

Can my business afford 12% interest rates? Here are some tips to consider if thinking about getting business financing.

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Considering rising interest rates, inflation and the current economic environment, I have written this article to share some aspects to contemplate when thinking about whether to obtain financing for your business.

I have included some “back of the napkin” math to help illustrate the points being made.

Here are some key aspects to consider in deciding whether to obtain financing or not.

Net Economic Benefit (NEB):

The underlying concept of this decision is that your business should have a Net Economic Benefit when considering borrowing the money.

For example, if a machine that can improve production efficiencies and reduce your labour spend costs \$100,000 and you can repay this over 5 years (or 60 months), the monthly principal payment would typically be \$1,667 (\$20K per annum).

Assuming your business generates \$2M in revenues at a 35% gross margin (ie: \$700,000) and the machine will generate a 1% improvement in margin, this would equate to an improvement in profitability of \$20,000 per annum (or \$100K over 5 years).

And if the machine also enables the business to operate with one less employee, then there would be an added saving in the reduction of annual salaries. Assuming an annual salary savings of \$50,000, then the combined annual margin improvement (or increase in profits) could approximate \$70,000 per year (or \$350,000 over 5 years), before interest costs.

If the interest cost is 12% on the \$100,000 loan (ie: \$12,000 per year and declining as the loan gets repaid), then notwithstanding higher interest rates, in this example there is a strong net benefit to the business to borrow the funds to buy the equipment. The Net Economic Benefit is \$58,000 (\$70K above less \$12K interest) per year and over 5 years could be almost \$300,000.

Apples to Apples Comparison on the Math:

Some business owners I speak to feel if their business only generates a 10% net profit margin, they cannot borrow at 12% as they will operate at a negative 2% loss.

However, it is important to understand that the interest rate expense is a function of the amount borrowed, not as a percentage of revenues.

Using my example above, assuming a business generates a net profit margin of 10%, then on \$2M in revenues the Net Profit earned would be \$200,000.

The interest cost of 12% is based on the loan of \$100,000 so it is \$12,000 per year.

So, one needs to extrapolate the math to be clear on the impact and to make sure one is comparing “apples to apples”.

Fixed vs. Variable Rates:

Some banks also offer a fixed or variable rate. Based on what I hear from economic forecasters and investors, my sense is we are likely at the tail end of rate hikes, so being variable may make more sense now.

Some clients like the peace of mind of just locking in a rate now for the next 5 years which is understandable.

To help with the decision, I recommend clients just do the math ie: on a \$250,000 loan, the difference between say 10% vs. 11% is only \$2,500 in the first year (or \$208 per month). Doing the math will help put the decision into context.

In conclusion, given rates are higher than they have been in quite some time, it is important to do some “back of the napkin” math to ensure there is a Net Economic Benefit to the business and to utilize the math to decide on the type of rate structure that helps you sleep at night.

At Isaacs Advisory, we have extensive experience in advising, structuring, and sourcing financing solutions for start-ups, early-stage, and growth businesses.

For more information on financing solutions please contact Adrian Isaacs at 416-835-4511 or aisaacs@isaacsadvisory.ca.

