Australian Bankers' Association Inc.

Fact Sheet

Refinance your business debt

For many small businesses the initial financing arrangements put in place at start up are still in place many years later. For example, a company starts off with a simple overdraft facility and may arrange for several modest increases in the facility overtime, without consideration of the suitability of the debt arrangements to its current and future needs or the cost/benefit of the facility.

Small business owners and their advisers should review existing debt finance arrangements on a regular basis. This ensures that the finance facility and structure fits the current needs of the business.

This fact sheet will discuss the areas that small to medium-sized businesses need to consider when undertaking a review of existing debt finance. It has been prepared by the Australian Bankers' Association and CPA Australia.

TO THE POINT

- Refinancing is essentially where the existing debt facilities are replaced with new facilities that provide more suitable arrangements to the business.
- The replacement of existing facilities can involve various alternatives to the original debt facilities, such as new facilities with the existing financial institution, or with new financial institutions
- Refinancing should only be undertaken after a thorough cost/benefit analysis of all options available
- It is important to understand all the implications before refinancing
- Refinancing may provide a range of new opportunities for your business
- When considering changing financial institutions, make sure you speak to your existing financial institution to see if there is an opportunity for them to offer similar services and facilities

UNDESTANDING THE JARGON

Dealing with money and banking involves lots of words and terms that you might not have come across before. In this fact sheet, we provide a simple guide to some of the common words that you might encounter when dealing with your financial institution.

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Risk: The meaning of 'risk' varies according to whether you are the borrower or the lender/investor. As a small business seeking a loan, risk would be the chance you take in borrowing money, and being able to repay it. You may "risk" your business or even your family home to support your business finance opportunity. As a lender or investor, 'risk' means the gamble taken to support your business, usually risking the repayment of the loan principal and the interest payable on it.

Security: In the legal sense, 'security' is a right against a particular asset belonging to another; for example, the financial institution may hold security over the home of a small business owner as collateral for a loan. A creditor without security has rights only against the debtor (or borrower), not against any specific property.

Cash flow forecast: Sets out all expected payments and receipts in a given period and helps the business to be aware of their future borrowing needs (in order to cover projected cash shortages). Forecasts should include all assumptions used to arrive at the projected cash flow, for example an increase in sales of 10%, and the factors supporting the assumptions

Cash reserves: Cash put aside or kept back by the business, sometimes for a special use.

Capacity to repay: The determination made by a lender on whether a borrower can repay a loan after examining financial statements, financial ratios and operating data.

Credit history: A record of an individual's or a company's past borrowing and re-paying behaviour. Your credit history is contained in a credit file and it will include credit applications and enquiries you have made during the past five years; records of some current credit accounts; overdue accounts (defaults) which may have been listed against your name; bankruptcy information; judgments; and public record information such as Directorships and Proprietorships.

Debt facility: Also called a 'loan facility', it is maximum amount a lender has permitted a borrower to borrow. The borrower can borrow **up to** the maximum amount and interest payable will only be on the amount actually borrowed rather than the full amount of the facility (unless the borrower has borrowed up to that full amount).

Interest cover: Determines the actual cash available to service the interest payable on debt, taking into account possible fluctuations in interest rates over the life of the loan and assuming full use of the loan facility.

Loan to Value Ratio (LVR) - This establishes the maximum size of a loan a lender may be prepared to make by applying this ratio to the value of a business asset offered as security. For example, if a factory is valued at $500K at an LVR of 65%, then the bank may consider a loan/facility of up to $325K (0.65*$500K)

REFINANCING YOUR DEBT FINANCE MAY INVOLVE:

- Changing lenders but retaining the same debt products
- Choosing different debt products to fund the needs of the business with the same or a different financial institution
- Combining debt into a single facility or product

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- Increasing or decreasing the total amount of the borrowing as part of the refinancing
- Changing the repayment amount or timing
- Increasing or decreasing the security offered to the financial institution/s

HOW REFINANCING WORKS

Refinancing involves replacing an existing debt facility with a new debt facility. The new funds are used to pay out your existing debt facility. Refinancing could involve using a new lender or changing what debt products make up your facility or increasing the maximum amount of the debt facility the business can access.

The key reasons why a business may choose to refinance could include:

- More debt is needed to finance an expansion of the business for growth, operational or strategic reasons
- Gaining a lower interest rate from a different lender or from a different mix of debt products
- Switching into a fixed or variable interest rate product
- Gaining more flexible features in a debt product to meet your business needs
- Increasing your overall borrowing with a new debt facility
- Changing the financial cash flow commitment required to fund debt (e.g. fully drawn advance to an overdraft)
- Consolidating debts to minimise and simplify repayments
- Releasing security over personal assets and/or specific assets as the business reaches a level of maturity at which point it has independent security to offer

ISSUES TO CONSIDER WHEN REFINANCING

Following a thorough review of the business's plan and current debt arrangements, you may find that there is a strong business case for refinancing the business. This process should not be undertaken lightly, as there are many issues which should be considered as part of your review.

It is important to undertake a thorough review of your business' circumstances prior to making any commitments for refinancing. When a business refinances the following issues can be either overlooked or not comprehensively considered:

Under-estimating the cost of paying out your existing debt facility

Your existing facility may have exit fees which could outweigh any future interest savings. Usually exit fees are charged by lenders if the mortgage or other debt facility facility is terminated or refinanced early, in other words, terminated before it maturity.

Deferred establishment fees may also apply on exit (which means the business had the advantage of not paying these fees up-front when the loan was established).

Fees which apply to loans are disclosed by banks in the terms and conditions of the debt products. If you are unsure of what fees will apply if you repay your existing debt facilities before maturity, contact your financial institution to discuss..

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Under-estimating the costs of establishing a new finance facility

Changing to a new lender (as opposed to a new product with the existing lender) may require additional costs such as application, documentation, valuation (to value your security assets) and mortgage fees, stamp duty on a new mortgage and settlement fees. If your new lender is keen to get your business you may be able to negotiate a waiver of some of the costs as part of the package.

These fees are disclosed by banks in the terms and conditions of the debt product. It is recommended that you discuss the fees that apply with the lender when discussing any new facility.

Not fully understanding how your current facility supports business operations

Often business's will have a number of different facilities with their financial institution and it is important to understand how these facilities support your business operations and how your personal or business assets are used as security for these facilities. For example, your existing financial institution may provide an overdraft facility using security over your residential property as well as facilities to support retail operations such as an EFTPOS/credit card facility and access to an automated payroll system to transfer funds into employee bank accounts. In the event that you change financial institutions to one that does not have such retail facilities, you may find that the business no longer has sufficient security to guarantee the payroll processing facility with your financial institution, possibly impacting on your ability to pay your employees.

Changing lenders before a firm letter of offer is provided

Before you commit to changing financial institutions or product, you need to ensure that you have a firm letter of offer in place and not one that is 'subject to' satisfactory valuation or a third-party validation (such as a mortgage insurer). For example, different lenders may apply lower or higher valuations of your property depending on the value used or the current market conditions, which may impact the maximum amount of the debt facility (and may be lower than your needs).

Impact of leaving a long-term relationship with a financial institution

You need to assess the strength of your long-term relationship with your current financial institution. Are there some intangible benefits to the business because, for example, the current provider understands your banking and business history in detail, which you may not be afforded in a new relationship?

BENEFITS OF REFINANCING

After carefully undertaking a cost/benefit analysis and evaluation of refinancing for the business, you may find that there are a range of new opportunities for your business's refinancing requirements. These opportunities may include:

New perspective based on your current position and not the past

You may find that a 'fresh start' with a new financial institution may not carry any of the long-term pre-conceptions which your previous provider had. These may have included a poor trading period in earlier years or a particular experience they have had with another customer in your industry which has negatively influenced their lending decision-making for your business.

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Access to increase in debt finance

Refinancing may also result in increasing the finance available for business growth. You should ensure that, in taking on additional debt, the business can service the higher debt commitment and that the investment of the new finance is targeted at achieving a higher return for the business.

Consolidation of debt funding/cash flow savings

There is often an opportunity to combine a number of ad-hoc debt finance arrangements into a single product to simplify repayments and to potentially reduce your monthly cashflow repayment commitment. This may also be achieved by changing from a principal/interest product to an interest only product or using a leasing product.

For more information on debt products, see the "Applying for a loan" fact sheet.

Restructuring security offering

Refinancing may also provide the opportunity for a change in the security required to support your debt facilities. It is possible that over time the value of security (assets) that were provided to support the existing facilities has increased at a far greater rate than the level of borrowing. As part of the refinancing review, consider what level of security assets will be required.

Refinancing a strong healthy business may also mean that there is an opportunity to separate your personal assets from security offered if the value of the business assets are sufficient to cover the borrowing (i.e. commercial land and building, debtors, fixed assets etc).

TIPS ON HOW TO COMPARE FINANCIAL INSTITUTIONS

A good relationship with your financial institution is crucial to your business operations and in many cases, the financial survival of your business. Financial institutions are vital to the financing of your business and a good relationship can help the business negotiate improved terms. Even if you are satisfied with the service quality of your financial institution, you should still meet with the staff once a year to discuss your business requirements and areas of improvements in products and services that your business could use.

If you are not happy with the service of your financial institution, you should review all of your accounts and facilities. What you should not do is to quit your financial institution for another, without comparing the services provided by your current provider with the new provider.

To help you review your accounts and facilities, follow this step-by-step guide:

1. Create a list of all accounts in your company

In this list, you should include what the account is used for, account details such as branch, BSB, account number, account name, and any special arrangements with each account such as funds sweep to another account or set-off arrangements. All social accounts, old companies, branch accounts, petty cash accounts and special purpose accounts should be included. This information can be taken from your statements or by asking your financial institution/s or your staff. You may be surprised at the number of accounts you have of which you are unaware of.

2. Obtain a letter of facilities

Request a letter of facilities from all the financial institutions with who you do business. The aim is to build a complete picture of all your financial arrangements with all of the business's financial institutions.

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In your letter, you should ask the financial institution to ensure that all facilities are covered, including:

- Credit or purchasing cards
- Merchant facilities
- Trade facilities
- Lease facilities
- Any information on loans
- Letters of credit
- Internet banking
- BPay
- Cheque cashing
- Deposit accounts
- Transaction accounts

3. Review options

When selecting a new financial institution, the decision can be based on any criteria such as the types of transactions, the quality of service, friendly staff, convenience, or pricing sensitivity. Don't forget to approach your current financial service provider to see if they want to match or better the offer from others

4. Finalise decision

Make sure you understand the costs and benefits of moving to another financial institution before the final decision is made. If you do choose a new financial institution, work closely with both the old and the new financial institution to make sure the process goes smoothly. You may wish to keep some of the accounts open at the old financial institution for a couple of months, just in case you have not notified all clients of your new financial arrangements.

Created: October 2009

Internet: www.bankers.asn.au Phone: 02 8298 0417 Fax: 02 8298 0402

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