How falling house prices are spelling disaster for small businesses

While it’s no secret that small business stress can lead to personal mortgage difficulties, signs are emerging that the reverse may now also hold true.

With property values declining across the country and bank interest rates on the rise, the danger for those who are using their homes as a guarantee to fund their businesses is becoming increasingly apparent.

Trent Devine

Jirsch Sutherland partner Trent Devine, believes that while the huge boom-fuelled increase in home equity has allowed many businesses to remain afloat, the current reduction of property values may now cause many to run aground.

“Any business that has used personal finances for business borrowings is now at risk,” he says. “That’s because we now have an environment where property prices are falling, which means reduced levels of equity with which to finance or prop up a business. In the past, we’ve seen many cases where small businesses in trouble have created personal financial problems for the owner. Now we seem to be at the start of a cycle where it’s working the other way.”

Trent says the practice of using homes to finance new small businesses (often mum-and-dad or husband-and-wife companies) is extremely common in Australia, adding that the past 12-months has seen an increase in small business stress as a result of declining home values.

“I think you’d find the majority of people with a start-up small business would use capital from their homes to start out, which obviously is a concern when things turn for the worse,” he says. “Borrowing from home equity to start a business has always happened, and with the huge price increases of recent years, struggling businesses have been able to lean on that equity. Now, with price drops and other factors, resulting difficulties can easily flow on to business.”

Muddied waters

Trent says the potential for business insolvency often stems from an ill-advised link between business and household finances – a situation he says is nonetheless unavoidable for many in the early stages of a new venture.

“Small companies often use the same bank for the business that they use for personal banking, so therefore they’re likely cross-collateralised,” he explains. “They may have their mortgage and business loan with the same bank. They don’t separate one from the other.”

Significantly, falling home values and a reduction in available equity are not the only problems faced by businesses. Mortgage stress triggered by factors such as flat wages growth, rising living costs, and growing levels of underemployment may also filter through to the ability of owners to sustain their company.

“Rises in interest rates, which we’ve just started to see, and resulting mortgage stress can certainly flow onto businesses,” he says. “If a business is struggling, banks might now note that there’s now no property to support that business because the mortgage is under stress. Clearly, this means that business insolvency becomes a strong possibility.”

When it comes to avoiding such risks, Trent says that treating home and business finances as separate entities is vital.

“Make sure to keep personal and company assets separate, and use different banks for business and personal uses so that cross-collateralisation is not an issue,” he advises. “Providing a secured loan to the business rather than opting for a capital injection might also be an option. Removing a house as a security measure as the business gets stronger is also a good idea. However, that might be a difficult thing to do right now.”