

FAST FACTS 20: BUSINESS FINANCE

It takes money to make money, and every small business needs money to get started, to operate, and to expand and grow. Many new businesses will exhaust their internal financial resources, which are used during the start-up phase, and will eventually seek additional capital to continue growing.

Why does your business need finance?

It is important to clearly identify the purpose of the funds. Business finance is generally used to acquire assets which are employed to help the business achieve its profit making objectives, such as:

- to purchase capital items (fixed assets) eg, plant, equipment, land or buildings, motor vehicles
- to increase holdings of trading stock and supplies
- to fund research and development
- to expand distribution or develop new markets

Types of finance

Two main types of finance are available to small business.

Debt finance

The majority of small businesses in Australia use debt finance, by borrowing from banks or other financial institutions. Debt finance is provided subject to specific terms and conditions for repayment (eg, overdraft or bank loan). The lender (eg, bank) will evaluate the risks of a business and seek security (collateral) to cover the risk of default. The borrower repays principal and interest.

Equity finance

An investor provides funds in exchange for a 'share' in your business. Equity investors provide total risk capital, and have no security to call on if the business does not perform as expected. Equity finance may be sourced through a joint venture, venture capital funds (such as the Australian Stock Exchange's new Enterprise Market), or private investors commonly known as 'Business Angels'. The equity investment process is more complex and time-consuming than the process involved in raising debt finance.

Applying for finance

Bank overdrafts and loans (debt finance) are the most important source of funds for small business. When seeking finance, it is usually necessary to make a formal application to the financial institution.

Because the bank (lender) can only make decisions based on the information you supply, you should try to give them as much detail as possible on all matters relating to your business venture. Remember that banks do credit reference checks, so there is no point in withholding information.

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What does the bank look for?

Applicants must be able to demonstrate that they have a plan, and that they manage their finances and cash flow carefully. The real issue is giving the bank confidence in your ability to repay the debt.

You need to convince the bank that your proposition is practical and that your business will be able to service all borrowings. The lender will have to be confident that you have the skills and ability to manage your business in order to repay the loan and interest.

A well-researched and well-presented application is critical. Be prepared to seek and accept independent, professional advice from your accountant.

Banks look at several factors when assessing a business loan application

- How much money are you seeking and why is the loan required? Be careful not to underestimate the amount you want to borrow.
- Have you considered any other options such as reducing costs, tougher debtor terms and capital injections from partner/s?
- Do you have a clear business strategy (a business plan)?
- Is there a clear plan to service and repay the debt from cash flow? The bank will want to see financial records and/or estimates.
- Does your business have good cash flow management?
- Is there a good track record of success?
- How much can you contribute and what security can you offer?
- Have you sought professional advice from your accountant?

Reasons why a bank will reject a finance application

Rejection of a loan application predominantly revolves around the bank not having full confidence in your ability to repay it.

Other reasons why an application might be rejected include lack of collateral (especially if cash flow is not adequate), inadequate information and unacceptable operating risks.

Some tips

Talk to the bank as early as possible when you are considering borrowing money.

Remember that it is not a prerequisite to have borrowed money before. Many people think that a bank will only lend money if you can show a prior repayment history. However, banks are in the business of lending money, so the real issue is giving your bank confidence in your ability to repay the debt.

Refer to Fast Fact 26 – Business Survival

For more information refer to other Fast Facts in this series or contact:

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