GOOD & BAD DEBT

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Understanding what bankers are looking for and what key aspects of your finances you should build skills in can make a big difference to successful borrowing.

Words ANNE LEE Article taken from Dairy Exporter - Summer 2024-25

Ex rural banker, with 30 years' experience, dairy farmer and professional director Peter Moynihan says building financial literacy can be a step-by-step thing.

He shared some of his key take-home messages.

Understand good and bad debt. Good debt is taking on debt to purchase something that enhances your short- to medium-term business viability and profit. It can be an asset that appreciates, reduces costs or increases income.

Bad debt is more likely associated with something that depreciates and does little to improve your business viability. Debt for consumer goods such as TVs could be an example.

Understand your cashflow and ensure you have banking facilities to manage the shortfall in cash during the seasonal variations.

Have buffers within your business. These can be cash, good fertility, up-to-date plant, spare feed and low contingencies.

Know your statement of financial position – your equity and debt – before you come to the bank to borrow money. Monitor that position closely throughout your career. It shows your progress and business strength.

Find out from the bank what equity ratio they require. Don't depend on your banker to be your key financial adviser, they are your banker. They are in the business of lending money, that's how they make money. Just because they are willing to lend to you doesn't mean you should borrow it. They may have a different risk appetite to you and may over/under assess your ability.

To make a decision on whether they lend to you, your bank will want to know:

- Your equity and statement of financial position.
- That your business is or can be profitable. A realistic budget will be required with indications of how that budget will be achieved, or proof from previous accounts to show your profitability and capability.
- That you are capable and have the ability needed to deliver your plan.
- That your operation is compliant with regulations.

Use the data and information available from DairyNZ or your accountant to help build your budget and to benchmark your financials.

Talk to your banker about what their specific bank expects. Find out what your bank's interest coverage ratio or debt coverage ratio is. This ratio shows your profitability and ability to service debt. An interest coverage ratio of 1 is when you make enough money to maintain your farm but make no cash surplus. Most banks would be looking for a ratio of greater than 1.2, know this figure. They would use a standard medium-term interest rate for the calculation of budgeted interest, so find out what that standard interest rate is.

Learning how to do sensitivity analysis can help when assessing future options. What happens to profit/cash when key variables change? Where is the critical point where you don't make money?

Understand your breakeven milk price.

Total income - expenses including* = breakeven milk price

*Total expenses include farm working expenses, interest and rent, tax, drawings, principal repayments if required from the bank, asset replacement allowance.

Know your strengths and weaknesses. While you're learning or if you can't or don't want to improve a skill then pay someone to do it for you and get help and advice. There are plenty of people who are very successful who outsource their financial management by having a good team around them. ●

Don't depend on your banker to be your key financial adviser, they are your banker.

ABOVE Peter Moynihan

Total income - expenses = breakeven milk price*

**Farm working expenses, interest and rent, tax, drawings, principal repayments if required from the bank, asset replacement allowance.*

GOOD & BAD DEBT QUESTIONS

These questions focus on key concepts, including the importance of financial literacy, what bankers look for when considering loans, and how farmers can manage their finances effectively.

1. What is the difference between good debt and bad debt? Can you give an example of each?
2. Why is it important to understand your cashflow as a farmer? How can banking facilities help manage cashflow during seasonal variations?
3. What is meant by "buffers" in a farming business, and why are they important?
4. What is a "statement of financial position," and why should you know your equity and debt before borrowing money from the bank?
5. Why shouldn't you depend on your banker to be your main financial adviser? What role does the banker play, and why is it important to have other sources of financial advice?
6. What are some of the things a bank will want to know before lending money to a farmer?
7. Why is it important to know your bank's interest coverage ratio or debt coverage ratio? What does this ratio tell you about your business?
8. What is sensitivity analysis, and why is it important when making decisions about the future of your farming business?
9. What is the "breakeven milk price," and why should farmers know what it is?
10. How can understanding your strengths and weaknesses help you in managing your farm's finances?
11. What can you do if you don't want to improve certain financial skills? How can getting help from others benefit your business?