FARM BUSINESS FACT SHEET

GRDC
GRAINS RESEARCH & DEVELOPMENT CORPORATION

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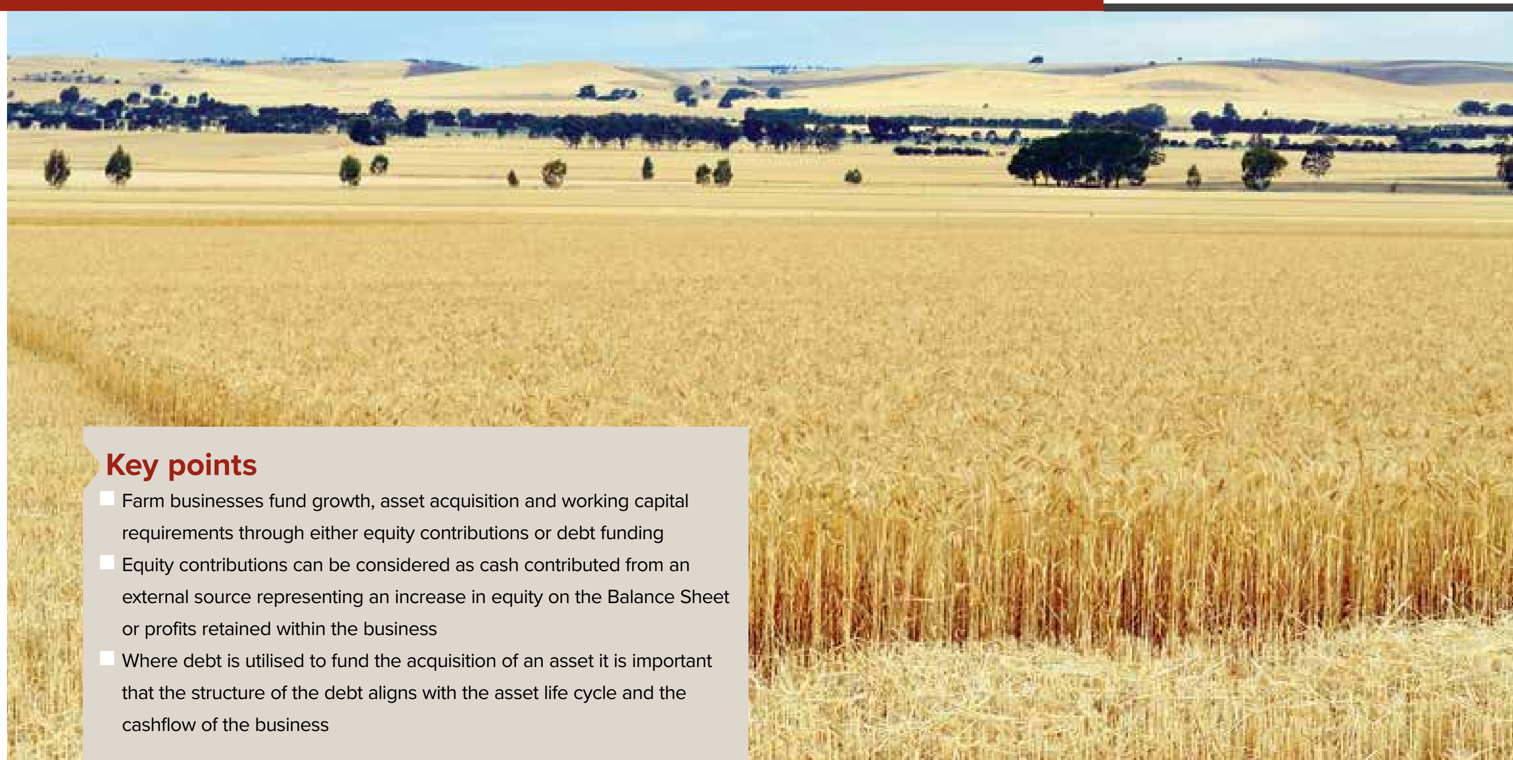


Key points

- Farm businesses fund growth, asset acquisition and working capital requirements through either equity contributions or debt funding
- Equity contributions can be considered as cash contributed from an external source representing an increase in equity on the Balance Sheet or profits retained within the business
- Where debt is utilised to fund the acquisition of an asset it is important that the structure of the debt aligns with the asset life cycle and the cashflow of the business

PHOTO: EVAN COLLIS

Financing: debt structuring and asset life cycles

When debt is utilised to acquire assets, it is important to ensure that the structure of the debt or loan is aligned with the asset's useful life

Summary

The decision to utilise debt or equity is a decision made within the farming business and is dependent on several factors. These factors are individual to each business and relate to timing factors associated with cashflow requirements and the availability and cost of capital. A loan taken at the time the asset is purchased should be finalised before the end of the asset's useful life. This is particularly relevant for plant and equipment such as harvesters or tractors. The reasons for this will be explained in detail.

The structure of debt is defined by the term of the loan and the repayment program, while the useful life of the asset relates to the time over which the asset will contribute to business operations. This practice ensures that debt obligations (repayment of principal and interest) on the asset are finalised before the time at which the asset no longer has a role to play in income generation within the business.

Background

ASSET LIFE CYCLE

The full asset life cycle relates to the acquisition, use and disposal of an asset within the farm business operation. This includes its purchase and use in the business, including its eventual disposal through sale or decommissioning. The useful life of an asset is the period over which the asset contributes to the operations of the farming business. Decisions to replace equipment may be driven by reliability or efficiency considerations or by new technology coming on to the market. The existing asset may continue to function but has reached the end of its life cycle within the business.

It is generally accepted that an asset acquired for business use will have a finite life expectancy within that business. Two of the few exceptions to this are farming land and livestock. This concept (critical to agriculture) is acknowledged by the fact

that land and livestock are not depreciated. The buildings and improvements constructed on the land can be depreciated. This reflects that a time in the future will arrive when the buildings are no longer suitable for use and will require replacement. Generally, the period over which the assets are depreciated will reflect a 'rule of thumb' life expectancy.

Machinery and equipment are always depreciated to reflect the diminishing value of the asset over time. At a point in the future, the equipment will no longer contribute to the revenue generation of the farm. When purchasing a tractor, the full cost of the tractor is not recorded as an expense in the year it is purchased. The tractor will be used on the farm over several years. So, the cost of the tractor is recorded as an expense to the business over its useful life, generally 10 years from new.

Depreciation is the mechanism whereby the cost of the asset is recorded against income, over a period reflecting the average useful life of the asset (that is, two to ten years). In a straight-line depreciation of a tractor over 10 years, a purchase price of $100,000 will be recorded as $10,000 per annum.

Note: There are alternative methods of recording depreciation. See the GRDC's 'Investment in Harvest Machinery' farm business fact sheet (https://grdc.com.au/FS-MachineryInvestment) for more information.

EQUITY FUNDING

Equity being contributed to the farm business may be derived from external sources (third-parties), or through the sale of assets owned outside of the business. It represents an ownership stake in the enterprise and entitles the contributing parties to a share of the profit. If the farm business is very profitable then the equity holder will be entitled to their share of the profit, which will be uncapped in real dollar terms. Equity once contributed represents an investment in the farm business, with the financial return determined by the performance of the business.

Equity capital is exposed to risk of loss or devaluation. This is because equity owners are the last in line to receive proceeds from the sales of an asset. Proceeds will be applied to the satisfaction of the outstanding statutory obligations of the farm business and then to the secured creditors and unsecured creditors, in that order.

DEBT FUNDING

When debt is funded, capital is contributed to the enterprise by a lender (e.g. bank). The lender will enter into a loan contract with the farm business. The contract will specify the term of the loan, the interest rates and any repayment structure that will apply to the loan principal, as well as how interest will be calculated and charged.

Lenders such as banks, generally provide the loan against some form of security (most often this includes land or machinery and equipment, but it may also include livestock). If the farm business is unable to fulfil the terms of the loan contract, the lender may exercise their right to sell the loan security to recoup the debt. They may enforce the sale of the asset to reclaim the outstanding loan amount, plus any accrued interest and costs. Under the terms of a loan contract the lender is only entitled to recoup the principal loan amount plus the prescribed interest and charges outlined in the original contract along with associated costs.

In the normal course of business operations the lender will not be entitled to any share of the farm business profits. This is an important characteristic of debt funding, which differentiates it from equity.

THE DIFFERENCE BETWEEN EQUITY AND DEBT

Equity investment involves a higher degree of risk than debt funding as the equity is not directly secured against the farm business assets. As a reward for this risk, equity investors usually seek a higher rate of return on their investment.

A company such as Australian Agricultural Company (AA Co.), which is listed on the Australian Stock Exchange, allows investors to purchase shares in the business. Investors will assess the rate of return they require as an appropriate return, determined by the risk associated in investing.

If AA Co. were to obtain debt funding, the interest rate charged by the lender should be less than the rate of return the investors expect. AA Co. is required to pay a higher premium for equity funding, but it provides greater flexibility to the business as equity investor's returns are determined by the financial outcomes of the operations of the business.

Debt funding is set at a prescribed interest rate. This interest rate reflects certain characteristics of the risk profile of the farm business, such as the strength of its balance sheet and profitability.

This risk profile is determined by the percentage of equity in the farm business as a measure against the total assets, the return on equity achieved by the business and the market value of any assets provided as security. It is a combination of these factors that will affect the risk rating and ultimately the interest rate charged.

At the time of purchasing equipment or land, businesses must decide how to make available the capital required to fund the purchase. This is the time when consideration is given as to whether equity, debt or a mix of both will be used to fund the purchase. There are generally several factors which will influence the decision on the funding mix used to pay for the purchase:

- The availability of equity capital – cash balances at bank, farm management deposits or proceeds from the sale of assets.
- Seasonal requirements of the business for working capital.
- The cost of debt funding.
- The opportunities to deploy equity in alternative business activities.
- The returns available on alternative opportunities.

If a farm business has surplus cash in bank accounts earning interest – classed as income for tax assessment purposes – it may be effective to use this cash for the asset purchase rather than secure debt funding. This assessment needs to be made in consideration of each individual circumstance.

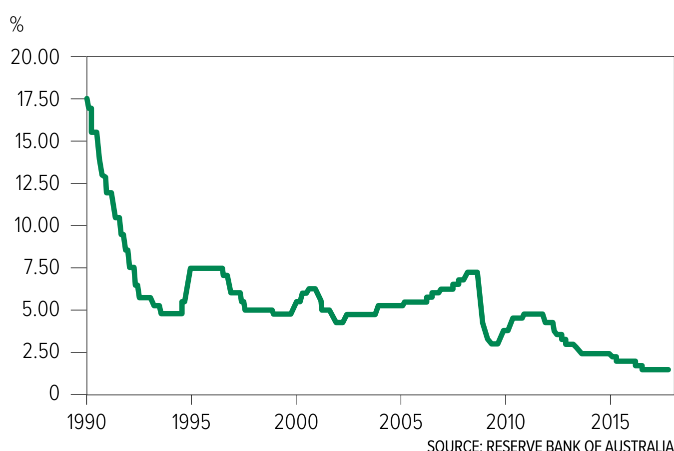
Equity funding allows the business greater flexibility regarding operational decisions. There are no committed time frames or cashflow requirements for the payment of interest charges and principal reductions. This means the business can make decisions optimal for the business rather than being constrained by a cashflow obligation to meet repayments on debt.

AT THE TIME OF PURCHASING

If the acquisition of the asset will achieve a cost saving (i.e. less repairs and maintenance on new equipment) or efficiency gain (i.e. more timely operations leading to improved production) the benefits of these outcomes need to be quantified to evaluate the cost benefit of purchasing the new equipment. Purchasing a new boom spray may require additional finance costs to be incurred. If spraying operations can be completed in a timelier, more effective way, positive impacts on production could potentially offset the additional finance costs. It is important that the potential benefits are not significantly overstated, to ensure that the benefits to the business are realistically evaluated.

The cost of finance will be impacted by the cash rate of the day, which is set by the Reserve Bank of Australia (Figure 1). As this rate decreases or increases so too will the cost of finance. When the cash rate is at low levels, the relative cost of finance may facilitate the upgrade or replacement of equipment more readily as the benefits of the replacement or upgrade of the equipment are able to offset the increased costs more readily.

FIGURE 1 Cash rate used to align the debt term with the useful life of the asset.



When debt funding is used to purchase a business asset it is important that the term of repayment of the principal, does not exceed the useful life of the asset. This ensures that by the time the asset has ceased to contribute to farming operations, no further cashflow from operations needs to be directed towards the repayment of the debt used to acquire it. This leads to further consideration as to the capacity of the cashflow to accommodate the scheduled repayments. A repayment schedule should ensure that the repayments on the asset are finalised within the term of the useful life of the asset and can be met from the farm business cashflow.

Increasing the term of the debt to reduce the monthly/ quarterly or annual repayment obligations, can have the effect of eroding equity within the business by creating the situation where the outstanding debt exceeds the value of the asset. Extending the term will also increase the overall cost of the asset acquisition through the additional interest charges over the longer timeframe. Consideration needs to be given to the declining value of the asset and the remaining life of the asset to ensure they are appropriately aligned. In terms of machinery and equipment, a harvester would have a longer useful life than the associated GPS equipment, which has potential to become outdated more rapidly by developments in technology.

Where the cashflow of the business cannot support the required repayments, it would be prudent to review the acquisition. It may be possible to identify additional income sources that could be generated. If the new machinery is more efficient and reduces the time of operations, there is the possibility that it could be deployed into contract work for a third-party.

The alternative strategy might be to review the asset acquisition and identify workable solutions, which require a lower initial investment, thereby reducing the debt requirement and the repayment commitment. This may involve purchasing secondhand equipment, as opposed to new equipment, or reviewing the specifications required to adequately complete the task.

FINANCING THE ACQUISITION OF LAND

Land is one asset class that is not depreciated. This means that the purchase and funding of land may be viewed differently to other asset classes. Interest-only funding is commonly used to fund the purchase of farming land. A key characteristic of interest-only loans is that annual interest is paid by the borrower to the lender on the debt, but there is no contracted repayment to reduce the principal component.

Calculating the finance costs on land

The real cost of this finance structure to the business will be determined by the negotiated interest rate, the profitability of the business against which the interest can be expensed and the increase in the capital value of the land (Table 1).

TABLE 1 Example calculation of finance cost on land.

Land cost of acquisition	$500,000	
Assume 100 per cent debt funding @ 6.5 per cent p.a.	$500,000	
Assume corporate tax rate 27.5 per cent	$32,500 interest expense	Tax component benefit $8937
Real cost of finance	$23,563	
Cost of finance as a percentage	$23,563 /$500,000 x 100 = 4.8 per cent	

An $8937 tax-reduction benefit can be deducted off the total interest bill. The real cost of finance can then be determined as $23,563, or, effectively, 4.8 per cent per annum, when calculated against the market value of the land.

The other financial benefit of land ownership is achieved through capital appreciation of the land over time.

FINANCING THE ACQUISITION OF MACHINERY AND EQUIPMENT

Machinery and equipment should be funded in line with the useful life of the asset, taking into account the effective life and realisable value of the asset, which is determined by several factors.

- Potential for the item to become obsolete:
- The length of time over which it will be used before it requires replacement.
- Accessibility to a second-hand market for the item.
- Depth of the second-hand market.

If the machinery or equipment could reasonably be expected to have a 10-year useful life within the business, it would be

acceptable to suggest that the term of funding could extend to this length of time. When initiating an asset finance contract such as a lease, chattel mortgage, equipment loan or hire-purchase it is unusual to find contracts that extend beyond 60 months. The method of reflecting a longer lifespan for the asset is to structure the finance contract with a balloon or residual.

When the initial 60 months is complete, the balloon or residual value left in the contract can be refinanced for a further period, effectively extending the term of the finance contract. In the case of a harvester, the initial finance contract might be for 60 months with a 40 per cent balloon at the end of this period. This allows two options:

a) sell the header and payout the balloon; or
b) refinance the 40 per cent balloon for a further period.

Overall the total period of the finance is the combined duration of the two contracts.

FREQUENTLY ASKED QUESTIONS

When is interest-only debt appropriate to use?

When purchasing land or real estate property, interest-only funding is often provided for an initial period. In the case of land involved in agricultural production, the effective cost of finance can be calculated and compared to the cost to lease land. It then becomes possible to make an assessment as to the relative cost benefit of purchasing or leasing. When purchasing a property, the owner also receives the benefit of capital gain on the land during the period of ownership and land is one of the few non-depreciating assets as its value is not extinguished through use.

If I have cash available should I use the cash to pay for new equipment rather than using debt?

There may be alternative uses for the cash that generate a better return within the business. Depending on the requirement for cash in the operations of the farm business, it may be better to maintain the cash for other opportunities and use equipment funding to finance the acquisition of new equipment. Each business will differ slightly so you would really need to review the situation within your own business.

How should I evaluate the term of finance I use on machinery acquisitions?

It is important to have an idea of the time over which you intend to use the machinery. If you intend to replace it after two years then the finance term should be no longer than two years with a balloon/residual. This will enable the machinery to be replaced without incurring penalties to pay out the facility.

If the asset will realistically have a limited useful life beyond three years, with no resale value due to it being obsolete, or lack of any second-hand market, the finance contract should not exceed 36 months. This ensures that when the asset requires replacement, all finance commitments have been extinguished. Similarly, if the business intends to replace the asset after 24 months and could reasonably expect to see about 50 per cent of the initial value retained, then it could be appropriate to enter into a finance contract for 24 months, with anything up to a 50 per cent balloon/residual.

What should be avoided is entering into a finance contract on which the termination date is after the intended disposal of the machinery or equipment. When a finance contract is paid out prior to the expiry date, the lender may impose a penalty on the borrower.

CONCLUSION

Capital is accessible to farm businesses via equity or debt funding. The cost of each is dependent on the rate of return expected by an investor or the rate of interest charged by a lender. Interest rates reflect the RBA cash rate and the prevailing economic conditions, including factors such as inflation and the risk profile of the business.

When assets are purchased they may be funded from debt or equity or a mixture of both. When debt is used to finance the purchase of land or machinery the finance structure should reflect the useful life of the asset. The purchase of land can be funded over a longer term as the asset is not depreciated. A harvester, by comparison, has a defined life and will be replaced at some time.

In the case of land, interest-only loans may be used, this reflects the characteristic of land and the fact that it is an appreciating asset. In the case of machinery, the outstanding debt will need to be steadily reduced as the asset is depreciated over time. This ensures that when the machinery is at the end of its useful life, the liability related to the asset does not exceed its realisable value from sale or trade-in. □

USEFUL RESOURCES

Reserve Bank website, https://www.rba.gov.au/statistics/cash-rate

MORE INFORMATION

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