TIPS FOR FINANCE

Management rights finance

Financing management rights purchases get harder and more complex each day.

A buyer needs to realise that the banks have a range of different policies and different appetites for certain deals depending on location, buyer experience, type of management rights, size of the transaction, agreements, etc.

PCS Finance have used at least six banks consistently over the past 12 months, which gives an indication of the range of finance available.

Just because your financier doesn't like a deal for some reason, doesn't mean another won't do it. This goes for brokers as well as banks. It never hurts to source a second opinion.

Another issue that buyers need to be aware of is that when a bank is undertaking its own due diligence, valuations, etc., it's primarily for the comfort of the bank and doesn't necessarily mean the buyer is being protected. Again, important for the buyer to have independent advice where possible. The banks, to their credit, are however starting to be more proactive where they see income and prices being inflated, which may make it difficult for the purchaser to sustain the income and value of the business being purchased.

It's very important to use an experienced management rights finance broker or banker.

Some differences between Banks requirements and policies:

Lending ratios: Range from 60 percent to 70 percent of the contract price

Repayments: Some banks will write interest only loans, terms range from 1 to 5 years, while some banks want Principal reductions from the outset.

Termination clause: Ranges from no action required to needing the agreements amended.

Buyers' experience: Varies greatly between lenders.

Interest rates: Varies between 4.5 percent to six percent. Depends on the lender, deal size, risk profile, etc.

Location: E.g. Few banks will lend South of the boarder.

Many more factors come into play,

but this gives you an idea.

The biggest problem at the moment is the time it takes for banks to process applications. An average finance timeframe of 21 days has increased to around 60 days in the last few years.

One of the main reasons is the time it takes to have a valuation completed. A valuation report can take anywhere from three weeks to three months.

The other problem is the extensive regulatory environment the banks have to operate under in the last couple of years; anti-money laundering, overseas tax evasion, and APRA (Australian Prudential Regulation Authority), to name a few.

I wrote to the treasurer, Scott Morrison MP, to whinge about the how the intensified prudential supervision of APRA will slow down business investment in this country.

In his reply, he pointed out that the government has cut red tape by $5.8 billion worth of savings. I'm not sure where they end up but certainly not in this industry. Also, the government has freed up the requirements for banking licenses, so we may see more competition in the market. I really don't believe competition is the issue as the banks are all keen on doing the lending and it's a very competitive environment already, we just need to jump through all the regulatory hurdles. Being a banker was way easier back in the day.

Tips for new buyers:

When shopping around for a management rights, check with your financier what you can afford. Just because you have the deposit doesn't mean the bank will approve a loan, serviceability comes into play as well. The banks have become quite conservative with their serviceability requirements.

You need an industry accountant to verify the income, but this is not the end of the story. Just because the income has been earned by the vendor doesn't mean its sustainable for the buyer.

Industry averages need to be taken into account for each income item, so read the accountants report and check the written comments. The banks and their valuers will change a profit and loss if they believe the income is overstated or the expenses are understated.

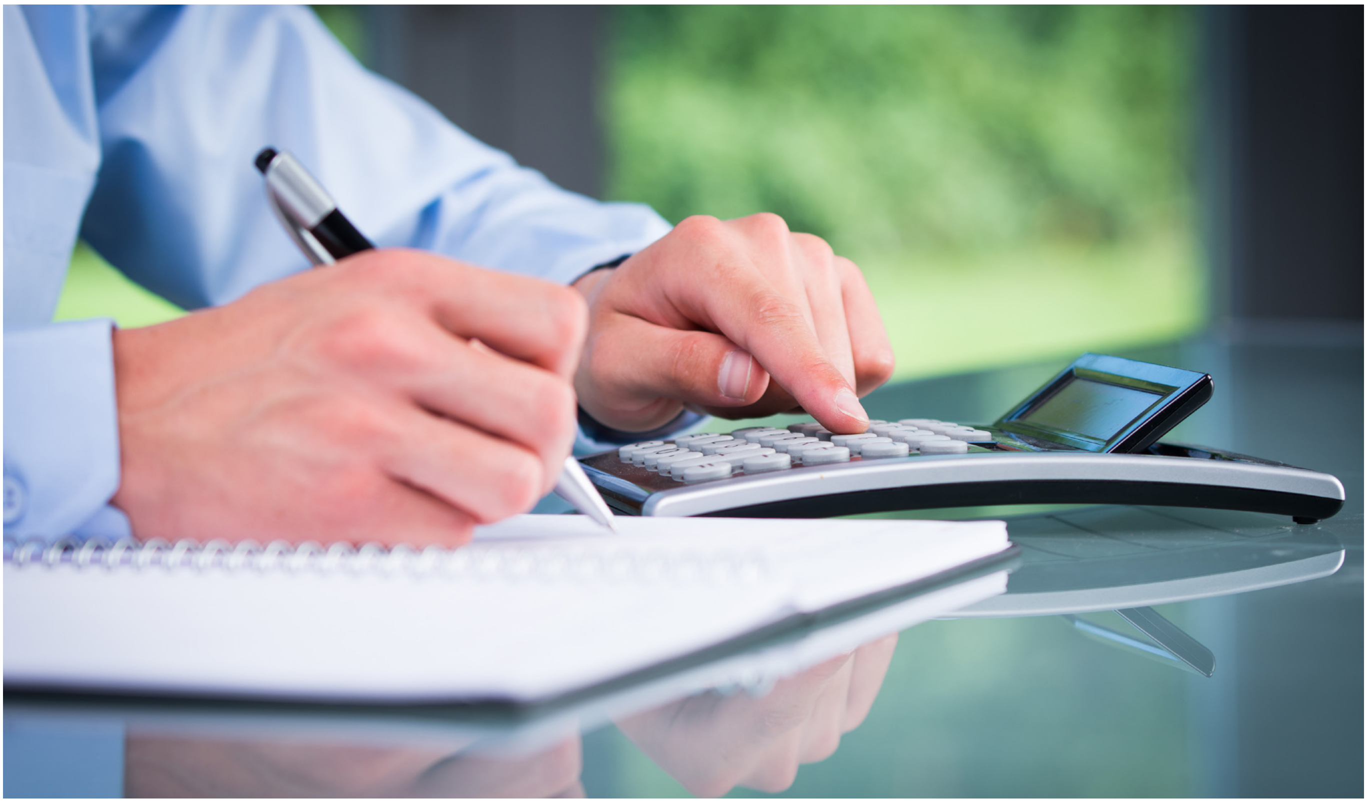
Examples:

- Staffing allowances can be under stated;
- Leasebacks, also called performance guarantee units, need to be scrutinised for sustainability;
- Profiteering on advertising;
- Cleaning margins: a high margin would indicate underpaid staff;
- Repairs and maintenance: income must be repeatable year-by-year;
- Credit card income: Needs to be set up properly in the letting appointment.

Just to finish off, buyers should not be shy about chatting to other industry people and getting another opinion when they are in doubt about any part of the purchase, or financing, process. ■

***By Steve Burton**, Principal, PCS Finance*

Accounting and taxation aspects of financing MR



Financing costs are a significant expense in the operations of a management rights business so it is important they are structured correctly to maximise the potential taxation benefits.

Here are a few tips to help ensure you optimise those taxation benefits.

Good and bad debt!

When looking at the various loan options on offer for a purchase of a management rights business most people would assume that the loan with the cheapest interest rate and fees is the best loan. That is a reasonable presumption and would be true if you were taking out a normal home loan to buy your residence and tax deductibility of interest was not an issue.

However once you are borrowing to buy a business asset or investment, the tax deductibility of the interest on that loan becomes an important factor. Any loan upon which the interest is not tax deductible (such as a home loan, credit card or personal loan) is what we call "bad debt" as the interest on those loans is not tax deductible. Conversely loans upon which the interest is tax deductible are "good debt".

For instance, a non-tax deductible loan with a 5 per cent interest rate will actually cost you more than a tax deductible loan at 7 per cent - sounds strange, but it is all to do with the tax deductibility of the interest! One of the key tax planning strategies in any business is to eliminate any "bad debt" and only have "good debt".

Structure of borrowings

When purchasing a management rights business there are two assets acquired, the managers unit and the business. The managers unit is generally treated as the manager's principal place of residence, which means the interest on any loans to acquire this unit will not be tax deductible (just like a normal home mortgage). The management rights business is as the name says 'a business' and therefore the interest on any loans to acquire this asset will be tax deductible.

A lender will want to take security over both assets in financing the purchase of the business.

The subtlety and what determines the tax deductibility of interest on a loan is how the loans are structured.

Take at a look at the following two scenarios:

Scenario 1	Unit	M/Rights	Total
Cost	500,000	1,000,000	1,500,000
Home loan	(400,000)	0	(400,000)
Business loan 1	0	(350,000)	(350,000)
Net equity	100,000	650,000	750,000

Scenario 2	Unit	M/Rights	Total
Cost	500,000	1,000,000	1,500,000
Home loan	0	0	0
Business loan 1	0	(350,000)	(350,000)
Business loan 2	0	(400,000)	(400,000)
Net	500,000	250,000	750,000

It is not uncommon for a lender to propose two loans:

- A home loan over the manager's unit (usually the lowest rate loan); and
- A second loan over the business

Scenario 1 above looks attractive on the surface as most of the borrowings are against the unit, and the home loan will have the lowest interest rate.

However from a taxation perspective this is the worst possible scenario as the interest on the home loan will not be tax deductible.

The only interest that will be tax deductible will be on the business loan, but this loan represents less than half the borrowings for the business.

Contrast this with scenario 2 where all the borrowings are against the business with the unit merely being used as part security for the business borrowings.

If the principal repayments are too high, it can severely curtail the cash flow of the business and leave the manager with limited funds.

The way this has been structured from a taxation perspective is that the purchaser has used their cash equity to purchase the unit with the balance of funds applied towards the business. The bank borrowings are therefore specifically applied towards completing the business purchase with both assets used as security. This is the most tax effective way to structure your borrowings.

This process is made easier if there are different entities purchasing the manager's unit and management rights business, which is fairly common particularly in medium – large buildings. In this case all borrowings should be in the name of the entity purchasing the management rights business.

Principal repayments on loans – how much?

There are two components in any loan repayment, interest and principal repayments. Most financiers will generally require some level of principal repayments on a loan, though the amount can vary substantially. The first thing to keep in mind is that it is only the interest on a loan that is tax deductible. Any amounts you pay off the principal of a loan are not tax deductible, which means this amount is coming out of the after tax profits of the business.

If the principal repayments are too high, it can severely curtail the cash flow of the business and leave the manager with limited funds.

Let's take the following example to explain the issue:

- Business profit of $200,000, multiple of five times, so purchase price of $1,000,000
- Managers cash equity towards purchase of $300,000
- Two bank loans of $350,000 each; total $700,000
- Interest rates are 6 per cent
- Business is in a company, flat tax rate of 30 per cent
- Bank 1 will allow interest only on the first loan but P&I over 10 years on the 2nd loan
- Bank 2 requires P&I on both loans over 10 years

As you can see the differences in principal repayments between the two loan options makes a significant difference to the manager's net income. Debt reduction is important in any loan structure and should be encouraged; however it has to be at a manageable level. You need to carefully consider the loan payment amounts in assessing any finance proposal, don't just look at the interest rate. ■

By David Jackson,
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	Bank 2	Bank 1
Business profit	200,000	200,000
Less interest on loans ($700,000 @ 6 per cent)	(42,000)	(42,000)
Taxable Income	158,000	158,000
Less tax @ 30per cent	(47,400)	(47,400)
Less principal repayments	(70,000)	(35,000)
Nett income to managers	$40,600	$75,600

When the norm is not standard

If I was to consider the most commonly phrased enquiries from purchasers on a weekly basis, regardless of the stage of a transaction, I would say that answer would result in something like this:

- what is the industry norm?
- what is standard?

As a legal service provider to the industry, I, like my colleagues, have an ability to answer this line of questioning by drawing on the many and varied past experiences to provide a concise response. I have no doubt this comment would be accurate for those in the accountancy and valuation professions also. That same line of questioning is likely to be more challenging to a financier because we all know that financial institutions are continuously assessing the market, reviewing lending criteria, revising benchmarks and so forth. Presently, we have a strong focus on experience and tuition.

How then do you breakdown questions such as these, which I would argue have a legal difference, in order to respond in a manner that ticks the boxes in purchaser's mind? A sound starting point is to ascertain what institutions are likely to finance the acquisition. As I have mentioned, lending parameters change but less regularly do the lines of enquiry from financial institutions in a legal sense. For those readers that are perusing the management rights loan market for the first time, each bank has a legal certification process for the associated business documentation, which industry-specific lawyers are equipped to answer.

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The elements to that financing process although substantially the same, do have nuances that require the certifier to call on industry-specific knowledge. Of course, the requirements marginally differ depending on the institution involved. Examples of these subtleties include interpretation of the remuneration and termination clauses, to name a few. As a result, I often make a point when answering a question about what is 'standard' by suggesting the answer lies somewhere in the vicinity of what your lender wants to see in the management and letting rights documents at that given time. That becomes the 'industry norm'.

An ideal way to demonstrate this difference is by focusing on a few scenarios:

1. A development site where a new body corporate or owners corporation is soon to be established

The number of times that a developer might suggest to a prospective manager that the wording adopted in a particular term or condition of their pending appointment is 'standard' is too frequent. I often find myself seeking to negotiate an 'industry norm' with a developer that is proffering a view about what is considered 'standard'. Moments such as these often requires a manager to maintain a certain legal position because to do otherwise would introduce an element that does not meet the 'industry norm' and invariably, would lead to a difficult lend in due course; and

2. When a manager applies for an extension or option of renewal and the body corporate or owners corporation considers that an appropriate time to (re) negotiate on the terms of exercising options generally

For agreements that contain numerous option periods, this conversation can be challenging and often requires reference to the 'industry norm'. I have experienced some proposals that despite having legal merit would not meet the 'industry norm' and therefore be unacceptable to a financial institution, so common ground is sought.

Although the above commentary establishes a subtlety between the opening questions posed, in no terms of appointment would you read a reference to the 'industry norm', and nor should you. However invariably, you could take to hand almost any management and letting rights agreement and read that there are stipulated standards to uphold. The advice that an investor to the industry requires is that on occasions you need to focus on the 'industry norm' and seek to have adjusted what might have been a historical or purported 'standard'.

Financiers will continue to look to legal consultants to assist with ensuring that management and letting rights meet their 'industry norm', which some might say is never 'standard'. Our banks require this consultancy when assessing investments in many industries but with management rights and the many moving parts to a transaction, this concept is more prominent. ■

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