borrow. Some were burnt during the GFC and others are intimidated by the complexity of borrowing. "SMEs have lost their appetite for debt," says Sue Prestney FCA, principal at MGI, which specialises in advising SMEs and writer of the Enterprise column in *Charter*.

But debt remains a crucial source of funding for business. It gives SMEs the firepower to grow, make acquisitions and increasingly to finance ownership succession.

For businesses which may need to tap debt funding to grow, it is crucial to get an understanding of how banks lend to SMEs, what is required to get a loan, who should advise you and how to strengthen your negotiating position is crucial.

"Ultimately it comes down to relationships and people and not just figures," Prestney says. "The bank wants to assess how good you are as a manager of your business. They will want to meet you and have confidence you look like a person who knows what you're doing."

Bank lending to SMEs ranges from overdrafts and lines of credit, which provide short-term working capital, to business loans which provide upfront finance to fund long-term investments. There is also specific financing available for particular needs, such as leasing and debtor finance.

During the GFC many banks cut lending to SMEs and toughened lending criteria.

Bank lending to SMEs has freed up but Prestney says the conditions under which they lend are still fairly tough. "They (banks) have a huge appetite for lending at the moment but the rules are staying the same – they're not freeing those up to any significant extent."

Carl Walsh, chief executive of accounting firm WHK Melbourne, says his firm has found a divide in the SME market when it comes to debt. He says the "Ms" – the medium size enterprises – want debt funding. But the "Ss" – the smaller firms with turnover less than \$2 million a year – are avoiding debt.

"The banks are making it difficult for Ss in particular," he says, adding that while banks are publicly saying they're freeing up lending "we're finding they're actually making it difficult for SMEs overall to get access to funding".

HOW TO GET FUNDING

Walsh says part of the problem is that many SMEs don't go about seeking debt the right way. So what is the right way? There are a series of steps that SMEs need to get right, including working out how much you need to borrow, what type of debt is required, who to approach at the bank, how to present the right information, how to provide the right level of security and hopefully securing the best terms by shopping around.

Some SMEs do choose to make finance applications themselves. "If they're going to do it themselves, then they have got to give it time," Walsh says. The key is to fill out applications so they're comprehensive, understandable and accurate. "It sounds very simple, but at a basic level that's not happening," he says.

Many SMEs choose to use advisors, either their accountant, business advisor or business broker. Walsh says many advisors are prepared not to charge for advice on debt applications. "I know in our business and a

lot of businesses like us, we see that as a value-add and wouldn't charge. I wouldn't underestimate the power of just asking."

The first step is to be clear about how much money you need, why you need it, and for how long you need it. "That should come from your business plan," Prestney says. "While banks will not necessarily ask to see a business plan, they will usually want you to provide three-way budgets which are budgeted profit and loss, cash flow and projected balance sheet."

Advisors can help with the second step: working out who you should be approaching at the bank. "We have relationships with most of the banks," Prestney says. "We know which people in the bank deal with what size clients and we know what each bank is attracted to and we know what sort of financing they have available."

Brendan Wright, NAB's general manager, small and emerging business, says SMEs should meet with a small business banker. WHK's Walsh says there is no harm in asking the banker for guidance, including things like what you need to emphasise or give more detail on in the application. "Bankers at the branch know more what their credit team is looking for than most people," Walsh says. "The person at the branch is incentivised to write more business. It's in their interest to help you."

The next step is to understand what banks are looking for. Wright says good quality, well managed and tightly run businesses with a clear strategy and sustainable business model will always enjoy the support of their bank.

As a general rule, lenders look at three key areas. Firstly, they assess the SME's ability to make a regular loan repayment. They then assess the business risk – the ability to ultimately repay the debt, factoring in any other debts which might already exist. Finally, they look at the level and nature of the security being offered if a business can't repay the loan.

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Prestney says knowing what the banks need helps with the application. "It's all about pre-empting what their questions will be and giving them everything they'll need to assess your business and whether you're going to meet their criteria in advance."

But she warns against trying to over-impress. "There's no point preparing a cash flow forecast to impress the bank that shows you don't need any funding," she says. "You'd be surprised how often that happens. Make sure the words and the numbers in your finance application work together."

PUTTING UP SECURITY

One of the big issues is security. WHK's June 2011 *SME Pulse Survey* found that two-thirds of SMEs have been required to use their private residence or personal assets as security for a loan in the past year. Walsh says it is very hard to avoid using the home as security. "There's no easy answer," he says, adding because of lack of

competition in Australia and the dominance of the big four banks "they can strong arm you into giving them the best security possible – your home".

Walsh said the banks like homes for loan security because it's easy to sign up as security and easy to value. With business assets "there's much more required to take them on as security", he says.

Prestney says don't offer up more security than you need. "They'll take whatever you offer," she says. "But you don't want to offer so little that there's no point in continuing the discussion. My advice is that - if you don't have previous experience in this process - consult a fellow Chartered Accountant who does."

SMEs, however, are not totally powerless and if they are a strong business they can negotiate. Prestney says it doesn't hurt to be talking to a couple of banks at once. "But much more than that and it gets complicated," she says. "Banks do a lot of

work assessing these things. You don't want to get them offside by sending them on wild goose chases."

Walsh says the strongest negotiation lever is threatening to leave the bank. But he says many SMEs have multiple accounts with banks. "To threaten to leave the bank is difficult because they have all that tied up with the bank," he says. "To leave is complicated; it's time-consuming and is not easy in Australia. There's a stress and time factor in moving." Walsh says smart smaller businesses spread their business.

Borrowing from banks doesn't have to be difficult, particularly if you have a strong, well managed business. "But it's one of those things where you just shouldn't do it on your own if you only have limited experience in finance applications," Prestney says. "If you're in doubt, get advice from a fellow Chartered Accountant with a track record in obtaining finance for businesses; as much for their network as for anything else." ☺