

Using your business to accumulate wealth

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.

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)	<ul style="list-style-type: none"> > Seek financial advice > Use surplus cash wisely
Medium term (3-7 years)	<ul style="list-style-type: none"> > Repay business loan > Expand existing restaurant
Long term (7 years+)	<ul style="list-style-type: none"> > Open a second restaurant > Continue to diversify and maximise wealth

Business resources	
Income	<ul style="list-style-type: none"> > Turnover – \$600,000 > Net profit – \$100,000
Assets	<ul style="list-style-type: none"> > Cafe – \$300,000 > Cash – \$70,000
Liabilities	<ul style="list-style-type: none"> > 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 managed funds – using \$50,000 of their cash and \$50,000 funded by a margin 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.

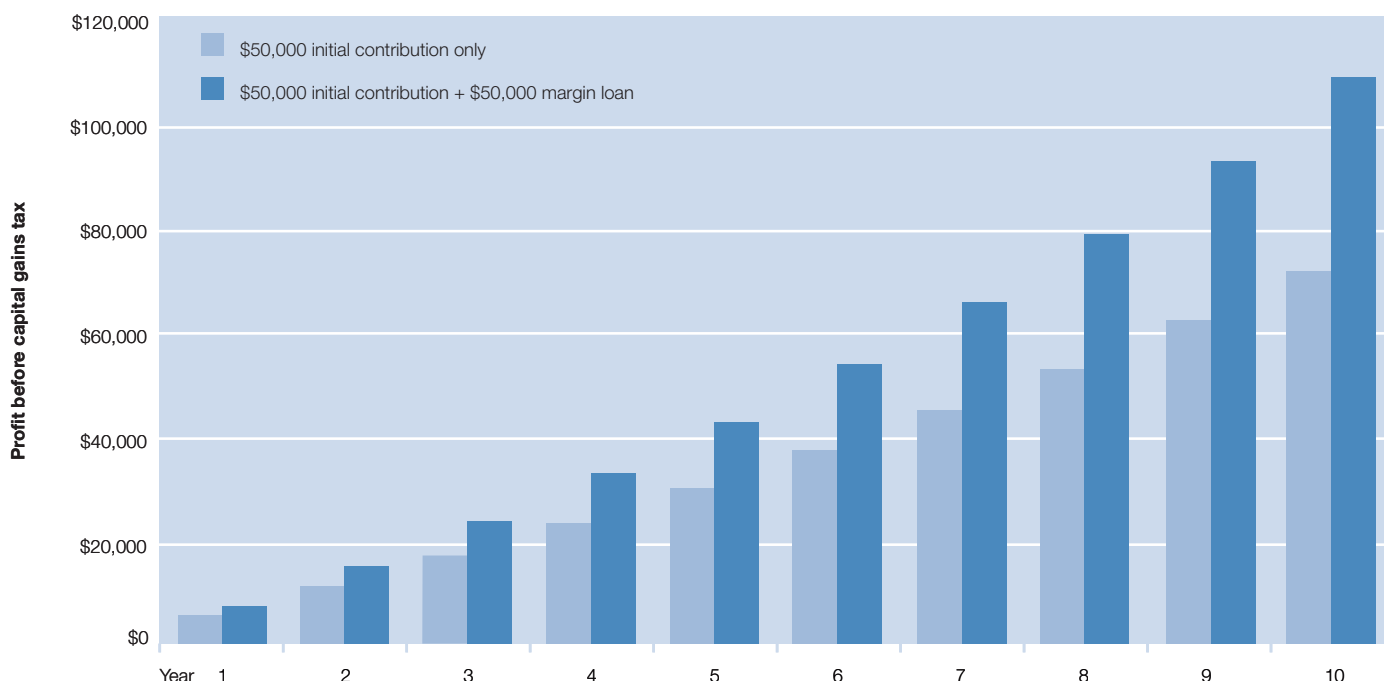
The result

If Steven and Michelle had chosen to only invest \$50,000, the investment portfolio would have grown in value to \$98,358 after 10 years. After allowing for the initial contribution and tax on investment income, the profit on the portfolio would have been \$70,360 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 \$196,715 after 10 years. After allowing for the initial contribution, margin loan, investment income, interest costs and income tax, the profit on the portfolio was \$107,471 before capital gains tax.

The difference in the profit outcomes of both strategies was \$37,111 or 53% 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 \$10,700 in income from the investment portfolio after 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 a margin 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 7.00%, an income yield of 3.50% with all income used to cover interest costs, distributions are 70% franked, a company tax rate of 30%, an average annual margin loan interest rate of 9.50%, an initial margin 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.

Getting the right advice

As with any financial strategy, borrowing to invest is not without its risks. One of the key risks of this strategy is that just as it can multiply your gains when you invest successfully, it can also multiply your losses if your investments fall in value. That's why it's important to get the right advice to ensure gearing is appropriate for your particular situation. Your adviser can help you construct a personalised investment strategy that takes advantage of the benefits while minimising the risks.

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

The Colonial Margin Loan is one of the products available under the Colonial Geared Investments brand and is provided by Commonwealth Bank of Australia ABN 48 123 123 124 AFSL 234945 ('the Bank'), administered by its wholly owned but non-guaranteed subsidiary Commonwealth Securities Limited ABN 60 067 254 399 AFSL 238814 ('CommSec'), a Participant of the ASX Group. As this information has been prepared without taking into account the investment objectives, financial situation and needs of any particular individual you should assess with the help of legal, financial and taxation advice, whether the information is appropriate in light of your own circumstances before acting on it. This hypothetical example is for illustrative purposes only and is not a recommendation. The names and identifying features do not reflect any particular person or time period. Information based on taxation is based on the continuation of current laws and their interpretation. This case study should not be regarded as a representation, guarantee or warranty by or on behalf of the Bank Group or any other person that such outcomes or their underlying assumptions will be met or that capital will be repaid. When investing remember that past performance is not a reliable indication of future performance. Please consider the Product Disclosure Statement (PDS) and Terms and Conditions, issued by the Bank, available from www.colonialgearedinvestments.com.au or by calling 1800 252 351 before making any decision about the product. Only investors who fully understand the risks associated with gearing into investments should apply. Applications are subject to credit approval. Fees and charges apply. MKTG458E (01/11)