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fresh ideas...

Is It Getting Harder to Sell Smaller Management Rights?

Rules are interesting. Some think the more rules the better while others subscribe to the school of discretionary decision making. I am a fan of some common sense latitude in most decision making processes, particularly those involving the individual merits of a finance application.

It is true that many cry out for absolute certainty in all things finance. Problem is, hard and fast rules will inevitably gravitate to a lowest common denominator environment where we will all be compelled to walk as slow as our slowest borrower. Have a look at some of the people giving evidence at the banking commission and I would propose that we will be walking very slowly indeed.

Post GFC we slowly moved to a fluid credit environment where broad based principals of prudent credit policy were overlaid by the discretionary powers of credit managers to make decisions reflecting the specific circumstances of the borrower and the transaction. Thanks to our friends in government and to the banking enquiry, those days are, for the time being, over. The enquiry is shining a very bright light on so called dodgy lending practices and placing significant weight on evidence being given by borrowers who feel they have been badly done by. That would be borrowers who happily took the loan but failed to take the responsibility that comes with it.

The banks are taking a lead from the commission and even before the findings are finalised have acted knee jerk like to ensure they please the regulators. As a result, borrowers need to fit a very specific box with little wriggle room to accommodate individual circumstances. The so called common sense credit decision is out the window, replaced by a rule book driven, tick all the boxes approach.

This is bad news for small business given that access to credit on reasonable terms is a primary driver of value for these operators. The simple economics is that the less people who can access credit = less potential buyers = lower demand = lower prices.

While the current situation is certainly impacting small businesses of every sort our obvious focus is on accommodation assets and in this case smaller management rights specifically. For the purposes of this discussion I will focus on rights with lower net profits (say <$150,000) and a balance term on agreements of less than 15 years.

Let's say you are a vendor and, having listed your property, an interested party comes along. They have been doing some research and have it in mind that 70% gearing is available. Here are a few of the more important hoops they need to jump through for finance.

Demonstrated debt servicing assuming interest rates go up 2% (as high as 3% for some lenders) on a Principal and Interest basis for all debt. That's any current debt plus what is being borrowed to buy the rights. If an interest only period is being required, then it's P and I at the higher (so called sensitised rate) over the balance term of the loan. Put simply, if the loan term is 10 years and a 2-year interest only period is being requested then the borrower has to be able to pay off the loan over 8 years at the higher rate. For many deals the maths doesn't work so no interest only is available. Strike 1.

Maximum loan terms are generally 15 years or the balance term of the agreements, whichever is the lesser. This is not always the case depending on the bank but more often than not these days. Balance term of agreements = total loan term so anything less than 15 years puts additional pressure on debt servicing. This can sometimes be mitigated to some degree by longer finance terms against

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notional real estate secured portion of total lending, but this is getting harder. It amuses me that banks may limit debt to 10 years because that's what agreements say but will do a 30-year home loan for a borrower with not much job security past the next company restructure. A strong history of agreement top ups used to carry the day, not any more. Strike 2

And now, the next hurdle. Living expenses are no longer allowed on a benchmark basis. The commission have made a big deal out of banks making standard allowances for living expenses. Until recently an allowance of say $40,000 for a couple and $5,000 for each dependent child was pretty normal. Now every borrower has to do up a personal budget which must be used in debt service calculations. This makes perfect sense to me for PAYG employees, but it becomes challenging for self-employed borrowers. There has always been a blurred line between personal and tax-deductible business expenses, so some common sense and discretion is required when assessing business debt service ratios. Sadly, the new rule book fails to cope so arguing the blurred line is becoming very challenging. Strike 3

Tax strategies and deductibility are becoming equally difficult to argue. While we see any number of legitimate tax strategies in play the banks are choosing to apply the new rules in a truly bizarre fashion by deciding to ignore the benefits of effective tax planning. The outcome is that lender allowances for tax obligations regularly exceed the actual tax that most of our clients will pay. Given that debt servicing must be proven after living expenses and tax we have, unfortunately, arrived at Strike 4.

I could talk about numerous other side issues such as the banks starting to cap loan terms to notional retirement ages, but I think you get the picture.

The inescapable outcome of the current situation is that 70% gearing for smaller management rights, particular those with 10 year terms, is becoming extremely hard to obtain. Unless the buyer has substantial external income (one partner works outside the business for example) I think the more likely gearing ratio will be 60% to 65% maximum. The obvious temptation for some buyers will be to take their available equity and buy a bigger business where 70% gearing might be available rather than put more into the deposit for a lower net profit and a lower return.

Ultimately, I suspect this is all about price. All things being equal every building has a debt level it can sustain. That might be 70% gearing, it might be 50%. The important thing for vendors to understand is where their building sits and what that might mean for value and demand.

My personal view is that lending to standard module management rights with strong top up histories provides one of the lowest risk small business opportunities for banks. Let's hope our friends in government understand the dynamics at play here and don't allow the extremely small number of bad apple cases the commission has uncovered to negatively impact us all.

Something about babies and bath water springs to mind.

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PS : If you would like to know what gearing your business can carry or what price you need to be at to carry 70% we are happy to provide this analysis free of charge. Only you know what you expect but it's always good to know what the numbers tell us.

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