There's Power in Knowing Your Borrowing Power!

What if there was a way that SMEs could identify their potential borrowing power simply? What if you could arm yourself with this information prior to seeking funding and present a case to ensure your growth plans could be supported by your financier?

Successful loan applications do not necessarily always happen by chance. Your ability to demonstrate how much you need, how the funds will be used and more importantly articulate your capacity to repay, can often mean the difference between a successful loan application or not.

How do you demonstrate your potential borrowing power?

Like all loan applications it will ultimately come down to the numbers. It is important to focus beyond the immediate need and start planning for your growth.

As a business it is critical to have funding limits in place that align with the growth profile of the business and allow you to draw the funds as required.

To achieve this, lenders will want to know your story! How can you mount a case that is clear, concise and compelling?

It all starts with the numbers and one approach that is powerful and profound is to demonstrate your capability to meet your commitments by using a breakeven analysis.

This is a powerful tool and one that provides greater insight into your business's performance with the impact that each additional sale has on the bottom line. You could be potentially increasing your chances of obtaining a loan approval or increasing your borrowing capacity.

How should you look at your numbers?

While there are many factors that are considered in a loan application, two of the essential elements include the necessary security and your ability to service the loan.

Your ability to provide security can normally be determined by reference to your balance sheet as it provides a breakdown of the assets owned by the business.

However your capacity to service the loan is normally determined by the cash flow of your business and that is more likely to be reflected in your profit and loss (P&L) statement.

However traditional P&L statements do not necessarily always tell the full story of your business's potential to service a loan.

A traditional P&L format generally deducts the direct expenses from revenue to calculate gross profit with indirect expenses calculating net profit. However, this does not necessarily assist SMEs to demonstrate the 'volume of sales' required to break even or their ability to increase their profitability from incremental sales.

This can be demonstrated by presenting your P&L in an alternate manner – rather than the traditional manner where expenses are allocated into direct and indirect. Your expenses can instead be presented by way of variable or fixed, thus telling a different story.

Variable expenses are those expenses that are only incurred should you make a sale, versus fixed expenses that are incurred irrespective of a sale being made.

Examples of a variable expense could include the cost of fuel if you are a freight company, or the cost of raw materials such as timber if you make wooden toys. Fixed costs could include your rental and utilities that remain unchanged regardless of how many sales you make.

Traditional P&L	Alternate P&L
Revenue Direct Costs	Revenue Variable Costs
Gross Profit Profit Margin (%) Indirect Costs	Profit Contribution Margin (%) Fixed Costs
Net Profile	Net Profit
Net Profit Margin (%)	Net Profile Margin (%)

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Once you have calculated your Contribution Margin, you can then work out your **break-even** sales point and your **profit contribution** from each additional sale. The formula to apply is Fixed Costs ÷ Contribution Margin %. To make it even simpler you can apply this on a single $1 basis. In other words, for every single dollar your fixed costs increase, how much will our sales need to increase to maintain your current profit?

This is a formula you can carry in your head and swiftly run the numbers on every single business investment decision you are confronted with.

Contact us for a practical example of these calculations.

How can understanding your profit contribution assist?

With this understanding you will be in a significantly better position to understand the incremental sales required to cover the additional repayments associated with the new loan and maintain your current level of profitability.

When you make application for a loan approval, it is ideal to be able to demonstrate that the new loan repayments can be met from existing cash flow. However at times this might be marginal, but demonstrating the additional sales required to be generated could make a difference in obtaining an approval. It is important to be able to explain your plan to achieve the increased sales revenue.

By way of example, you are looking to purchase a truck to add to your existing fleet. If your business contribution margin is 22% and the repayments on the truck are $1,600 per month, you will be required to earn $7,272 per month ($1,600 ÷ 22%) in incremental sales to cover the costs of the additional truck. If your existing trucks earn on average an amount higher than this (say $12,000 per month) and there is currently surplus demand that you are unable to satisfy, you should be able to demonstrate the likelihood of being able to make the repayments.

If you are looking to acquire additional assets, equipment, vehicles or other machinery to assist your business's growth and want to better understand your ability to service the repayments, please contact us and we'll assist you in determining how best to present your loan application.

Remember to contact us to read our topic sheet **'A Proven Formula to Run Numbers for Any Business Investment'.**

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