ACCESS TO COMMERCIAL FINANCE
FOR RURAL INDUSTRIES

OBJECTIVE

"To develop products or approaches that realise rural equity"

Background

One of the major challenges identified by numerous surveys, consultation processes and investigation into the financial capacity of the rural industries is the capacity of the industry's businesses to attract investment monies or access commercial finance.

Following analysis of ABARE data and benchmarking studies as well as semi-structured interviews with banks and other rural lending houses it is apparent that:

- cashflow is a key driver of debt-based financing
- the risk associated with primary production are all to apparent and lenders have equity benchmarks that are time-honoured.

With respect to the last dot point and in terms of debt-based financing it is apparent that 70% equity is required as a minimum and this figure (along with cashflow capacity) dominates lending practices.

In comparison, businesses in other sectors require a notional 50%equity. Therefore it is difficult for primary industry to compete on return on capital invested, benchmarks.

Given that rural sector debt-financing requires 70% equity is there potential to unlock this equity to be put to work in other investment areas which is acceptable to debt-financiers that hold first and second mortgages.

To this end one would have to assume that only liquid capital guaranteed approaches would be appropriate. Or would they?

This conundrum is at the crux of a research investigation and if this issue can be resolved and appropriate instrument commercialised there is a market which offers significant opportunity.

Typical Farming Scenario

We are 48 and 45 years old.

Over the last 2 to 3 ten-year cycles we generally have 3 good years 4 what you might call average years and 3 poor to rotten years. All in all we cope and for the last 5 years we have stacked-away about $20,000 a year in super, have the 2 kids (15 and 13) currently away at boarding school (the 9 year-old will also go when she's 12) and we make a point of taking a good break for a couple of weeks each year down at the coast. Other than that we seem to be able to get by and do what we like to do best - "doing what we want to do, being our own boss and living on the land".

One day (when we're 60-65) we want to set up (after the kids have been through Uni) one of them on this place, make sure the other two are set up in some sort of career/business of their own and retire comfortably.

So basically the situation to date looks like this:

We have a freehold title to 2500 hectares of farming country conservatively estimated (by local standards) at $400 per hectares on a walk-in-walk-out basis.

Most of our machinery is leased or hire purchased (for tax purposes)

We have a working over-draft of $175,000 which is presently drawn down.

We have a term-debt of $150,000 (we have just renewed this at the best rates available)

Our turn-over is about $500,000 on average each year.

Our running costs (lease, cropping, R&M etc) and living costs (super, school, drawings tax etc) is generally around the half-a-million as well.

Our equity is just under 70%

In fact, when we think about it, there hasn't been to much change in this scenario since I took over from Dad about 15 years ago and it was probably the same scenario when he took over from his Dad some 40 - 45 years ago.

Actually it's pretty typical of just about all of the people we know that's in the rural game.

However we know that to be able to do what we want to do (ie educate the kids through Uni, set them up and for us to retire comfortable off the property) we are going to have to do a bit more with the money we have tied up.

We would like to invest in some off-farm income producing or asset creating exercise so that when we have to do the sorts of things we want to do we have the "readies" to do it.

However when we went to the banks, and its one of the thing that really irks us, is that traditional banks wont lend us (and its not just us) any more money. They say the industry benchmark for equity is 70% (maybe 65% if we weren't at a stage of live where we have heavy drawings for kids education and stuff) even though we have just under $700,000 unencumbered - just sitting there. They reckon its because the nature of the industry is risky (seasons, commodity price variability) are such we require this "buffer" compared to other sectors.

OK, I know cashflow is king and farming is seasonal but I cant recall in my lifetime anybody going broke (other than a Queen St lawyer type over Wildcatchum way and he was only trying to speculate on capital gains). So its got me beggared how come we have to have all this equity sitting there when for the life of me I cant tell you when the last time there was a foreclosure of a real farm.

So, how do we unlock this equity and what sorts of thing can we do with it that doesn't put the family farm at risk??. As we said, we want to use this unencumbered capital to work for us to generate off-farm income and/or assets.

What advice have you for us??

SCOPING THE ISSUE (Stage I)

In Stage I of the EOI we would like to see advice and suggested approaches to further pursue in Stages II and III. The advice should scope the issues alluded to above, offer suggestions on structure of the business and any existing products that are currently available or planned to be available and make recommendations as to possible solutions. In addition we also would expect some initial ideas on conceptual approaches that would need further investigation that would lead to new products or instruments that would meet the objective.

DEVELOPING NEW PRODUCTS (STAGE II)

While the above scenario is not a real life case our research indicates that this scenario is widespread throughout the industry. It is acknowledged that financial services professionals may be able to provide advice on better structures for the business and offer a number of existing products for better advantage however we are unaware of a universal solution to the issue.

To this end Stage I of the EOI wants advice on structure and products alluded to in the paragraph above. But more importantly in Stage II we would like to further explore the development of specialist products that deals generically with the issue of the rural industry requiring 70% of its capital tied up redundantly against traditional debt-based financing instruments.

Our view is that the financial services sector continues to use only the traditional debt-based approaches and has not applied more contemporary thinking to developing more contemporary instruments.

In Stage II the task is to scan the latest in contemporary debt and equity approaches and to conceptually design possible approaches and/or products. It is expected that the while the detail is not “hung on the frame” we would like to see a “frame” that is theoretically possible that meets the objective.

COMMERCIALISING THE PRODUCT (STAGE III)

In Stage II above we have explored in greater detail the possibilities of new products at least to a conceptual and theoretical stage. Phase III is about taking the best of these conceptual options (ie the best bets) and pursuing these to a defined product. However as the front end to Stage III we would like to investigate a number of options that our research has identified, specifically:

The unencumbered asset is:

- rented (maybe through a LOC/bank guarantee type process) and this realised equity is deposited in a bank which in turn fractionally banks this "reserve" and lends into the real estate market to borrowers (with mortgage insurance),
- borrowed against for capital guaranteed products that provide income streams and/or capital growth.
- mortgaged (with appropriate capital guarantees) against tradeable debt instruments.

After investigating and testing the best bets and deciding on the preferred model Stage III must develop this approach or product to a point that it is investor ready and able to be commercialised.