

MANAGING FINANCESADDRESS TO THE FIFTH AUSTRALIAN COTTON CONFERENCE7-9 AUGUST, 1990A.J. CHATTERTON, CHIEF GENERAL MANAGER, AUSTRALIAN BANKING  
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As most cotton is exported the cotton industry has a high exposure to exchange rate fluctuations. Similarly, as credit is such an important part of the cotton enterprise interest rates are an important cost factor.

During the last two cotton seasons, high interest rates, while contributing to the general financial squeeze, have focused attention on the need for good financial management. This season there should be some slight relief on both exchange rates and interest rates.

Westpac's economics department is forecasting a fall in interest rates of approximately 2 to 3 percentage points. That would mean a fall in the base lending rate of approximately 4 to 5 percentage points since mid 1989. The dollar is predicted to ease in value to be around 0.73c by June 1991 which would mean a drop of 5 cents since mid 1989.

These predictions of course depend heavily on the governments easing of monetary policy and other factors in the intervening months.

In this scenario what are the financial issues for the cotton farmer of the 1990's?

The traditional face of farming has changed, with new and improved technology and more innovative production and marketing approaches, coupled with a more extensive range of products and services being supplied.

Rural customers generally, and cotton farmers particularly have become more business oriented, better informed, better educated and developed a more entrepreneurial outlook towards the risks and benefits associated with the rural industries.

There is an increased willingness and ability to "shop around" for the most professional advice and the best deal, as there are many more financial options available to the rural customer than there was prior to deregulation.

To be able to provide the quantity and quality of service the "new rural customer" is demanding, the finance sector has had to adopt a more innovative and customer focused attitude.

To this end, technology, such as computers, specialised servicing through innovative marketing campaigns and specific staff training and education have become essential elements for the successful financial management of rural customers.

It will be through the medium of technology and expanded rural education within the finance sector that bankers can provide the information and financial management advice that is required.

Cotton farmers already utilise the computer facilities or services offered by a wide variety of support industries to supply themselves with management and technical information ranging from irrigation scheduling to whole farm budgeting.

There is much to be gained through the expanded use of computers particularly in regard to information transfer.

Information can be transferred from farmer to banker in the form of cash flow and other production data for use in the financial analysis of farm businesses.

There are also the home-banking facilities which can provide large amounts of information and which mean that farmers do not now have to take the trip into town to conduct simple transaction business. The scope for use of these types of products is enormous.

After deregulation, banks began operating in an environment that experienced dramatic change. They endeavoured to diversify from the "common approach" in an effort to maintain or gain additional market share in a more competitive financial market.

Deregulation also meant that banks were no longer impeded by Reserve Bank restrictions on funds in the scope of their lending.

All lending proposals can now be individually assessed on their merits and, providing they display both short and long term viability, they can be approved without fear of funding constraints. Viability considerations must of course take into consideration ability to meet possible interest rate and currency fluctuations.

In an environment of volatile interest and exchange rates farmers themselves must be certain of their ability to meet loan commitments both now and in the future.

To a large extent Cotton farmers are achieving this through a more business like approach and improved financial management - but this must include a greater emphasis on risk management.

The type of risk management most familiar to cotton farmers is price risk management. That is the use of forward contracts, cotton and dollar futures and options to reduce the adverse effects of, or possibly capitalise on exchange rate movements.

Risk management must extend to cover the risk of interest rate movements as part of day to day financial management.

With so many interest rate outcomes possible, and such a wide range of financial products available, to comment on the "best" specific strategies is not easy. I can however specify the areas of financial management which will assist with good day to day management of finances.

Financial management starts with careful consideration of all the available options. Comparing different financial arrangements does not just involve knowing the costs and terms, but also being aware of the associated risks.

Organisation of the debt or borrowing portfolio is important. Not only for planning but also monitoring financial arrangements. In many circumstances it would be prudent for instance, to separate core debt dating back to development work from short term debt arising yearly as a result of crop costs.

Hopefully crop proceeds will annually retire the short term debt and provide an instalment for repayment of the core debt. Regular reviews of equity are needed to monitor progress in this area.

Sound financial management also involves monitoring the economic environment. Commodity Price outlooks, economic indicators and changes in the tax and financial systems all impact on farm financial decisions. Good information and advice in these areas is essential for good financial decisions and is readily available - at a price - but then what is the cost of not being in command of those factors which have such a large influence on farm profitability.

Any financial plan needs to be flexible. Circumstances can and do change very quickly and the plan should also be capable of change.

There are two important aims for financial management. These are firstly minimising the cost of finance and second minimising the risk of unmanageable financial costs.

Some possible strategies, for dealing with the first aim i.e., minimising the cost of finance, are :-

1. Develop a long term trusting business relationship with a financial institution;
2. Keep abreast of industry financing trends and seek professional advice on the best deal for the situation at hand;
3. Use more convenient, but sometimes more expensive types of finance as required, but revert to cheaper types of finance when possible - for instance, a mix of and ability to swap between fixed and variable rate finance;

4. On large longer term facilities it may be an advantage to time principle payments to coincide with farm income and save excessive use of the overdraft;
5. Accounts of the "sweepover" type are becoming popular. Income is credited to an interest bearing deposit account and funds are automatically transferred to an operating account as and when required.

Strategies for minimising the second aim for financial management i.e., - risk of fluctuations in market interest rates and therefore the risk of unmanaged interest costs, may include :-

1. Monitoring the relative proportions of total debt which are at fixed or floating interest rates. The higher the proportion of fixed debt, the lower the exposure to interest rate fluctuations. The "optimum" relative proportions of each depend on the strength of the business.

It is nice to float the entire debt when interest rates are low, but if an upward swing in rates will break the business then perhaps there is a risk management case for a proportion of fixed interest rate funding at medium rates.

2. Fixing rates for different periods of time. Think 5 years ahead. If the entire debt is locked in at say 14% and falls due in 5 years when market rates may be 20%, can the business wear the additional interest cost?

It may be possible to spread the risk across the borrowing portfolio by fixing interest rates on various portions of the portfolio for different maturity dates.

3. Innovative forms of risk management are becoming more readily available to rural producers. These include :-

- . "Cap" options where for a premium one insures the maximum interest rate paid for any period to cover against rising rates while being able to take advantage of lower rates during the period of insurance should they occur;

- "Swaps" as an alternative to fixed interest rate bill lines which can be used to switch from fixed to floating rates or visa versa;

and

- "Forward Deals" where interest rates can be secured ahead of time if the futures rate is deemed manageable - the customer is committed to the borrowings;
- "Forward Rate Agreements" which protect against movement in interest rates whilst not committing the customer to the borrowings.

In the 1990's the key to good financial management for cotton farmers will be risk management. Price risk you are well aware of and forward selling of cotton is common-place.

Good financial management will include a sensible plan for debt which caters for the risk of interest rate rises while remaining flexible enough to capitalise on interest rate falls.

If Cotton farmers can apply the same innovative thinking and resourcefulness to financial management as they have to crop management then they will be a long way down the track towards a stable and hopefully profitable business.