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Debt v Equity
and Vendor Finance Explained

Is it just me or are these editorials coming around faster every month ? After more than 10 years writing industry articles and analysis it occurs to me that I have no more to say. Then I am reminded by those who know me well that I believe everyone is entitled to my opinion so here we go with this month's gems of admittedly questionable wisdom.

It seems that in this quite buoyant (some might say bullish) market lots of buyers are interested in getting into accommodation businesses that they cannot afford on their own. Obviously one way of achieving this outcome is to find some investors, create a partnership and go shopping. Certainly if you fall into this category as either active operator or investor we can help in terms of managing the entire process on your behalf. A word of caution however. Only experienced managers need apply. The clear message from the investors we talk to is that the managing partner needs to have a demonstrated history of successfully operating within the accommodation sector. Partnership transactions work best with large net profit assets and these are typically not the sort of businesses that should be taken on by the inexperienced. Yes, there are exceptions but the message from investors in the market is clear.

So, you have found the right property, you have come up short and it's not a partnership play. No problem, the vendor will leave some money in. Here comes the critical question. Is the vendor leaving money in as debt or equity? In other words, is the vendor intending to become a silent partner with the money left in being his equity or is he intending to become a creditor. By the way, I use the male reference (his/he) with no offence to the ladies. I just can't seem to get the PC stuff right !

You may ask, Who Cares ?............ and what's the difference anyway. Put simply equity does not create a payment obligation and debt does. Most importantly the banks have gearing ratios that they don't like to exceed. For management rights its 70%, for motel leases 50% and for freeholds 65% to 70%. There are good and prudent reasons for these policies. Economic cycles can impact demand, asset values and interest rates and these factors can all have a negative impact on gearing and debt servicing capacity. If you borrow 70% from the banks and the vendor leaves 15% in as vendor finance you are geared at 85%. If the banks thought that was a great idea they would lend the 85% themselves and make more money out of the deal. In effect the borrower is servicing gearing at 85% and generally vendors (as second ranked creditors) want a return that's higher than the rate the borrower is paying to the bank. To put it simply, the bank is comfortable with the asset geared at 70%, if vendor finance takes notional gearing higher then the bank gets less comfortable.

To add to the challenge of vendor finance most vendors only want to leave money in for a short period, typically 1 to 3 years. At the end of the vendor finance period they want their money back. So, the operator not only has to service 85% gearing, they also have to put enough money aside to pay the vendor finance out in a short period. The cash flow scenario that flows from this situation seldom works and seldom finds favor with the banks.

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All is not lost however. Should the vendor decide to leave money in as equity then no debt obligation ensues. The vendor simply becomes a minority shareholder in his business and the buyer becomes the working partner. There is no debt service obligation as dividends are only paid to the owners once all obligations, including bank interest, are met. Gearing stays at bank comfort levels and all is well. Of course, it's not quite this simple, particularly if the vendor is heavily geared and needs full sale proceeds to clear current debt but in a lot of instances this scenario can work quite nicely.

Finally, a quick word on gifts. Long story short, its fine for a friend or family member to gift you some cash (inheritance in advance perhaps) to put toward your purchase. However, it's got to be a gift and the bank will ask for a statutory declaration to that effect. If the gift turns out to be a loan it will most likely turn up on your accountant prepared balance sheet and profit and loss as a non-current liability and interest cost respectively and the bank will find out at your first annual review. Not something I would recommend. If the gift has a condition that it be paid back when the asset is sold that's fine. It's also fine to have a hybrid equity / gift arrangement and we are happy to talk to clients about this strategy.

Until next time I'll leave parting words of wisdom to this old American proverb:

"Before borrowing money from a friend, decide which you need most."

Disclaimer : This article does not constitute investment advice. We are not financial advisors nor do we hold an AFSL. The percentages and concepts used are for illustration purposes only and should not be relied upon in any manner. Parties contemplating the purchase of any business or any investment should consult their professional advisors.

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