Using Your Business to Accumulate Wealth: *Case Study*

Owning a business can be a challenging yet rewarding experience Aside from the day-to-day issues of managing the business, it's also important to plan for the future and invest any profits wisely. Should you pay off debt, expand the business, or diversify into other income producing assets? With the right advice you can develop a strategy that will help maximise your wealth and generate additional income.

Steven and Michelle
Hospitality

Introducing Steven and Michelle

Steven and Michelle are the owners of a seaside cafe. After both working in the hospitality industry for over 10 years, they decided to open their own cafe which is now running at close to capacity after receiving several glowing reviews. The last financial year resulted in an annual turnover of around $600,000 and a net profit of $100,000. With $70,000 in the bank and a $100,000 fixed business loan, Steven and Michelle are unsure of their next steps. They want to use their surplus cash in a way that will diversify their business assets and provide another source of income – but how can they achieve this without taking on too much risk?

The Challenge

	Business Goals
Short term (1-3 years)	• Seek financial advice • Use surplus cash wisely
Medium term (3-7 years)	• Repay business loan • Expand existing restaurant
Long term (7 years+)	• Open a second restaurant • Continue to diversify and maximise wealth

	Business Resources
Income	• Turnover – $600,000 • Net profit – $100,000
Assets	• Cafe – $300,000 • Cash – $70,000
Liabilities	• Fixed business loan – $100,000

The Strategy

Steven and Michelle decide to visit a financial adviser to explore their options. After evaluating their current situation and long term goals, the adviser recommends the business invest $100,000 in shares, managed funds or ETFs – using $50,000 of their cash and $50,000 funded by an investment loan. This strategy will allow Steven and Michelle to:

- Double their exposure to potential capital gains, distributions and franking credits.
- Use investment income and franking credits to offset interest costs.
- Claim the interest costs as a tax deduction for their business.
- Pay tax on investment income at the company tax rate of 30%.
- Diversify their assets and introduce another income stream.

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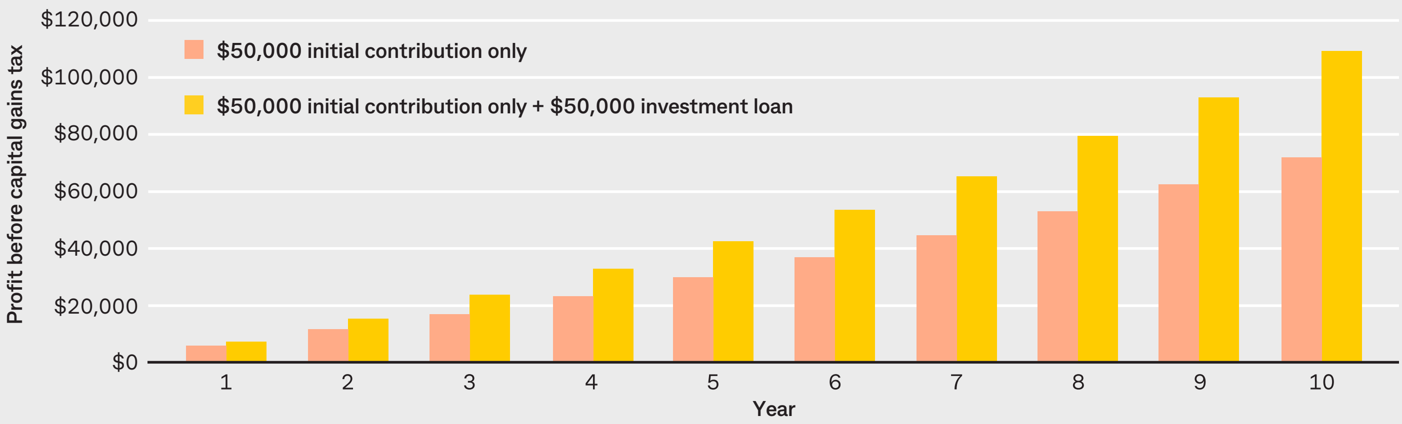
The Result

If Steven and Michelle had chosen to only invest $50,000, the investment portfolio would have grown in value to $77,648 after 10 years. After allowing for the initial contribution and tax on investment income, the profit on the portfolio would have been $50,013 before capital gains tax.

But having followed the financial adviser's recommended strategy of borrowing to increase exposure to growth assets, the investment portfolio grew to $155,297 after 10 years. After allowing for the initial contribution, investment loan, investment income, interest costs and income tax, the profit on the portfolio was $72,026 before capital gains tax.

The difference in the profit outcomes of both strategies was $22,013 or 44% over the 10 year period. At the same time the income from the portfolio more than offset the cost of the loan after tax. Over 10 years they earned more than $16,729 in net income from the investment portfolio after income tax and interest costs, giving them an extra source of business cash flow.

The investment in managed funds also helped to diversify Steven and Michelle's assets, ensuring all their capital wasn't tied up in their business.



Assumptions: The graph compares the potential return on the investment portfolio with and without an investment loan. The calculations show the profit before capital gains tax of each strategy after loan and interest costs have been paid. It assumes an average annual capital growth rate of 4.50% p.a., an income yield of 4.00% p.a. with all income used to cover interest costs, distributions are 70% franked, a company tax rate of 30%, an average annual investment loan interest rate of 8.00% p.a., an initial investment loan gearing level of 50%, brokerage and any other fees are excluded. While capital gains tax implications have been ignored, they should be considered before investing.
• This example is for illustrative purposes only. It does not reflect any particular person or situation and should not be taken as an accurate forecast of any outcome.

What are the Risks Involved?

Borrowing to invest can multiply your investment returns in a rising market. However, if your investments perform poorly, it can also multiply your investment losses.
Other risks associated with an investment loan include:

- borrowing limits may be reduced, increasing the potential for a Margin Call.
- the variable interest rate may increase resulting in higher interest costs.
- margin calls may require investments to be sold quickly at unfavourable prices if you are unprepared.
- tax legislation or marginal tax rates may change.

There are a number of things you can do to reduce the risks associated with an investment loan. For example, borrowing less than the maximum allowed reduces the risk of a margin call.

Before you apply for an investment loan, you should speak to your financial adviser who will be able to help you put an appropriate strategy in place. Investors should also obtain professional taxation advice that addresses their individual circumstances before taking out an investment loan.

Please speak to your financial adviser for more information about how borrowing to invest can help diversify your assets and grow wealth.

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