HOW A BANK VIEWS MY FARM

TYPES OF BUSINESS BORROWING

There are four common ways that a farm can borrow off a Bank or Finance Company:

1. Overdraft – permission to go into a negative figure on a Bank account.
2. Loan – this can be unsecured or secured. If secured against property it is commonly called a Mortgage or Agricultural Mortgage
3. Asset Finance – usually secured against the asset, typically machinery, being purchased – this is common in Agriculture
4. Sales Finance or Invoice Discounting – as you issue invoices, rather than await the period of credit given to your customer the Bank or finance Company pays you a percentage up front as you issue invoices to debtors.

Which is the best way for a business to borrow money?

- This will depend on the following key questions.
- What is the purpose of the borrowing?
- What is the nature of the business?
- How is the debt to be repaid?
- What assets does the business hold?
- What type of legal entity is the business trading as?

Types of Legal Entity.

- The 3 most common types of legal entity in business are:

1. Sole Trader - a person who is the exclusive owner of a business, entitled to keep all profits after tax has been paid but liable for all losses.
2. Partnership - Partnership. Sometimes referred to as a general partnership. The **relationship which subsists between two or more persons carrying on business in common with a view to profit**. Partnerships are governed in the UK by the Partnership Act 1890. A partnership is not a separate legal entity. Partners generally have unlimited liability.
3. A Company - an **association of persons formed for the purpose of some business or undertaking, which has a legal personality separate from that of its members**. A company may be formed by charter, by special Act of Parliament or by registration under the Companies Acts.

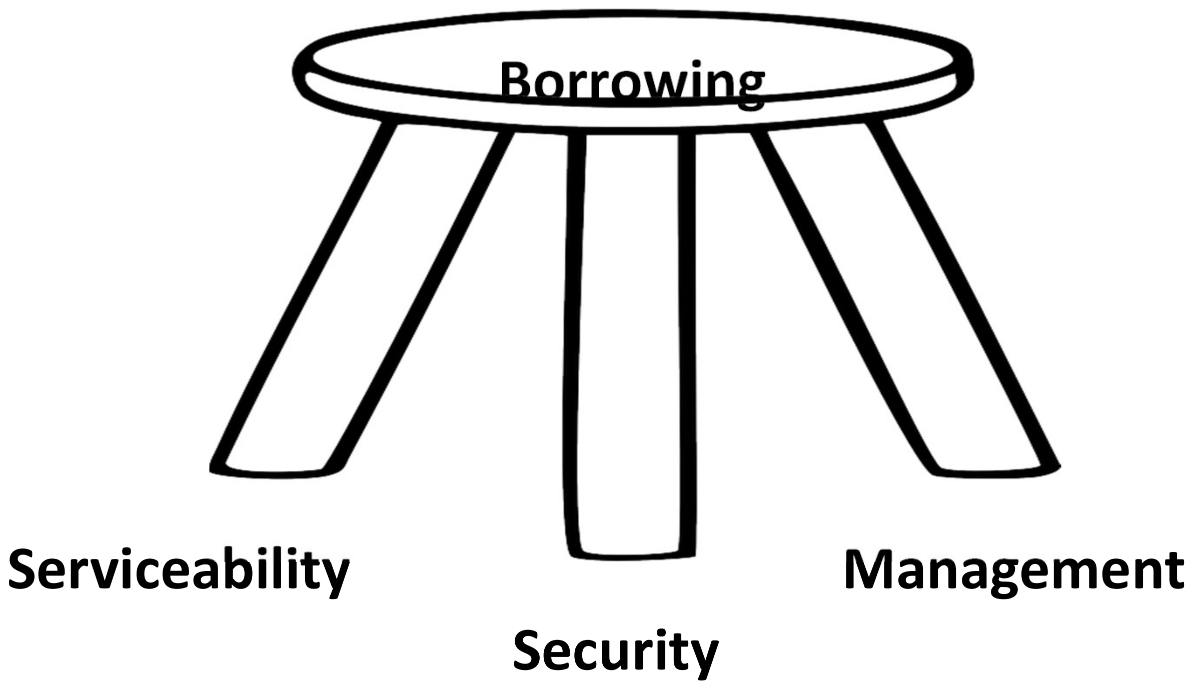
Other Types of Legal Entity and considerations to be given to them

- Trusts – Formed by a deed. This is not an uncommon form of business, but any Trust Deed must give the trustees authority to borrow for the debt to be enforceable. If a trustee borrows money on behalf of the Trust without that authority they may become personally liable for the debt.
- Limited Liability Partnership – this has the same basic principle as a Partnership, but differs in one key aspect, that is the Partner's liability for any debt incurred is limited by an amount, or limited to the assets of the partnership. In this aspect they are more akin to Companies. They do have to be registered at Company House in the UK.
- Clubs and Associations – these are people joining together for a common interest or cause, but not for profit. Whilst not impossible for them to borrow, if borrowing is required it is more usual for them to incorporate (become Companies). Current identification and verification requirements make them increasingly hard to Bank if they are not incorporated.
- Charities – these can be registered or unregistered and may take the form of a Trust or Company. If they are not formulated by a clear process (as a Company or Trust) the ability for them to Bank let alone borrow can be restricted.

Matching the borrowing purpose to the type of borrowing examples:

PURPOSE OF BORROWING	OVERDRAFT	LOAN	ASSET FINANCE	INVOICE DISCOUNTING
Working Capital	x			x
Purchase of Premises or land		x		
Purchase of Vehicles			x	
Purchase of Machinery			x	
Funding Growth of Turnover	x			x
Raw Materials/Stock	x			
Buying out a competitor	x	x		x
Funding recovery from disaster e.g. catastrophic crop loss	x	x		

WHAT DOES A BANK OR FINANCE COMPANY LOOK AT.



SECURITY – what will repay the loan if the business cannot repay it.

- Personal Covenant – this is the financial worth of the individual or partners of the business and is particularly relevant for sole traders and partnerships where they have personal liability. In the case of a Company the personal covenant can be tied into the Company's borrowing by the individual issuing a personal guarantee for the Company's debts.
- Mortgage – this is a charge usually over land assets that means if the business fails any proceeds of sale clear the debt. It is possible to have a chattels mortgage over machinery. In the case of Agriculture there is an "Agricultural Charge " available that can secure the crops, livestock and machinery on a specific area of freehold or tenanted land. This gives the lender the ability to trade through an agricultural cycle to get the best out of a failing farm's assets.
- Debenture – a Company can give a debenture over its fixed and floating assets. In times of failure the beneficiary of the debenture can take steps to control and realise these assets. If you give a new lender a debenture it can push prior lenders down the pecking order, this can be controlled to the satisfaction of multiple borrowers by the issue of a deed of priority for the amount of the debt. But care should be taken where multiple debentures are issued.
- Hire Purchase – this is commonly used with vehicles and some machinery where the asset remains the property of the lender until the final payment is made. Alternatively a charge can be made over the asset securing that debt.
- Personal guarantee – this is most often used when a Company borrows money, but the premises may be owned by a director or shareholder so they will possibly give a personal guarantee supported with a mortgage over their property. A sometimes tidier alternative is for a third party mortgage to be given by the asset owner as this captures the full value of the asset for the mutual benefit of both borrower and lender.

EXAMPLES OF GOOD AND BAD SECURITY

GOOD SECURITY

- Freehold land and buildings used by the business.
- Agricultural land without a tenant.
- Vehicles or machinery on wheels.
- A floating charge over book debts owed by good quality Companies.
- An Agricultural Charge – typically tenant farmers can give this it is a charge over the tenancy, all livestock, crops and unencumbered machinery. It is also occasionally used on Freehold land.

BAD SECURITY

- Personal dwelling house – whilst this may be good security for the Bank your home is at risk. Banks do not like kicking people out of their homes. Because of this any lending to a soletrader or partnership that uses a house as security is heavily regulated.
- Livestock – they only have a value once sold and require upkeep – however for shorter trading cycles such as pigs and poultry this may not be an issue.
- An empty pub, shop or nightclub, or property with specialist use – a pub, shop or nightclub has a greater value whilst it is occupied – for this reason a lender may take a supplementary charge to give it the right to keep it open to realise a greater value.

Value of Security

Depending upon the business Bank's typically lend at 70% loan to value with overdrafts and loans. This percentage can go up and own depending upon the quality of the business and the Bank's exposure in the market place. However, it is common for farming businesses to use more than one Bank. The typical model will be that AMC lend money to buy land, they have a 1st charge and then another Bank will take a second charge on the same land to enable it to lend a working Capital overdraft. Using more than one Bank in this way can be a disadvantage if you have limited assets as security – consider the following example.

FARMER A has £1,000,000 farm as security he only uses Lloyds Bank. He has a mortgage of £600k and can have an overdraft of £100k thus 70% Loan to Value (LTV)

FARMER B has £1,000,000 farm as security. He has £600k mortgage (60%) LTV He also wants a working Capital overdraft with Barclays, whilst happy to take a second charge behind AMC the value of the security is much reduced because of the following:

£1million – 70% of this is £700k – AMC lend £600k – this means the available value of security to Barclays is £100k. 70% of 100k is £70k. By multibanking Farmer B has lost borrowing power.

Value of Security

For land to have its maximum value for borrowing purposes it has to be valued by an independent valuer who will consider the value of the land UNDER FORCED SALE CONDITIONS.

This is often below the current market value and should be considered when calculating potential ability to borrow.

SERVICEABILITY – the most important factor of all , how the debt will be repaid.

Examples of sources of repayment:

The trading cycle – typically the period from when stock and raw materials are purchased to when the finished goods are sold and payment received.

Profits – more correctly surplus profits - a business can make a profit but still be short of cash to service a debt - often EBITDA is used Earnings before interest, tax, depreciation and amortisation less drawings to identify the amount of funds available to service debt. You then have to consider **all** the debt that the business repays.

Future sale of an asset

Serviceability – The Trading Cycle

The key to this is that the lender understands the different trading cycles of a business and a good borrower takes time to explain this clearly to the lender in order to get the right type of borrowing sanctioned.

Typically an overdraft or invoice discounting will each be repaid comfortably within a trading cycle. But this will vary greatly from business to business and one business may have many cycles – examples as follows:

Mr Bennett the Butcher purchases carcasses from a wholesaler on a Monday. He makes sausages, pies and butchers the meat into joints and these are mostly sold within a week. This means that he needs to fund a trading cycle of one week from when the carcasses are purchased to when they are sold.

Mr Giles the Farmer buys calves from the local dairy, he feeds them on grass for eighteen months and then sells them to the abattoir who pays him within a month. This means that Mr Giles needs to fund a trading cycle, the cost of animals, feed, vets etc for nineteen months.

Mr Giles the Farmer also grows wheat that he buys seed in October, plants in November and harvests in July when he sells it off the field and gets paid a month later. This is a trading cycle of 10 months. If he stores grain this could extend further.

Serviceability - EBITDA

- Earnings Before Interest Tax Depreciation and Amortisation is a key method of calculating serviceability of debt. Provided you have up to date full annual accounts this can be easily done.
- 1. Take Net Profit before tax
- 2. Add Depreciation
- 3.Add interest charged during the year for debt
- 4.Subtract amortisation (most common item amortised is Goodwill)

This should give you the EBITDA figure, from this you then take off any essential drawings or dividends this gives you the amount of cash the business has generated that is available to repay debt.(N.B. Essential drawings are the minimum required by the partners or directors to enable them to live)

MANAGEMENT

How good is the management of the business?
Experience and track record as both a farmer and a buisinessman?
Good management looks like:
Good records and up to date accounts.
Low bad debts.
Contingency or “what if” plans
Management of change and ability to adapt.
Clear communication within business and happy people
Planned expenditure and cost control
Well utilised machinery and people

Bad management looks like:

Poor records, bad accounts , bad debts

Poor communication between people

No contingency or “what if” planning repeatedly blaming on bad luck or the actions of others.

Unhappy people with high staff turnover

Poor organisation, waste of money and resources

Inability to accept change, even if that change requires drastic action.

Underutilised machinery and people

PURPOSE OF DEBT

Debt reduces the choices of what a business or an individual can do with their cash in the future as the debt will need to be repaid. With this in mind consideration to what is good debt or bad debt should be given.

For a farm good borrowing purpose would typically be: purchase of land and premises; purchase of machinery; working capital; funding expansion of business; funding a new project that has been costed and forecasted to increase profit; funding recovery from a disaster such as flood.

For a business bad borrowing purposes could be: funding of luxury vehicles; funding growing year on year losses; funding lifestyle of owners; funding uncosted and ad hoc projects that may not increase income.

These principles are not set in stone, but are a guide for consideration