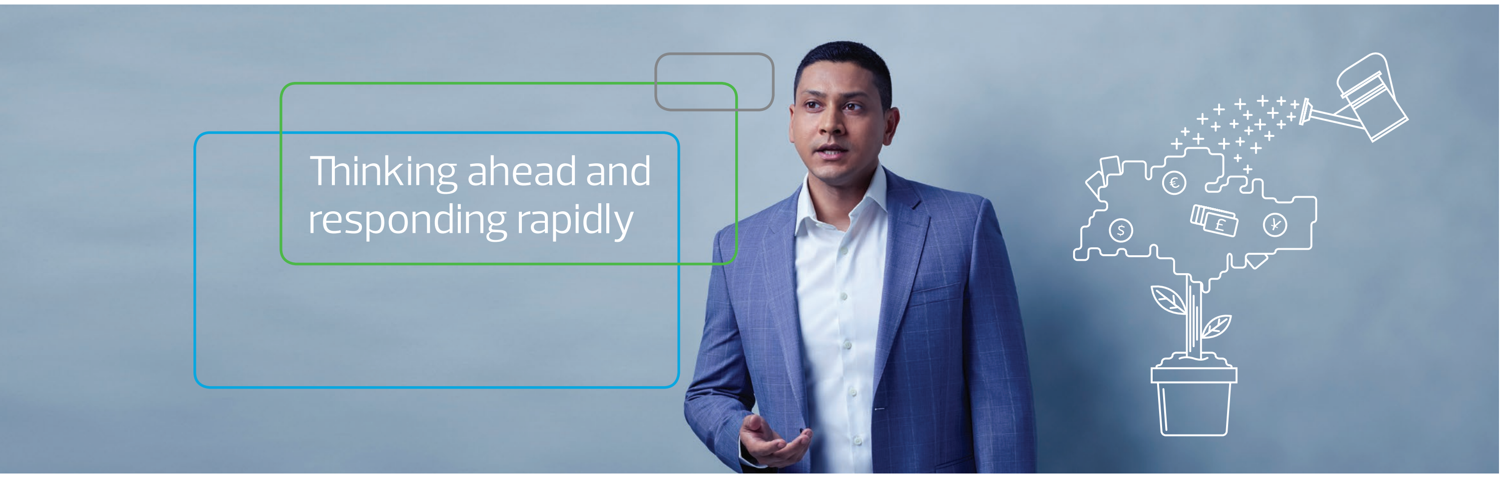

ARE LOW INTEREST RATES REDUCING BUSINESS RISK?

The current low-interest climate

In 2016, the Reserve Bank has again lowered the cash rate, taking a 0.25% cut to bring the rate down to the current 1.5%. It really is staggering – an official cash rate of just 1.5%. Recently one bank has come out and boldly predicted the rate will fall to 1.0%.

We did a little research and have found that this rate has been declining ever since October 2011 when it was – wait for it – 4.75%. And then that rate was a 'peak', having risen from 3% in Sept 2009. The last time the cash rate was in double digits – September 1991. That is 15 years ago.

Should you pay more?

With the cost of funds heading south, how does this impact one's view of buying a business? Should you pay more for the business because the cost of money is cheaper?

The answer to that question is a fundamental 'No!' Irrespective of how much you are borrowing to fund the acquisition, any business has an inherent commercial value. Your focus should be on what profit is generated by the business and what is the price paid. This derives the return on investment (Profit generated / Price paid). The profit measure is taken before interest, confirming the separation from debt in order to determine the value. (This profit measure is known as EBITDA).

Do you have a margin of safety?

Your bank will be very focused on the Interest Cover Ratio or the ICR. The ICR is calculated by the formula of EBITDA / Interest expense. Historically banks have set a ratio of two times. That is, EBITDA must be at least two times interest. In our view, if your ratio is at two times, you are potentially a step away from running into serious cash flow problems unless your business is on the up and not flat-lining or even declining. Business owners should ensure they have a margin of safety in their operating result and this implies probably operating at an interest cover upwards of three times. Well-balanced operators are easily operating at four to five times. Let's look at what the ICR implies. Refer to Table 1 for an example.

You can see that in this business with typical sales and EBITDA, the change in the ICR with the different level of interest costs. On the left-hand side, where the ICR is just two, 50% of the profit is eaten up in paying interest. Where the ICR is four times, this reduces to 25% of profit.

The most important thing to remember is that if you assume that interest rates are 5%, then the amount of debt in the situation on the left-hand side is $2.4m and on the right-hand side is $1.2m. While the profit appears to cover the interest of $120,000, does the business value support a debt of $2.4m? And if profits can't be lifted, what are the implications for the owner?

Table 1

	% Sales		% Sales	
Sales	100%	3,000,000	100%	3,000,000
EBITDA	8%	240,000	8%	240,000
Interest	4%	120,000	2%	60,000
ICR	2		4	
Net profit available for tax, drawings, loan reductions		**120,000**		**180,000**

Keeping things under control

There is some misplaced attraction in 'getting a tax deduction' and 'using the bank's money so that I can use mine for something else'. A better view to take is this. For many owners, the profit produced by your business or, if more than one, your businesses, is what underpins your overall growth in assets, your ability to undertake other investments when appropriate and supporting you and your family. On this basis, the goal should be to preserve the strength of your business profits. You should be aiming to have a comfortable margin of safety in your core operations.

Budgeting ahead

Planning for the year ahead with sensible budgets is a good way to achieve this. Budgeting is not difficult. It can help you monitor how your business is going and identify some of the challenging areas of your business to be improved. Budgeting can help you focus on outcomes that firstly you believe the business is capable of and secondly that you want to see on the bottom line so that you have that required margin of safety.

The process might look something like this:

a. Once you lodge your April BAS, you have the results for ten months of the financial year.

b. Run out into a spreadsheet the results by month.

c. Use these results to forecast the result to June.

d. Now use this information to forecast the result for the next financial year.

10 STEPS TO TAKING CONTROL

1. Assess expected product or service volumes.
2. Review unit pricing of your products or services.
3. Know your customer numbers and average sale to forecast retail sales.
4. Consider how else you can add value and try to identify additional or new revenue streams.
5. Apply your expected margins.
6. Estimate your overheads including your bank loan interest.
7. Review your KPIs that fall out from this, including ICR. KPI's stands for KEY Performance Indicators – know the KEY indicators for your business.
8. Try to assess cash flow, don't forget to allow for your drawings and income tax.
9. If you don't like the answer, where can you tweak the results?
10. Still don't like the answer? Maybe get some help in to review the results with you.

Enjoy the current low interest rate environment. However, ensure you 'gamble responsibly'.

For further information, please contact your local RSM adviser.

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