Introduction

An agribusiness requires producers to plan, manage, record keep & monitor their financial progress. Producers need to have an understanding of how much money the business is making & to forward plan & expand their businesses. Being able to plan for & finance a large capital item required to expand or grow the business is vital. Being able to calculate how much money is required to finance their business, or how much may need to be borrowed will ensure survival.

The following are important ideas within the Big Picture:

- Understand the importance of a strategic capital expenditure decision.
- Understanding what finance is required to operate within the primary sector.
- Explaining the effect of financing options of a strategic capital expenditure decision & the consequence(s) of these options on a business.
- Understand the medium to long-term impacts a strategic capital expenditure decision may have on the agribusiness

What is the Big Picture?

- Capital expenditure is the way forward for any successful business & allows the business to grow or to expand their operations.
- However, it comes with benefits as well as risks.
- To be able to see the implications on the business of a capital expenditure decision is important before the decision is finalised.
- Understand the importance of capital expenditure.
- Understanding what finance is required to operate within the primary sector.

What is a strategic capital expenditure decision?

- A strategic capital expenditure decision requires a business to raise additional equity or finance to fund the capital expenditure.
- The capital expenditure is relevant to the business & the decision has a medium to long-term impact.
- Examples are; a second cray fishing boat, a new logging truck, a labelling machine on a kiwifruit grader, purchase of more land.
- It is not routine expenditure such as more cray pots, repairs & maintenance of a truck.

Why make strategic capital expenditure decisions?

Allows the business to

- Take financial control of their business.
- Assess the viability of new opportunities & borrowings.
- Plan asset purchases / renewal / replacement.
- Plan for growth, expansion or development.
- Plan future income & expenditure.
- Plan & avoid financial trouble.
- Make informed operating decisions.

- Decide whether the proposed plans are achievable & profitable.

What information do you need to make a strategic capital expenditure decision?

Financial information
- Financial plan, or feasibility budget, that covers all phases of the venture. (Usually 3-5 years). This will tell us whether or not the business is sustainable in terms of income & expenditure. (Inclusive of debt servicing).
- Budgets e.g. cashflow.
- Profit or bottom line.
- Annual report.
- Liquidity.
- Shareholder & / or stakeholder expectations.
- What are the projected returns from the strategic capital expenditure?

Non-financial information.
- Location
- Expansion
- Competition / competitors
- Goals / aspirations of the business.
- Impacts on the community.
- Advantages or disadvantages.
- Consider health & safety, work life balance, meeting legal regulations & forecasting the workflow that is required for the business to operate successfully with additional investment.
- Other intangible impacts.

Goals / aspirations of the business.

- Before embarking on any business venture, the business needs to be sure that the venture is compatible with long-term goals. I.e. what are the businesses plans? Where are they going?
- It is important that goals & objectives are clearly identified, (both business & personal), as these objectives guide & focus decision-making, & provide a means of selecting the best of any alternative plans.
- The goals of all stakeholders in the business need to be considered before a business venture is selected, as compatible goals will be a large factor as to the success of the venture.
- Maximising profit is a common goal to most businesses, but differing goals can result in differing business plans.

What is capital?

- Any business requires capital to be able to operate & to remain viable.
- Capital in an agribusiness is typically represented by money, i.e. savings & borrowed capital, along with land, labour & livestock, & is one of the main resources available to the operator.
- Capital is generally limited in amount & availability, & so any decisions concerning the use of capital must be carefully analysed to make the best use of that available.
- Anyone taking on the management of an existing business should be looking for possible ways to reallocate the capital held within that business. The most efficient use of that capital will result in greater returns.
- Many people think of capital as cash; bank accounts, savings, etc. This, however, is a very narrow view. Agribusiness capital should be defined in broader terms to include; money invested in livestock, machinery, land, & buildings, as well as any liquid savings.
- The total capital used in an agribusiness can be expressed in terms of Equity & Borrowing. Total Capital = equity + borrowed capital.
- Equity is the measure of net financial worth. Equity = assets – liabilities. (A growth in net equity over time is a good indicator of financial health).

The capital requirement for the business.

Businesses have 3 distinct phases;

1. The establishment phase - due to the costs of establishment & the unknowns associated, is the period of greatest risk. Because of this, it is a good idea to include some contingency amount in the setting up estimates used.
2. The development phase is when the business is operating, but development is occurring to increase production & returns. Extra capital is often required for inputs associated with increased productivity during this phase.
3. Normal operation (stability) - is when the business is operating in a stable manner. This is when all capital assets are being used to maximum efficiency, & reductions in debt can be made. It is during this phase that the decision must be made either to expand further, or to consolidate. This decision, again, has to be made according to the goals & objectives of the relevant stakeholders.
4. The capital requirement for the business will differ depending on which of the phases they are currently positioned in.

Assets.

- An asset can have value for two reasons;
    1. It can be sold to generate cash
    2. It can be used to produce other goods, which can be sold to provide cash income.
- Assets are categorised according to liquidity & useful life.

<u>Current Assets</u>

- Current assets are the liquid assets, i.e. can be readily converted into cash. They can be used or sold in the next year, as a normal part of business activities, & their sale will not disrupt or affect future production activities.
- Examples of current assets are:
    - Cash on hand, & savings accounts
    - Tradable stock

    - Tradable shares
    - Stock / supplies on hand (inputs, grain, wool etc)
    - Debtors
    - Saleable feed on hand.

<u>Fixed Assets – also known as PPE (Property, Plant and Equipment)</u>

- Fixed assets are those that generally take some time to be converted into cash. Their sale would seriously affect the ongoing nature of the business.
- Examples of fixed assets are:
    - Land & buildings
    - Dairy Plant & equipment
    - Capital stock
    - Non-tradable shares (Ballance shares, LIC shares)
    - Differentiate between current & fixed assets mainly to determine the suitability of capital structure, i.e. fixed assets are generally financed by equity & term debt. Current assets are generally more suitably financed by short-term debt or operating surpluses

Credit & borrowed capital.

- Credit is defined as the capacity or ability to borrow money.
- The ability to borrow money is a valuable asset, as it allows you to use borrowed money to help start a business, expand a business, & to generate additional profit. This ability should be used just as other assets are used to increase profit.
- Whether capital is owner's equity, borrowed capital, or a combination of both, it will always be necessary to create, expand, or maintain a business. Capital is also necessary to increase efficiency & to meet seasonal needs.
- Today's managers must be skilled in allocating, organising, using, & the acquiring of capital, whether it is equity or borrowed capital.

Types of Loans

There are many different types of loans. Loans can be described by length, use, security, and repayment schedule.

<u>Length</u>

- Short-term loan
    - These loans are normally repaid within a year and are mainly used to purchase inputs needed to operate through the production cycle or as a means of bridging finance.
- Intermediate-term loans
    - When the length of a loan is over 1 year but less than 10 years it is classified as an intermediate term loan. Some repayment may be due each year, but the borrower normally has several years to complete repaying the loan.
    - These loans are often used to purchase livestock & machinery, as a short-term loan is not suitable as they will be used in production for more than one year and cannot be expected to pay for themselves in a short time. Many intermediate loans are for a term of 5-7 years.
- Long-term loans

  - A loan with a term of 10 years or longer would be classified as a long-term loan.
  - Assets with long or indefinite life e.g. land & buildings are purchased with funds from a long-term loan.
- Overdraft Facility / Seasonal Finance
  - An overdraft facility enables withdrawals more from the account than is in it up to an agreed amount. An overdraft can be paid back at anytime without penalty, the limit amount would be based on the forecast cashflow requirement. The interest is calculated daily on the current overdraft figure.

Use

The use or the purpose of the loan is another common system of classification.

- Property Loans / Mortgages
  - Loans for purchase of property such as land & buildings. Property loans are typically long-term loans.
- Business Loans
  - All business loans other than real estate loans are included in this category, which would include both short-term & intermediate term loans.
- Personal Loans
  - These are non-business loans used to purchase personal assets e.g. homes, vehicles & appliances. Even though they are non-business loans most lenders want them included on the borrowers' farm balance sheets to get a complete picture of their financial condition.

Security

The security for a loan refers to the asset or assets pledged or mortgaged to the lender to ensure loan repayment. If the borrower is unable to make the necessary principal and interest payments on the loan, the lender has the legal right to take possession of the mortgaged assets. The lender typically sells the assets & the proceeds used to pay off the loan. Assets which are pledged or mortgaged as security are called loan collateral.

- Secured Loans
  - With secured loans, some asset is mortgaged to provide collateral for the loan. Lenders obviously favour secured loans, as it gives them greater assurance that the loan will be repaid. Land & buildings provide collateral for real estate or long term loans. Machinery and stock are used as collateral for immediate loans.
- Unsecured Loans

A borrower with good credit & a history of prompt loan repayment may be able to borrow some money on the promise to repay or without pledging any specific collateral. This type of loan will always have a set period for repayment. Some short-term loans may be unsecured, although it is possible to mortgage non-breeding livestock & growing crops to provide security

Sources of capital.

- Agribusiness can borrow money from a number of different sources. Some lending institutions specialise in certain types of loans, while some provide additional financial services in addition to lending money.
- Borrowing can be a major expense for an agribusiness, so borrowers should be prepared to invest time & effort into ensuring that their financial arrangements are appropriately made.

Personal & family sources

- Personal sources of capital are the most readily available, & the most flexible.
- These sources could include;
    - Cash or savings
    - Supply of an asset already owned
    - Sale of other assets or off-farm investments
    - Sale of personal assets
    - Inheritance
    - Re-investment of business profits
- Many agribusiness ventures are started with family help & input, due to the large amount of capital required.
    - Direct family investment. (Money left in as equity capital or as low interest loans).
    - Family trusts. (Capital may not require repayment under certain conditions, or be in the form of low interest loans).
- With any family investment it is important that all issues are discussed & clearly understood. Misunderstandings can lead to conflict & relationship problems within the family.

Trading banks

- Trading banks offer a wide range of short, intermediate & long-term loans.

Solicitors

- Solicitors generally provide short-term finance (2-3 years), but longer-term loans are sometimes available.

Hire purchase / equipment finance

- e.g. John Deere Finance
- Generally available on vehicles, machinery & household goods. There is normally an establishment fee, & interest rates that are considerably higher than other lending institutions. However recently these rates have come down to compete with the established trading banks.

Lease of land/plant/stock

- e.g. Stockco
- This is a way of obtaining land or stock without having to supply cash yourself. You do not own the asset, but pay a rent/fee for the use of the asset. Generally the cost of the leasing is more than the borrowing cost would be on 100% finance, but advantages are;

- No security required
- No risk in reduction in asset value
- Set fees, so cashflow can be set.
- Asset can be upgraded / replaced easily.

International finance

- Interest rates overseas are often lower than those available in New Zealand. This, along with the deregulation of some financial markets, means that it may be an advantage to look at overseas finance.
- The major problem is the exchange rate risk. If the $NZ goes down in value compared with the currency from the country borrowed from, it will cost substantially more in $NZ to make interest & principal repayments.
- Unless you are selling product overseas with returns in that currency, this source of finance is not recommended. Even then, problems can occur in managing a relationship with the lender.

<u>Other institutions</u>

Under certain circumstances, there are other institutions that will lend money for land, stock, plant & development, e.g. building societies, insurance companies. Once you start looking past standard lending institutions, you tend to be paying premium interest rates.

Financing options

- Build the case for investment
- Establishing borrowing requirements.
- Need to determine the cost of the proposal, & then the resources available that may contribute towards that cost. This is worthwhile for the following reasons;
  - Both the borrower & the lender can assess the risk of the new proposal.
  - The new proposal can be assessed in terms of equity brought about by the cost of making the change.

Factors affecting credit & lending margins

- When trying to establish or develop credit it is useful to look at it from the lender's point of view. I.e. what does a lender consider when making a decision on a loan application? Why can one person borrow more money than another? Why are interest rates & repayment plans different?
- The main influence on interest rates is the risk factor on whom ever money is being lent to. (Interest rate is based on the wholesale value of the money plus risk). When a lender is assessing a proposal for a loan many factors go into making the loan decision, as the lender wants a profitable loan that will be repaid.
- These factors can be summarised as;

<u>Security</u>

- The security for a loan refers to the asset or assets pledged or mortgaged to the lender to ensure loan repayment. If the borrower is unable to make the necessary repayments on the loan, the lender has the legal right to take possession of the mortgaged assets. These assets are normally sold by the lender, & the proceeds are used to pay off the loan. Assets that are mortgaged as security are called collateral. Land, livestock, machinery, buildings, crops etc., can all be used as security.

<u>Personal factors</u>

- Honesty, integrity, reputation & other personal characteristics are all considered by the lender when considering a loan application. An honest & open relationship with lenders is essential to maintain credit.
- The management ability of the client is also evaluated;
    - Past record & past financial performance
    - Background, training & education
    - Decision making ability
    - Management ability
    - Experience
    - Sound farming practises & skills
    - Presentation of proposal
- Lenders often rate poor management ability as the main reason for borrowers getting into financial difficulty & therefore place great emphasis on this factor.
- The purpose of the loan also has a bearing on lending criteria. Loans for personal & family living expenses are likely to be viewed less favourable than those for generation of assets & income.

<u>Debt servicing ability</u>

- An accurate & well-presented proposal that includes budgets, cashflows, & statements of financial position & profitability estimates will certainly influence a lenders perception of your management ability. As well as this, complete & detailed historical records included in the application will do much to ensure a favourable response.
- There must be enough profit in the venture to meet living & taxation expenses, as well as the interest & principal repayments on the loan.

The financial package

There are many components to any financial package that can influence the cost of capital.

<u>Interest</u>

- Interest can be thought of as the rent paid for the use of borrowed money. The interest rate offered by the lending institution will depend on the level of risk they think is involved & the wholesale interest rate.

<u>The floating rate loan</u>

- With a floating rate, loan repayments rise & fall with changes in interest rates. In economic times of changes in interest rates this can make cashflow budgeting more difficult. Principal can usually be paid in lump sums or in full at any time.

<u>Fixed rate loans</u>

- With this type of loan the interest rate is fixed for a specific period of time. This makes cashflow budgeting easier, but there may be restrictions or penalties if the loan is repaid or the loan amount is changed before that specified period of time.

<u>Loan application fees</u>

- The loan application fee will vary depending on the lending institution, the proposal, & the information the applicant provides. (The more financial information provided; budgets, cashflows etc., the greater the chance of reduced fees).
- Loan application fees are negotiable & vary from no cost to 1% of the amount to be borrowed.

<u>Bank fees & charges</u>

- These vary from a flat fee on a monthly basis, to a charge per transaction, or a combination of both (e.g. per cheque, per electronic transfer, etc.). If using electronic banking, the greater the potential to reduce costs.

Service commitment fees

- These fees are charged on some short-term loans, for the ability to have seasonal finance when required.

Legal fees

- There will be legal fees required to be paid for the checking of documentation, & the registration of securities. When a loan is repaid there will be a fee for discharging the mortgage. Mortgage related legal fees are tax deductible.

Repayment terms

- Some loans have flexible repayment schedules, whereas in other cases penalties apply for early repayment.
- In most cases, all the costs of borrowing are negotiable. The work that the lender has to do in analysing a proposal also has a bearing on cost. If a full Business Plan & Capital Profile for the venture is presented, it puts the business in a strong position to negotiate costs & fees. It also shows good management ability, & strong business sense

Selecting a lending institution

- An agribusiness loan is a major expense & commitment & so a borrower should be prepared to invest time & effort into ensuring that their financial arrangements are properly made. Factors to consider are:

Products & services

- To have effective control of the business, certain products such as internet & telephone banking may be essential.

Expertise of staff

- It is an advantage to have lending staff who are knowledgeable & understand agribusiness in your area, & who will offer high quality support & advice.

Commitment to your business

- Is the lending institution going to give long-term support to your type of business, or are they only involved during the 'good times'?

The financial package

The whole package is made up of many components; interest rates, fees, advice, repayment terms, services, etc, all these should be assessed together to gain an understanding of the whole package, & the cost involved. Finance brokers, consultants, accountants, etc, may be of help in selection & negotiation

Sensitivity analysis

- Once you have completed your budget, it is useful to look at how sensitive your forecast is to changes.
- In any phase of the business venture there is always an element of risk. The risk involved reflects the ability of the business to meet estimates of production & profit. The key question is, when should we expand, or should we consolidate?
- Running sensitivity scenarios allows you to gain a clear picture of how exposed your cash position is to risk. It also equips with key information to allow you to review your budget

to ensure you will be able to meet your goals & targets even when unexpected situations arise.

Decision making steps.

- SWOT analysis
- Cost benefit analysis

SWOT analysis

- A SWOT analysis is a quick way of measuring where the business capabilities & passion lies & areas where the business should not be heading or areas where you need to improve so your business can succeed.
- SWOT refers to the identification of:
    - Strengths in the internal environment.
    - Weaknesses in the internal environment.
    - Opportunities in the external environment.
    - Threats in the external environment.
- The internal environment are factors which occur in the business that fall under our control such as production, financial arrangements, staff quality, skills, capabilities, resources. These are all factors that can be controlled, changed or improved by management.
- The external environment are factors which fall outside our direct control such as weather, product prices, government & political issues, socio/demographic factors, environmental factors, economic factors.
- The SWOT analysis can state how your business;
    - Capitalise on strengths.
    - Minimise weaknesses.
    - Capture opportunities.
    - Avoid threats

Cost Benefit Analysis

- The purpose of a cost-benefit analysis is to examine both the costs & the financial benefits of a project to determine if it is beneficial to actually do the project. If the benefits (or the return) outweighs the costs, then it is a profitable project to invest in.
- Why do a cost-benefit analysis?
- Help defining project objectives.
- By establishing a “budget” of estimated costs & benefits, the business can track the success of a project.
- A cost benefit analysis can also help the business to estimate all associated costs of a project.
- For large capital expenditures & new ventures, a cost-benefit analysis is a critical piece of the decision process.

<u>Costs & benefits</u>

- Fixed costs
- Salaries
- Cost of loan repayment (also called a Principal & Interest or P&I payment).
- Operating & maintenance costs
- Revenue & pricing considerations
- Cost & expense considerations
- Government subsidies if available.
- Tax incentives

Explain and evaluate the effects of the financing options and the consequences of these options on the business.

Students need to analyse the financial options & evaluate the consequences of these options on the business using both non-financial and financial information.

- What are the repayments and terms?
- What are the implications if the terms are changed / modified / broken? (Penalty clauses, early repayments, opt out).

Recommendation – select an option.

- Decide whether to finance the capital item or not.
- Can the business afford this expenditure?
- Evaluate the impact of this option on the business.
- When are the benefits expected to be received? (Financial and non-financial)