Finance for farmers

P.P. Eckersley
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Finance for farmers

By P. Eckersley, Marketing and Economics Branch

Financing has always been an important part of farming. With more and more sources of farm finance, it has become more complicated. This article outlines present sources of farm finance and suggests how a proposal for a loan should be presented.

A farmer must at least match the productivity of his competitors to maintain a comparable income. In the attempt to produce more per man, farmers are using more land, larger machines, more inputs of materials such as fertiliser and sprays, and more sophisticated management.

However, it is becoming increasingly difficult to finance these inputs from a farmer’s own resources, as buying and running a farm is more costly than ever. For example, a typical central wheatbelt farm is worth at least $400,000. This is made up of land and improvements valued at around $300/ha, plant and machinery at around $50/ha and livestock at around $20/ha.

On top of this, farmers often need to outlay a large proportion of annual expenses months before they receive their main income for the year. Annual running expenses now average around $40/ha in the wheatbelt.

To illustrate the changes in farm finance, 15 years ago a farmer with average ability on an average sized farm could keep up the repayments on debts totalling 30 per cent of gross farm value. Today he would find it difficult to keep up repayments on debts amounting to 40 per cent of gross farm value.

Savings possible
With the increasing number of sources of finance for farms, the range of terms and interest rates has widened. Annual instalments are much lower for farmers who obtain longer term finance, matching more closely the payback period of investment in land and farm development.

Savings are also available in the form of lower interest rates. Low interest loans are available for those who can demonstrate a need for growth of their business and the ability to repay. This requires a well-planned proposal.

A well-planned proposal also gives the lender confidence in the borrower. It usually reflects a better standard of management.

SOURCES OF FARM FINANCE
Where farm expansion requires a large amount of borrowed money, often the only practical financial proposition for a farmer is to combine loans from two or more sources. One effect of this is to complicate the job of arranging finance, and it may well take longer to complete settlement and documentation.

This will cost more in time and money, but could be very worthwhile as a means of acquiring a good sized property.

The right combination of loans will depend on the particular investment proposal involved.

Land
Buying an area of land that is large in relation to his present farm will require a long term loan unless large cash reserves are available to meet the deposit and early payments.

Trading banks and vendors have been traditionally the major sources of finance for land purchases, although the Commonwealth Development Bank and the Rural Adjustment Authority have funded many purchases in the 1970s.

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The availability of funds through trading banks from the Primary Industries Bank of Australia may reverse this trend as this new "wholesale" Bank lends for terms from eight to 30 years. The trading banks may increasingly concentrate lending of their own funds on terms of less than eight years.

Interest rates do not vary greatly between these sources, at around 10 per cent reducible, with loans exceeding $100,000 attracting an interest rate of at least 12 per cent. The exception is the Rural Adjustment Authority which lends mainly at 7.5 per cent.

The Rural Adjustment Authority and the Commonwealth Development Bank are last resort sources of finance for farm purchase concentrating on the amalgamation of holdings to create more viable units.

Vendors are an important source of finance for farm purchase especially now that the large sums of money required often exceed the loans available from other sources. Vendors are often prepared to carry part of the purchase price over a five to 10 year term, at or just below the current interest rate on bank overdrafts. Common failings in land purchases are an unrealistically low deposit with excessive annual repayments, and a lack of regard for the costs of machinery, livestock and carry-on finance needed to generate income from the land. Financing of these other expensive inputs should be planned with the land purchase.

The investments required in plant, stock while securing most farm debt at lower interest rates, against land.

Detailed descriptions of the terms and conditions of availability of finance from each source can be found in the Department of Agriculture's Farm Budget Guide.

**Farm Development**

A farm can be developed to generate higher income in many ways, including clearing, pasture improvement, fencing, water supplies, yards and buildings.

Often such projects have been financed by farm income, which has sometimes restricted the rate at which they could develop. It has also often left farmers short of cash that they have been unable to carry on. Of course, development expenditure is not the only type of self-financed investment that has brought these problems.

The trading banks have funds which can be loaned over terms of up to 15 years for farm development, although they have usually found good customers who can repay over a shorter period.

The new Primary Industry Bank now also provides funds for development loans, once again through the trading banks, over terms ranging from eight to 30 years. With the present interest rate of 10 per cent there is, however, little advantage in lengthening the term beyond 20 years.

Table 1 shows how annual repayments vary on a loan of $100,000 when terms and interest rate are varied.

The Commonwealth Development Bank was the main lender for major development in the 1960s and 1970s. Customers must be unable to obtain funds elsewhere, and must apply through their own trading bank.

The Rural Adjustment Authority also provides finance for development. It differs from the Commonwealth Development Bank in that its interest rate is only 7.5 per cent, but applicants are eligible only if sufficient funds are not available from other sources, including the Commonwealth Development Bank.

Farm Water Supply Loans are another source of development finance, available at concessional rates and not subject to a means test.

An eligible farmer may use these funds for any purpose which he and the Department of Agriculture adviser consider will ensure the farm could withstand a season of poor winter run-off.

The loans are for providing a water supply, but not for reticulation. They are handled by the R and I Bank and repayable at seven per cent over 10 years after five years paying interest only.

**Machinery and equipment**

Most farm machinery is bought with cash, the trade-in value of an older machine, and/or hire purchase.

However interest charged on hire purchase finance is high. Rates range from as low as 15 per cent on new machines with Commonwealth Development Bank Hire Purchase to as much as 23 per cent.

<table>
<thead>
<tr>
<th>Interest Rate</th>
<th>Term (years)</th>
<th>5</th>
<th>10</th>
<th>15</th>
<th>20</th>
<th>25</th>
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<td>$24,720</td>
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per cent on second-hand machines with low deposits.
Finance companies find that the risks involved and the competition for funds by other borrowers require such interest rates to make this lending profitable and many farmers are prepared to accept finance on these terms.
With the solid asset backing of the average farmer there should be no security problem for the lender. The ability to repay has become the dominant yardstick for lending. The basic reasons why bank managers direct clients to their bank's hire purchase facility rather than provide a term loan are probably the limited supply of term funds and the greater degree of competition between borrowers than between lenders.
Alternatives to high interest hire purchase loans are to buy machinery only when cash is available, or to use trading bank term loans, Commonwealth Development Bank term loans or in some cases Rural Adjustment Authority or State Government finance (R and I haybaler loans for shared haybalers). However, to negotiate these alternative sources of finance requires more time and effort than the spur-of-the-moment signing of a hire purchase contract.
Commonwealth Development Bank term loans have recently been extended to include machinery replacement. This has been popular as the machine can be paid off over its full useful lifetime. Tractors, headers and other major items of plant are normally used for about eight years before being scrapped, or more usually, relegated to a secondary role, whereas hire purchase contracts don't normally extend beyond four years.
Another innovation is "Reckon", a computer system for comparing alternative machinery deals. "Reckon" was developed by the Farm Management Foundation and has been purchased by the Department of Agriculture, which is designing a format for farmers to use it.
Leasing of farm machinery is an option which is used either when it is the only way that the farmer can pay for large items of plant, or when the marginal rate of income tax is high enough for him to benefit from the full deductibility of lease payments. The effective interest rate on leased machinery is close to that for hire purchase contracts.

Livestock
As with farm development, trading banks, the Commonwealth Development Bank and Rural Adjustment Authority provide finance for stock purchases where the stock are for a long term build-up of flocks or herds.
However, stock firm finance is used more often, for both resale stock and herd build-up. The interest rate charged on this finance is usually about two per cent above bank interest, and the lender normally expects the debt to be cleared within 12 months.
Unfortunately, due to accidents of seasons and markets, as well as to poor planning, these accounts have often become "hard core" debts (not cleared each year). Again, loans which are easier to obtain are usually harder to repay.
Stock firm finance for purchase of livestock is usually in the form of a trading account on which is also debited certain working expenses such as stock requisites and fertilisers.

Carry-on
"Carry-on" describes all requirements for continued trading and operation during the production phase, until income is received from sale of produce and stock. Carry-on finance is usually repayable within 12 months of borrowing.
Sources include trade creditors, trading banks, stock firms; New Land Farmers Carry-on; Emergency Drought Relief and other disaster relief funds administered by the R and I Bank; and the Rural Adjustment Authority.
The diversity of sources of carry-on finance is both a boon and a trap for farmers. In difficult times, it allows farmers to borrow more than would be available from only a few sources.
These relief schemes should not be relied upon under normal circumstances, as neither State nor Federal Government can be expected to under-write agriculture, which has always had to live with unpredictable weather and often unpredictable markets.
Because of this uncertainty a good level of liquidity is desirable. It is wise for farmers to ensure they provide most of their own carry-on especially after a period of good returns or when market prospects are not good.

Housing
Finance for housing has long been a problem area for farmers, partly because they have preferred to borrow for projects more likely to boost farm income.
Also, lenders such as building societies have preferred metropolitan lending. In the city, first mortgage security is more readily available, homes are more readily saleable and less expensive to build, and household income is more evenly spread through the year and from one year to the next.
Trading bank loans have been
almost the only source of finance to complement the farmer's own savings for building a home. In a few cases life assurance societies and stock firms have provided funds for housing. However usually the interest rate is high and repayment may be required within a few years.

The Rural Housing Authority, set up by the Western Australian Government in 1976, has certainly helped to provide finance for farm housing. Some assistance has been by way of direct concessional loans to farm families unable to service housing loans from commercial sources.

However, most of the Authority's impact has been to improve access to normal sources by informing lenders about farmers' housing problems, and through provision of Government guarantees as back-up security on housing loans.

Seeking a loan
For many reasons, the farmer's own bank manager is the most important person to understand and to influence on matters of finance. Access to most sources of finance is through a bank manager, whether it be from the bank, the Primary Industry Bank, the Commonwealth Development Bank, the Rural Adjustment Authority or State funded finance schemes.

It is worthwhile for the farmer to understand the bank manager's point of view. The first thing that should be realised is that there is not an unlimited supply of funds, while there are usually plenty of potential borrowers.

Availability of funds is influenced by Government policy as well as by the balance of payments and other features of the economy. There are also seasonal changes in bank liquidity.

A bank manager does not automatically understand a client's farm, his managerial ability, how good his production record is, or why he should spend more on fertiliser or sprays. The banker, especially if he has limited country experience, needs help to quickly judge the soundness of a proposition.

Another feature of a banker's life is his dependence on head office for decisions on larger loans. However those decisions can be influenced by the submission passed up the line.

The human side of financing is important with all lenders. It is good business to make a good personal impression, face-to-face, on the people who decide or influence lending decisions. When lending policies differ from normal banking practice, it is invaluable to discuss a particular proposition with potential lenders before applying.

Some useful conclusions from a recent study of bank managers by the Department of Agriculture in New South Wales were:

- Their approach to lending has changed over the years. There is now less emphasis on banking history, "connections", and security, and more emphasis on managerial capacity of the borrower and hence capacity to repay.
- Bankers are therefore required to make more technically-based judgements.
- Different managers, given the same bank lending guidelines, were prepared to lend different amounts for identical loan proposals.

Farmers should be prepared to shop around when seeking farm finance, even when that may mean changing banks.

Be early
The sooner a farmer becomes aware of the amount of finance required, the easier it will be to arrange. Planning and looking ahead will also help by giving the bank manager some advance warning of requirements. Acting early on finance allows the farmer more scope for minimising the costs of finance and for making alternative arrangements if necessary.

In spite of the fact that some bank managers refuse to consider overdraft levels for the coming year before the current season's crop is harvested, early applications are more likely to succeed than late ones.

Best programme first
It is to the farmer's advantage to be early and to submit his "best" programme first. Financial limitations may cause this to be pruned later, and an alternative feasible plan can be retained in case less than the optimum finance is available.

Document it well
Because of limited time and reliance on memory, face-to-face or telephone communication must be well supported by figures, words and pictures to give the lender a clear idea of what is required and how it will be repaid.

Applications for development finance or for funds to buy a new farm are best supported by budgets for more than just the year ahead. A cash flow budget is necessary to determine peak debt, and background assumptions on yields, rates and prices should be included in such a submission.

A lender can approach an obviously well-planned and conservatively budgeted project with confidence. Confidence is a vital ingredient in business decisions, for farmer and banker alike. Unless the banker knows the farmer extremely well, he will need evidence that the project is a good one.

Persistence
Nothing impresses a lender less than the borrower who fails to show enthusiasm and interest in his proposed venture. As well as showing this enthusiasm, keeping in touch with the lender will enable the farmer to ensure that assessors have all the information they require. Just occasionally this can alert the lender that an application has been mislaid!

These and other normally unwritten "rules" amount to no more than common sense, a vital ingredient in any business undertaking.