MONEY … JUST ANOTHER FARM INPUT

Michael Ryan

Principal Consultant, Booth Associates, Griffith

QUICK TAKE

- Money is a tradable commodity just like grains, fruit, iron ore, water and fertiliser.
- Best business management requires competitive pricing for all inputs—including money.
- Interest rates could bottom out in the next year and provide opportunities to save farm costs.
- There are risks in inappropriate mixes of fixed rate facilities.
- The money market is competitive with significant opportunities for farmers to reduce lender margins.
- Optimising borrowing costs requires well-prepared business plans and experienced negotiation.

A key strategy in successful farm business management is to negotiate the cost of inputs such as chemicals and fertilisers, while retaining a pragmatic relationship with the supplier. Negotiation over the cost of money with your financier is no different. Money should be regarded as another tradeable commodity in the farm business.

A commodity is a marketable item produced to satisfy wants or needs and includes goods and services. Examples of output commodities include grains and fruit, and input commodities include fuel and fertiliser. Wheat harvested and sold off the farm is an output commodity, whereas it is an input commodity to a flour mill or feedlot. Water is also a commodity. There is a recognised market for each commodity which is inevitably driven by the forces of supply and demand.

Money is simply another tradable commodity and there are a number of recognised markets for trading money. One example is the Sydney Futures Exchange (SFE) for commercial bills. Other markets exist for a diverse range of money products such as bonds, currencies and hedging products.

Efficient management of commodities

Farmers buy fertilisers, chemicals, fuel, electricity and other inputs to produce grains, livestock, vegetables, grapes and other crops. To pay for the inputs and to receive payment for the outputs, the funding source is a commodity called money.

It is good business to prudently control the cost of inputs provided yields, quality and profits are not compromised and the asset base is not run down. Cost control includes both the cost of the input and the amount used. Provided the amount used is not excessive for sustaining profits then the opportunity to use less of a commodity is limited and the same goes for money as for other inputs.

Lender profits are dictated by the volume of money under loan and the margin between the cost of funds and income from loans. Financiers also need to constantly improve their efficiency in loan management.

Just as you would negotiate the cost and supply arrangements of farm inputs, you should also be negotiating over the cost of money with your financier.

Commodity booms & busts

Every commodity is subject to a boom/bust cycle and generally the bigger and longer a boom, the bigger and longer the subsequent bust. Talk to wine grape growers and wool producers if you wish to query the boom/bust cycle concept!

The current money market is a mix of boom and bust like any other commodity market cycle. Because current interest rates are so low, it is a boom cycle for borrowers and a bust cycle for investors seeking interest income. For business owners (farmers), the current money market provides an opportunity to make significant savings in the cost of borrowings.

What does money cost?

Simply, the cost of money is what the bank decides to charge you on the agreed mix of facilities. If you have some leverage to negotiate then the cost of funds would be more favourable than for the average borrower.

Table 1 provides the indicative interest rates rounded to the nearest 0.1% for a mix of floating and fixed rate facilities, compiled from six banks at the end of June 2013. Also included are the 90-day bank bill rates traded on the Sydney Futures Exchange (SFE) plus an assumed 3% margin. These rates change constantly so will have changed by the time this article goes to print but the underlying principles and degree of variability will not have changed.

The indicative rates shown in Table 1 are negotiable with the level of variation being driven by factors including:

- the date of the agreed offer
- quality of the business plan being funded
- quality of the security provided
- size of business and the size of the loan
- compliance with lending ratios
- quality of business management
- negotiation skill of the proponent.

Please note a financier may seek to charge fees and margin loadings, which in total will exceed the comparative guidelines in Table 1, where the proponent is seen as a higher risk and/or has a poorly prepared and presented proposal.

As a general guide, better clients have loans in the 5.3–5.8% range but there are some up to 7.0%. We are aware of a total facility offered at 4.9% to fund a very large well-managed business. At the other end of the scale we see new clients with rates up to and over 9.0%.

Just as you would negotiate the cost and supply arrangements of farm inputs, you should also negotiate the cost of money with your financier.

Outlook for money

Figure 1 shows the Reserve Bank (RBA) target cash rate from 1990 to 2013, as a guide to past interest rate trends.

Following the high inflation rates in the 1980s RBA target cash rates were relatively stable from around the early 1990s until around 2005 when rates trended up as the mining boom increased. The global financial crisis saw a downwards correction which then stabilised by 2010–11 before the new downwards trend since 2011.

Figure 2 represents the traded market for 90-day bills on the SFE in about 15-day time steps, over the past 13 months to July 2013. The graph reflects the net impact of changing supply, demand and risk outlooks in the money market where the outcomes reflect all that drives a free market.

The data depicts the not-unusual bumps in the market within an overall downward trend from around 3.5% to the current 2.6%. In the absence of significant market changes and given the RBA's recent

While interest rates are at an historic low, there may be other priorities for your family or business than locking into fixed rate loan facilities.

Table 1. Comparison of indicative interest rates for borrowed funds as at 30 June 2013

Financier	Floating facilities		Fixed rate facilities						
	Overdraft	Variable	1 yr	2 yrs	3 yrs	4 yrs	5 yrs	7 ys	10 yrs
A	10.2%	**BBSW	6.7%	6.6%	6.8%	7.2%	7.3%	–	–
B	8.2%	7.2%	6.3%	6.7%	7.0%	7.3%	7.5%	8.1%	8.7%
C	*–	–	6.3%	6.3%	6.5%	6.7%	6.9%	6.8%	7.1%
D	9.6%	–	5.9%	5.9%	5.9%	6.1%	6.2%	–	–
E	–	6.4%	6.2%	6.2%	6.6%	6.9%	7.2%	–	–
F	8.1%	7.3%	6.1%	5.6%	5.8%	6.5%	6.7%	6.7%	7.0%
SFE	5.9%	5.9%	5.9%	6.3%	7.1%	7.4%	7.4%	–	–

* The blank spaces are where no data was available; **The Bank Bill Swap Rate (BBSW) is currently around 2.9% on the SFE and as a comparative guide, a 3% margin may be assumed.

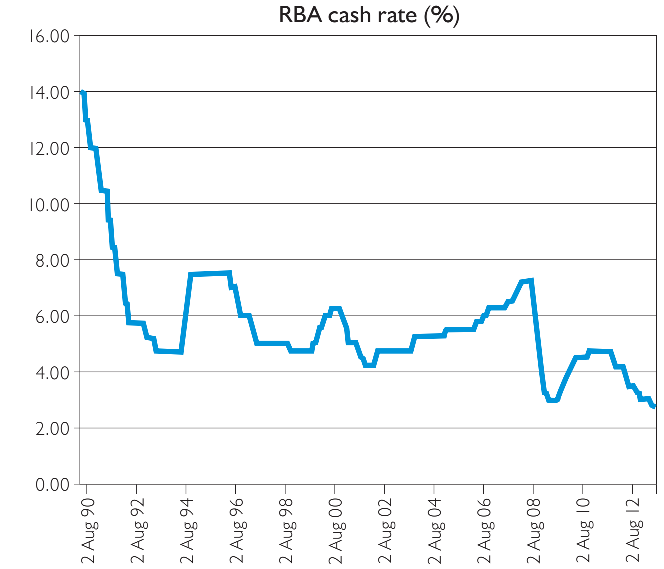

Figure 1. Reserve Bank (RBA) target cash rate 1990–2013, as a guide to past interest rate trends

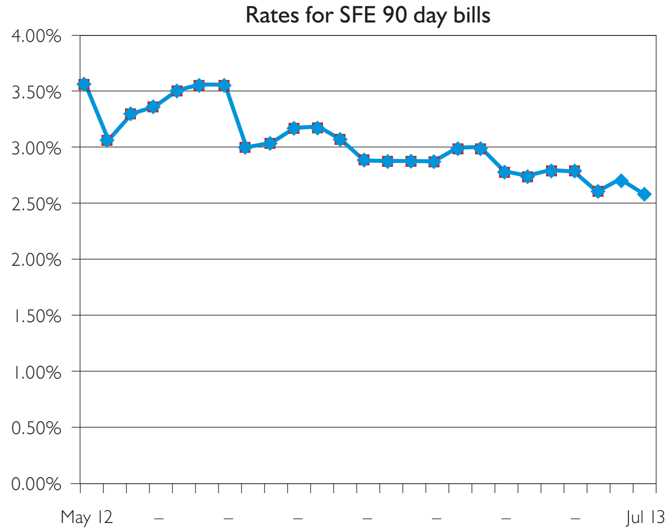

Figure 2. The traded market for 90-day bills on the Sydney Futures Exchange in approximately 15-day time steps over the past 12 months to June 2013

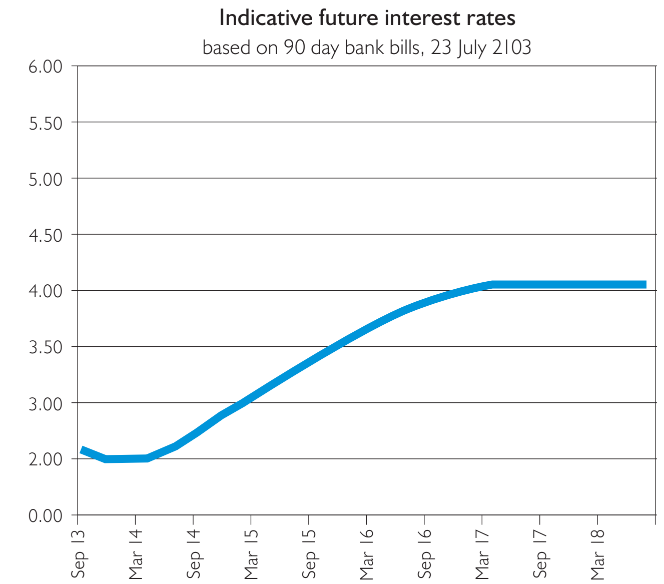

Figure 3. Indicative future interest rates based on SFE futures for 90-day bank bills, as at 23 July 2013

announcements about the key drivers and trends affecting the national economic outlook and the Aussie dollar, it is possible for this downward trend to continue until late 2013 or even as long as mid-2014.

Figure 3 provides the SFE markets view of future interest rate trends out to June 2018. No one knows what will actually occur but markets do seem to build a momentum of their own.

Figure 3 is indicating the market believes there is a modest potential for more falls in RBA rates until late 2013 and into early 2014, after which there is a reasonable chance the rates will commence to rise. The data suggests the anticipated rise is relatively small from 2.6 to 4.4% over 4–5 years.

What is more important and beyond this article is the change in the shape of the (yield) curve over the past month or so. For the past two years the initial drop in bill futures has been quite pronounced and extended and the rises thereafter only modest which reflected the then general negative outlook in the money market. That negative outlook is no where near as pronounced today and may be driven by the combined recent drop in the Aussie dollar and informed commentary on the interest rate outlook.

What does it all mean?

Firstly, no one can be absolutely sure of what markets will do despite trends. However, there are a number of converging indicators to suggest interest rates may be near the bottom of the cycle and start to rise from some time in 2014.

Being near to what seems to an historic low interest rate does not infer there should be a rush into locking into fixed rate loan facilities. The evidence suggests there is time available and settling other business/ family issues first may be more important than seeking the absolute bottom of the market. For example, settling succession planning and who will be eventually responsible for the debt, what capital will be needed and when for business expansion and/or intensification, what capital renewal provisions should be made and when, what education needs to be paid for and/or a raft of other people and business specific needs which must be first addressed.

Understand what you are doing

The opportunity exists to lock in a significant part of your debt for up to 10 years. That is fine but be aware that too much debt maturing at the one time may expose the business to future expensive debt renewal during a period of high interest rates. Managing risk of future debt renewal is as important as locking in the cheapest rates now.

Fixed rate facilities have a premium pricing attached to them so that a lock-in will require an additional interest cost over that for a floating facility. Fixed rate facilities may require the payment of a potentially large 'break' fee, especially on a falling market. Whilst locking in at current low rates should be less risky, long-term fixed facilities should be approached with care, especially where family succession or farm sale is being considered.

How much can you gain or lose?

Using the guideline interest rates in Table 1 and comparing the floating rates with the 10-year fixed rate and assuming a $1.0 million debt, two comparative outcomes may be:

- for financier B the 10-year fixed rate is 8.7%; or 1.5% above the floating rate. Extra cost = $15,000/year
- for financier F the 10-year fixed rate is 7.0%; or 0.3% below the floating rate. Lower cost = $3,000/year.

Assuming these differences remain in a negotiated outcome and the relationship factor is no different, there would be a 1.7% gain (8.7% – 7.0%) or $17,000 per year gain by moving from financier B to financier F which equates to $170,000 in total over 10 years.

Choosing when to lock in

By preparing a business plan and undertaking a negotiated facility does not mean you are committed to locking in at that time. The name changes between financiers but a "switch" facility provides you with the right to choose when to lock in and what mix of maturity dates you elect to run with. That is, you could settle in principle with your financier in say October 2013, then follow the market and choose to lock in a $1.0 million of debt as, say:

- remain with $1,000,000 as a floating facility
- lock $300,000 in December 2014 for 10 years, leaving $700,000 floating
- lock $250,000 in June 2015 for 5 years leaving, $450,000 floating
- lock $300,000 in December 2015 for 7 years leaving, $150,000 floating.

The key point is that you can prepare early, settle negotiations, and by monitoring the market, choose when and in what amounts and for what periods of time, you wish to lock in.

What to do

As with all business decisions, follow best business practice of strategic planning in collaboration with your trusted advisors to benefit from their independent critique and that the plan itself is marketable to financiers to best advantage. Strategic planning is time consuming but imposes a discipline on thinking and ultimately ensures future decisions are in tune with where the business and the family need to be.

The process of preparing a well-considered strategic plan and negotiating with financiers is beyond this article. However when completed it will optimise your chances of minimising the cost of future borrowings. As a guide, each 1% saving on a $1.0 million debt is $10,000 of cost saved per year which is best used to further the development of your business.

Further information

Michael Ryan
T: 02 6964 9911
E: mryan@boothassociates.com.au