TIPS FOR FINANCE

Financing your Management Rights Purchase

In this article I'm going to cover the basics of successfully acquiring a loan to purchase management rights. However, before we plunge in let's take a step back and think about what it is that we are dealing with here.

The purchase of a management rights business involves, in almost all cases, the acquisition of a unit in a strata scheme and the acquisition of a business. The business is, in essence, really two businesses. There is a caretaking role remunerated via a body corporate salary and there is a letting business. The caretaking is essentially a list of duties for which the resident manager is paid a set salary. The letting business is predicated on a pool of units that the resident manager arranges the letting of (either short or long term) and is compensated by way of commission and fee for service income.

The health of the business will be determined by the ongoing composition of the letting pool, revenues per available room (RevPAR), the effective discharge of the caretaking duties and a strong working relationship with the body corporate.

When first considering a management rights business the intending purchaser should start by clearly understanding what sort of management rights they are going to buy and how much they can spend. An idea of locality is also important. It's at this early point in the process that the golden rule of management rights purchasing comes into play: Always use industry professionals who understand the industry back to front.

A specialist management rights financier will take you through a pre-qualification process that will give you a clear idea of your purchasing power, likely loan commitments and an indication of your income after debt servicing. There is simply no point in looking at a range of buildings until this pre-qualification has been completed.

TABLE 1 PURCHASE PRICE		
$650,000 cash deposit / divided by 35	x 100 = $1,857,142	maximum purchase price

Lenders are currently using a range of calculations to determine borrowing capacity. Some allot a maximum lending percentage to the unit and a lower percentage to the business. Others use a flat gearing ratio across the total value of the unit and rights. At present an 80% unit and 65% rights calculation is common while a flat ratio of 70% is also used.

For experienced operators acquiring high quality buildings in appropriate locations flat gearing to 75% is available. Experience suggests that working on a 70% flat ratio in terms of prequalification is an appropriate approach. In fact, the 80% unit and 65% rights calculation can sometimes result in a building with a very high unit value and disproportionately low business value appearing to qualify for a higher loan amount than a more profitable building.

Of course, a return on investment and debt servicing capacity calculation will soon reveal the more appealing purchase. Based on the 70% flat gearing assumption a purchaser should allow 30% of the purchase price for deposit plus around 5% of the purchase price for costs. In simple terms the calculation looks like this: (*See Table 1*).

It is possible to gear against other security (generally a house) and use those borrowed funds to either supplement or make up the total deposit. Of course, the rental income from the house together with the rights profit will need to be able to service the entire debt. Expect your lender to allow up to 80% of a house value less any existing debt.

Once you have gone through the finance qualification process it's time to go hunting. Typically you'll see several management rights that appeal. It's important to have a financier who can run "what if" scenarios for specific buildings as part of your pre-purchase assessment. Each building is different and ultimate funding packages can change dramatically from business to business.

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Typically a lender will think about the following when providing a likely funding scenario for a building:

- Your previous experience and capacity to run the business
- Ratio of unit and rights value
- Return on investment
- Purchase multiple (rights price divided by net profit for sale purposes)
- Composition of the letting pool and any concentration of ownership
- Asset type (short term, permanent , corporate etc)
- Net profit
- Balance term of agreements
- Legislative environment (state to state)

Purchasers with no previous experience running a management rights will have little difficulty borrowing provided they have the necessary life skills and asset backing. A detailed CV and a couple of strong references can make a world of difference when negotiating finance.

Once you have gone to contract on a building the financier will take a formal credit application and commence processing the approval and loan documentation. In all cases the unit will be valued and, for larger loans, the management rights will also require valuation. The lender should work closetips for finance

Financing your Business: Why Interest Can Be Interesting

In this article I'm going As every well heeled entrepreneur knows, business ventures can be financed in one of two ways, either through debt or equity. Whilst in these, still, uncertain times there are advantages to fully funding new business opportunities through equity financing (i.e. using your own money), careful consideration needs to be given whether that new venture should be funded largely though debt financing via a loan (i.e. using someone else's money). There are taxation opportunities, such as the ability to obtain a deduction for the interest on the loan, that a business could avail itself of which could provide an incentive to largely debt finance the venture. Choosing the best taxation outcome involves the engagement of a tax specialist who is, ideally, part lawyer and part accountant.

If a new business elects to obtain a loan to partly (or wholly) fund a venture it is critical that the business first understands the taxation treatment of that loan. When contemplating a loan a business should consider the following factors.

Is the interest deductible?

A critical legal question a new business needs to consider is whether the interest on the loan is deductible. In this regard, interest is deductible if the requirements of section 8-1 of the Income Tax Assessment Act 1997 ("ITAA 1997") are met.

Section 8-1 states that a loss or outgoing is deductible to the extent it is incurred while gaining or producing assessable income or necessarily incurred while carrying on a business for the purposes of producing assessable income and is not of a private, domestic or capital nature.

Therefore, if the purpose of the loan is not to produce assessable income then the interest will not be deductible. Obviously, if the loan is used to pay for business expenses or for asset purchases which will assist in producing assessable income then the interest will be fully deductible. If only part of the loan is used in such a manner then the ATO requires an apportionment of the interest.

A word of caution as to when the interest is incurred. If interest is incurred prior to any income producing activities commencing then the interest will not be deductible. The ATO can provide some guidance on whether interest has been incurred too soon as part of an enterprise for it to be deductible however; it is always recommended that sound taxation advice be sought.

Are the borrowing costs deductible?

Borrowing costs associated with a loan include costs such as related legal costs and disbursements, valuation fees, and commissions that may be payable in respect of the borrowing. Whether these costs are deductible are also determined in accordance with section 8-1 of the ITAA 1997 which ultimately means much of this expenditure is deemed to be capital expenditure and not deductible unless the expenditure falls within the ambit of section 25-25 of the ITAA 1997. Again, seek the advice of a taxation specialist who is well placed to provide advice whether or not the expenditure will be allowed as a deduction under section 25-25.

Will the loan be treated as equity for income tax purposes?

There is both a large body of case law and a series of ATO rulings that will confirm that if a loan is treated as equity for income tax purposes, via the complex debt/equity rules, then the interest paid by the new business will not be deductible. If a business is looking to receive loans from related parties, such as shareholders, it is imperative that the taxation treatment of the loan be clarified so that it meets the 'debt' threshold test. Again, the ATO has provided a wealth of information (some of that information can be somewhat confusing) that a taxation adviser can work through with a business to ensure that its taxation objectives are met.

The loan documentation

If a business elects to obtain a loan as part of its funding strategy, then it should consider one final piece of timely advice. The financier will often require a number of loan and security documents to be executed before the loan is able to be drawn down. Often, the documentation is provided only a few days prior to an important business milestone e.g. the settlement of a business purchase. It is highly recommended that the business give thought to having the loan and security documentation reviewed by a commercial lawyer so that the business is fully aware of the ramifications of the documentation it is signing off on. A topical issue at the moment are instances where guarantee documents contain charging clauses where, if properly drafted, the guarantors are consenting to the financier placing caveats over their own real property.

A new business can be both an exciting and daunting prospect. In terms of financing a business through a loan, a business should be mindful of ensuring that it is maximizing its tax position with respect to that loan. Seeking appropriate taxation advice is a must.

ly with the sales agent, accountant and lawyer (all of whom must be industry experts) to ensure a smooth finance approval process. In the majority of cases it is the profit and loss verification and legal due diligence reports that the lender relies upon to make the final loan approval decision. Ensure that you use industry recognised experts in these fields and the loan process should be hassle free.

In terms of loan structure most lenders will provide a loan against the unit value and a loan against the business. You should expect the unit based loan to reflect a housing style interest rate while the rights loan will be priced on a commercial finance rate. Dependant on gearing and agreement terms interest only options will be available to most borrowers.

Both facilities will be secured by a registered first mortgage over the unit and a charge over the management and letting agreements. If you are using a company to purchase the business you will need to provide director's guarantees. It is essential to consult your accountant and lawyer prior to entering into contracts and at finance application stage to ensure an appropriate tax and asset protection strategy.

Finally, make absolutely certain that you are dealing with an industry expert lender. The management rights purchase process involves significant legal and accounting costs. It is imperative that your finance pre-qualification is backed by the lenders credit department and that your lender has historical industry experience.

Just as importantly, make sure your lender has a long term commitment to the industry and an ongoing positive credit appetite. If in doubt seek independent advice from an industry expert finance advisor. You simply can't afford to have it any other way.