How the start-up process works for an SME... | by Russell Sharp

SME Advisory

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Turning Dreams to Reality ...

Most soon to be business owners start with a dream – a dream of being business owners or entrepreneurs, a dream of a new lifestyle and income levels.

As part of that process, it is critical those individuals have done their homework. To realise your dream you must have a strong understanding of the business you intend to buy, the drivers of that business, the returns generally experienced in the industry, the usual working structures, cash flows, and overall operations.

From there, the key to turning that dream into a reality
is answering key questions like the following:

- What capacity have you got to buy a business?
- What equity and cash have you got to put into
  the transaction?
- If the business type has a bank standard for lending e.g. for the accommodation sector, depending on the debt service cover, banks will generally lend 30% to 60% of the value of the purchase price.
- If you go to buy a business, let's say you will be getting a return of $250,000 a year, is that enough to meet your financial goals and commitments personally?

Once that analysis has been done, we can identify the potential businesses you have the capacity to buy. From there, you are enabled to go out and find
the right business for you and hopefully, make and get an offer accepted!

Next, once the offer has been accepted, the loan process begins with the lender of choice and legal and accounting advice confirms direction.

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For example, in the accounting sphere there are several matters to deal with for example if we are increasing borrowings for an individual or family, it is critical to secure income and higher levels of asset protection. Further it's key to get the accounts set up on a strong system and make general preparations for the business to begin or take over.

While that's happening work begins on the loan approval. From the moment the offer is accepted to when settlement occurs is an average of approximately 90 days. MPR Finance can assist with:

- Business/franchise purchase
- Additional site expansion and development
- Refurbish or Move the business
- Capital expenditure
- Additional stock
- Working capital
- Personal requirements e.g. home or investment loans
- Ensuring sale and purchase ready.

Frequently Asked Questions

What can a person borrow? What is the lending to equity ratio?

Debt Service Ratio
Generally a bank looks at what's called your 'debt service ratio' or DSR – that is calculated as the expected business profit less your tax, then less your loan repayments and if they can see that you cover the
debt by 1.5 times, they will generally lend.

Example:
Expected business profit
Less loan repayments X 1.5

So this question is: can the business make 1.5 x the principal and interest repayments as the total amount. what this means is for example, if the principal and interest repayments were $100,000 for the year, the bank would want to see that the business could pay back $150,000 per year – just to manage their risk, this allows for a margin of error if business slows.

Benchmark Interest Cover Ratio
Next, there is what's called the 'benchmark interest cover ratio' or 'ICR', ideally the banks generally want it to be above 2.0, that is, 2 times. This question asks: can the business support its interest bill? For example, if the interest is 8% and the banks want 2 x that figure, they then want to see that the business can support a 16% interest cost.

Example:
Interest rate 8% on $1,000,000 = $80,000
X 2 = 16% on $1,000,000 = $160,000

So, how do these figures work together?
If you have an interest cover ratio of 2.0 and you had a debt service ratio of 1.5 – they would generally lend.
The higher the interest cover ratio and debt service ratio, the more the banks will lend. If your figures calculate to lower than 2.0 or 1.5 respectively, they may lend but the amount that could potentially be borrowed would likely be lower.

Bottom line: you want to get the best possible debt service ratio and interest cover ratios as possible.

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However …

It is variable and often also depends on security.

Generally, the bank will lend between 30% and 60% based on the factors of your 'interest cover ratio' and 'debt service ratio'. The stronger you can make those figures the more they will likely lend. To make that happen reducing personal borrowings may be required.

What information is required when preparing an application for finance?

- The current business or franchise must provide:
- Profit & loss for the last 2 to 3 years
- Balance sheet last 2 to 3 years
- Various individual information
- See 'finance checklist'

How do the banks qualify lending money?

- See the 5 c's mentioned in the article 'when looking to borrow – what do the banks want?'

A Quick Tip for Sellers!

As a seller if you want to sell the business, it can be a great exercise to work out the lending or funding viability of the business for an 'average person'. You would need to consider:

- Their likely home loan situation and debt levels
- The term of their lease.

For example, the business might have 3 years left on lease but bank won't lend outside the lease term, in thinking about the sale of the business and its viability for someone to purchase you would have to factor that in.

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