NSW DPI
primefacts
PROFITABLE & SUSTAINABLE PRIMARY INDUSTRIES www.dpi.nsw.gov.au
SEPTEMBER 2005 PRIMEFACT 48

Financial management during drought recovery

Extensive Industries Development Branch

'Rain rekindles hope, but cash flow budgeting assists in establishing the facts — can borrowings be repaid?; The opportunity exists to confront the reality of the farm financial situation and consider all opportunities both within and outside farming.'
Fran Rowe, Chair, Rural Assistance Authority Board

Introduction

When things are changing dramatically, after substantial rainfall, careful financial planning will assist you to cope with the many decisions that you are going to have to make about the future of your farm and your family.

Most farmers will find that their financial position has deteriorated during the drought because of crop failure, fodder costs, or the fact that stock numbers have been reduced and will need to be replaced when you are sure the drought is over.

Assets and liabilities

It is important that you try to prepare a statement of assets and liabilities to calculate equity in your property and to prepare a cash flow projection of anticipated monthly income and expenses for at least 12 months.

As a general rule for mainstream agriculture it is desirable to have equity of at least 75%. Equities lower than 70% should be viewed with caution, and one option is to give consideration to selling the farm. A farm decision making checklist is included in this Primefact for your use.

Preparing a cash flow projection

If your cash flow budget shows more anticipated expenses than income, what can you do about it? Are there good reasons for this shortfall? A substantial outlay may have been budgeted for in the next 12 months for restocking. If this is the case, and income will not be back to normal in the next 12 months, you may need a longer cash flow projection. If your projections show that you expect cash flows to improve after the first year, it is in your interests to prepare a cash flow projection beyond 12 months to show your bank. You may be able to convince the bank that your risk is short term and hence have your interest margin reduced.

Options to improve cash flow

Buying stock versus breeding up numbers

Buying stock to replace those sold in the drought will initially reduce cash flows, but at a later stage it will improve cash flows when production from the purchases is ready for sale. A useful measure to judge whether it is worth your while purchasing cattle is to look at the return on capital tied up in livestock. If, for example, you are considering breeders which will return an expected gross margin per head of $300 per year, and the purchase cost of the breeder is $700, then the return on livestock capital is 43%. This return is sufficient to pay interest on borrowings plus some principal, so unless you slip back into drought, the example used would show that in the longer term, buying cattle will produce a better cash flow than would breeding-up. However, a cash flow for each of the breeding and purchase options would be required to see how long it takes for the purchase option to get in front (see Agnote DAI-223 *Restocking after a drought*). The Impack model in the NSW DPI software program StockPlan is designed to answer this question and will help the manager decide which option is best. See your local livestock adviser about StockPlan workshops to be held in your area.

Sheep versus cattle

Historical returns on livestock capital have generally been considerably higher for sheep than for cattle, and the total cost of stocking a paddock with sheep compared with that for cattle has generally been lower. With recent increases in ewe prices, however, returns for sheep and cattle have been closer on a livestock capital basis, but they still generally favour

sheep. If your country is suited to both sheep and cattle, and you have the facilities to handle both, sheep are likely to cost less and are likely to pay for themselves more quickly than will cattle.

The final result will depend on the prices paid for sheep and cattle products over the next few years. For help in choosing enterprises, see the section on Outlook information (under 'Further assistance').

Planting that extra paddock of crop

If stock numbers are low, then an option in cropping country is to plant more crop than you normally would. It is advisable to prepare a gross margin estimate for the crop you have in mind. Sample gross margin returns are available for winter crops in the major cropping districts. Contact your nearest NSW Department of Primary Industries (NSW DPI) office for copies, or see Farm budgets and costs.

Compare gross margin returns for winter crops with the likely gross margin returns you would expect from a livestock-based enterprise to see which enterprise is more attractive. Cropping requires an outlay for cultivation, seed, fertiliser and chemicals. Stocking that same paddock to the recommended carrying capacity with either sheep or cattle is likely to be more expensive.

Your crop price projections should be based on outlook information or on the cash prices being presently offered for the end-of-season crop, not on present grain prices. If the next winter crop harvest is near average or better, prices for all grains will fall considerably from their present levels. See the section on sources of Outlook information for more detail.

Bear in mind that if machinery capacity is being stretched, an extra paddock could mean that the timing of operations may not be optimal and yields may be down. In addition, gross margin expectations for cropping should be adjusted downwards if there are low levels of stored moisture. Also, cropping the paddock this year may limit your options in a following year. Yield potential in following years may be reduced, so that a crop planted one year will boost the cash flow in that financial year, but may reduce the cash flow for the following year. See also Agnote DPI-356 *Winter cropping following drought* and Agnote DPI-355 *Soil management following drought*.

Reducing costs

Take a close look at all major cost items to see if there is scope to reduce costs in a certain area. It may be time to consider whether the leased four-wheel-drive is really necessary or whether a more modest vehicle can get you through until things pick up.

Do you have any machinery items which are not being used regularly that could be sold? Look especially at those items of machinery which are being used for work that could be done by a contractor.

It is generally not prudent to reduce costs involved in production, such as drenches or cropping fertiliser, but a very close look at your major overhead costs may well indicate some areas where you could limit expenditure.

Even though initial interest rates may be higher, consider locking into fixed interest rates so that you will know what your total interest bill will be.

Review your subscriptions, and discuss your bank fees with your bank manager to see if there is room for improvement. Check that professional fees are in line with what other people are paying, and consider paying your shire rates by instalment.

Refinancing

Your cash flow budget will indicate whether there is a need to refinance. If your overdraft does not fall to zero for any month for the next 12 months, this indicates that your hard core debt has increased and that you should consider transferring some of your overdraft into another form of financing at a lower interest rate. A budget, especially one that projects for a number of years, will give an indication of the best form of finance to aim for. You will be in a better position to know whether you require short-term or longer-term finance.

The Rural Assistance Authority will assist eligible farmers in getting back on their feet through interest subsidies for farmers in areas listed as affected by drought exceptional circumstances. Details of this scheme and eligibility criteria are available from the Rural Assistance Authority.

For a new loan it is worth calculating the effective interest (including costs). Annual charges and the establishment fees can add significantly to the cost of a loan.

To calculate your own effective rates of interest, the publication *Understanding the Cost of Farm Finance*, available from the Australian Bankers' Association (ABA) website, contains a very good method of comparing loans.

If an existing loan has an effective interest rate (including costs) which is higher than an alternative loan, it may also be worth changing, but make sure any costs involved with early settlement of the loan are included in the calculations.

A cash flow budget is part of the information useful to your bank manager.

Other information that will assist you in putting together a business plan to provide the best case possible is covered in the section 'What do the banks

want?' later in this Primefact. It covers some of the factors that banks use to decide your interest rate margin and the range of information useful to the banks. The list seems long, but farm businesses that have been through the process have a much clearer picture of the direction they wish to head, and consider the preparation time was time well spent.

Your rural counsellor is very experienced with loan negotiations and can give you some pointers.

If the budget is still poor

If you cannot make the budget look reasonable with realistic projections over 2–3 years, it may be best to consider getting out. There are plenty of farmers who have made a success of life after farming, while others who have sold their farms have remained in agriculture as employees or managers, or have leased some country.

It may be difficult to consider these options in isolation, and it is helpful to get another opinion from a rural counsellor, a drought support worker or a farm consultant.

If you are in the areas which have been listed as experiencing exceptional circumstances, you may be entitled to an exceptional circumstances relief payment. These are included under the Farm Help package run by the Federal Government.

Farm debt mediation

Under the *Farm Debt Mediation Act 1994*, a creditor under a farm debt must serve written notice on the farmer advising the farmer of the creditor's intention to take possession of the farm property or other enforcement action under a farm mortgage. The creditor must offer the farmer mediation regarding the farm debt.

Mediation is a structured negotiation process in which the mediator, as a neutral and independent person, assists the farmer and the creditor in attempting to reach agreement on the present arrangements and future conduct of financial relations between them.

Mediation is a simple, voluntary and confidential process that is quick, accessible and affordable.

There are certain time lines under the Farm Debt Mediation Act that a farmer must comply with. For further information, contact the NSW Rural Assistance Authority on 1800 678 593 (toll free) or (02) 6391 3013.

What do the banks want?

Relationships between farmers and their lenders have gone through a period of significant change over the last 15 years, primarily as a result of the stock market crash in the late 1980s and the rural recession.

Bankers have changed the way they appraise loans; farmers need to change the way that they prepare for loan applications and annual reviews, particularly in the context of drought.

At your annual review, the bank evaluates not only your performance but also your perceived level of risk. The risk is reflected in your margin or in the additional price you pay for the loan.

Lenders used to be more preoccupied with security than the ability to repay. They used to ask borrowers to submit a list of assets and their value, from which a borrowing limit would be calculated depending on the type of security offered. However, the collapse of the property and stock markets in the late 1980s, coupled with a rural recession and the large bank losses that followed, particularly on corporate loans, rendered this technique virtually useless and also very costly to the banks.

In response, the banks initiated a new technique of risk rating loans. This is a grading system which reflects the quality of the loan and hence the risk to the bank. It is also used to reflect the margin the customer is expected to pay. Obviously, the riskier the loan, the higher the margin.

This risk rating technique has switched the emphasis from security to the ability to repay both principal plus interest. While banks often will not divulge the basis for their grading systems, they usually cover three broad areas:

- management factors
- financial factors
- industry factors.

As banks are now reviewing a broader range of aspects of farm businesses, increasingly they request comprehensive business plans at the customer's annual review.

Your business plan

A business plan is far more than a financial plan. It is more comprehensive and covers all facets of your farm business. It should set out, in a logical manner, the current position of your business. The basic components of your business plan should include the following:

- **A clear, concise title page**, with your business name and contact details.

- **An executive summary**, outlining the amount and type of loan applied for, giving the bank the opportunity to accept, modify, improve or reject the loan. Clearly state the purpose of the loan and how it will be repaid. Also, briefly describe the business structure (sole trader, partnership, trust or company).

- **A mission statement**, detailing your goals and direction of the farm.

- **A management profile.** One of the most important resources of a farm business is its staff — remember that banks lend to people, not to the land. For this reason it is important to highlight the experience, qualifications and background of all members of the farm family.

- **A physical plan.** Banks place a major value on your major asset or land. It is in your interest to present it in its best light. Include location maps or photos, discuss any special attributes, such as highway frontage, closeness to town, or soil fertility. If you have a property management plan, offer it.

- **Enterprise or production plans.** Discuss such things as additional costs over and above the usual as a result of the drought breaking, or expected commodity prices, both paid and received. This enables the banker to understand the differences in the budget you forecast when the drought breaks compared with your actual performance in previous years.

- **Development plans.** Highlight any strategic plans or significant changes from previous years, e.g. anticipated capital purchases in coming years, or changes to enterprise mix or management control. Discuss any areas where there is a slightly longer pay-off period, such as breeding programs and spreading lime.

- **Marketing plans.** Banks like to see attempts to manage income as well as costs. Examples may include negotiating reduced commissions; having a range of selling methods, such as selling direct to feedlots or abattoirs; or perhaps production changes in micron (fibre diameter) or breed to meet client requirements. This section also provides the opportunity to include copies of any media articles received through the year.

- **Financial plans.** By placing this section last, the bank has had a chance to build up a perception of what the finances will look like without any unpleasant surprises. Banks will often ask for the last 3 years' tax records, but they should be accompanied by the last 3 years' management records, giving the banker a more complete picture of the farm's performance. They will also expect a cash flow statement along with a list of assets and liabilities. Also include details of any insurance policies held.

This sounds like a lot of preparation but it will reap significant rewards when negotiating at your interview. It is often said 'the art of negotiation is in the preparation'. Remember that the depth, detail and understanding demonstrated in the loan proposal document will reflect the character, attitudes and values of your farm business. It will show your ability and commitment to servicing the loan, repaying the capital, and generating a return on the bank's investment in your business. It will also directly influence the bank's perception of your professionalism, and hence the margin you pay.

It is important for you to be aware that every year the banks are designing new products. It is therefore important that well before your annual review you investigate the alternatives.

Farm decision making checklist

The farm decision making checklist provided at the end of this Primefact was adapted from the Commonwealth Bank booklet FARM (Finance, Agriculture and Rural Management), 3rd edition, 1992.

Further assistance

Outlook information to prepare your budgets

The Australian Bureau of Agricultural and Resource Economics (ABARE) prepares detailed Outlook information in February and further updates during the year.

Farmers are increasingly subscribing to the range of newsletter services and 'infofax' services available for grains and livestock products. These services not only help in arriving at a realistic budget estimate but are even more valuable close to the point of sale when prices are being negotiated.

Further information

- Drought recovery information on the NSW DPI website.
- Agfact P1.3.2 *Farm machinery: repair or replace?*
- Spackman, G 1994, 'Surviving and Recovering from the Drought', *The Australian Farm Manager*, 5:3. (Mainly financial considerations when preparing for recovering, including preparation of a farm business plan.)
- Australian Bankers' Association, *Understanding the Cost of Farm Finance*.

Acknowledgment

This Primefact replaces Agnote DAI-222 *Financial management during drought recovery*.

ISSN 1832-6668
JOB NUMBER 6096
Updates of this Primefact are available at
www.dpi.nsw.gov.au/primefacts

Farm decision making checklist

1. Are debt repayments a significant problem for me?	YES — Proceed to 2.	NO — Proceed to 3.
2. Can I reduce my debt repayments? Consider, for example: ▪ seeking lower interest rates; ▪ extending the period of the loan; ▪ seeking an interest-only loan; ▪ selling some less-productive assets to repay some or all of the loan, e.g. the 'back' paddock; ▪ repay the stock and station agent; ▪ machinery that could be hired or contracted instead; ▪ livestock that could be replaced by agisted stock.	Yes — Proceed to 3.	
3. Can we increase our family income? Consider, for example: ▪ increasing crop yield; ▪ increasing crop area; ▪ increasing livestock numbers; ▪ increasing marketing percentages; ▪ increasing growth rates; ▪ improving product quality; ▪ improving marketing; ▪ introducing new enterprises; ▪ getting a job off-farm; ▪ investing in an off-farm business; ▪ contracting or share farming.	YES — Proceed to 4.	NO — Proceed to 4.
4. Can I reduce my costs? Consider, for example: ▪ minimum tillage; ▪ rationalising your machinery; ▪ reducing wastage at harvest and in storage; ▪ sharing your machinery or specialised buildings with neighbours; ▪ sell equipment under hire purchase or lease; ▪ using sires longer; ▪ reviewing feed purchases; ▪ improving fuel efficiency; ▪ reducing hired labour; ▪ lowering your sights; ▪ altering your lifestyle; ▪ reducing personal costs.	YES — Prepare gross margins for the enterprises currently on the farm, and also look at other possible enterprises. Proceed to 5.	NO — Proceed to 5.
5. Can I now see any action that I can take to improve our situation?	YES — Prepare a cash flow budget for the coming 12 months. Proceed to 6.	NO — Proceed to 6.
6. Will I now have enough cash to pay my bills as far as I can see into the future?	YES — Proceed to 7.	NO — Proceed to 8.
7. Will this new situation offer me and my family a satisfactory life?	YES — STAY WITH IT !	
8. It seems clear that I cannot continue to farm my own land. Can I see any other ways of continuing to work on the land in a satisfying manner, apart from owning my own land? Consider, for example: ▪ selling, and working for another farmer; ▪ selling, and leasing the farm land; ▪ selling, and leasing a more productive farm; ▪ selling livestock and machinery, leasing the farm to someone else, and working for another farmer. You would be well advised to discuss your plan with your family, your banker, your accountant and your solicitor in order to see if there are any hidden traps. If there are not, proceed as quickly as you can without unduly jeopardising the price you will receive for your land, livestock and machinery.		