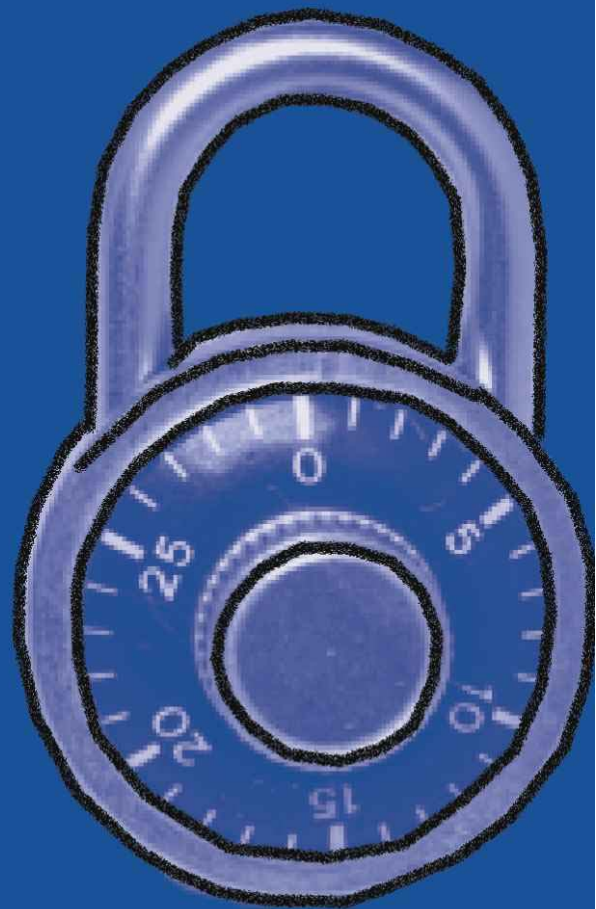




DEPARTMENT:
AGRICULTURE

Financing your **AGRICULTURAL** Business



BOOK TEN

Financing your AGRICULTURAL Business

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Published by
Department: Agriculture
Private Bag X250
Pretoria
0001

Design, Layout and Illustration by
Dimensional Dynamics

Printed by
Consortium Publishers

ISBN: 1-86871-102-1

BOOK TEN

Outcomes

1

After you have studied this booklet you should:

- ✓ know what capital is and in what ways capital may be acquired to finance your cooperative
- ✓ know what type of loans are available and how to calculate the interest on these loans
- ✓ know the importance of a budget and what kind of expenses you should take into account when drawing up your budget
- ✓ know what assets are and how to calculate depreciation, repair cost and how to finance your operating cost
- ✓ be able to work out how much you will have to spend on salaries
- ✓ know the meaning of working capital

Introduction

It is impossible to start a cooperative without money. The money needed is called capital.

The saying, 'you need money to make money', is very true when you start your own cooperative. This can be easily explained by looking at the following example:

Bongani wants to start his own cooperative. He wants to buy goods to sell to clients. Bongani thinks he has enough money to buy some stock, but it is not nearly enough. He needs much more to buy enough stock. To make things worse, he needs premises for his business, a well-trained workforce and equipment. It is no use thinking about his future profits if he has no money with which to set up his cooperative.

Where will he find the money to pay for everything?

In the following paragraphs we will try to answer this question. We will also explain to you how to budget so that your capital can be used to its full potential.



Capital

3

It is necessary to obtain capital to start a cooperative. This will finance your initial expenses, for example paying the rent for your premises, buying your initial stock and buying equipment.

Where do you find this capital? There are two ways to obtain money to finance your business:

Share capital:

This is the money you provide for the business from your own pocket. Usually, if you have a business partner or partners, you and your partners may each provide an amount of money to start the cooperative. In other words, each partner pays an amount to buy a share or an interest in the business. The shares do not have to be equal. Neither does it necessarily mean that the partner who invests the most money in the cooperative runs the cooperative. You and your partners should agree on how much each partner should invest in the cooperative and what each partner's benefits will be.

Loans:

Usually one's own capital is not enough to start a cooperative. Another source of capital will be needed. This capital can be obtained by approaching a bank or a building society for a loan. It is important to stay away from private moneylenders or loan sharks. They are known to ask unreasonable interest on loans and may well cause you to go bankrupt early.



Loans

There are two types of loans: long-term loans and short-term loans.

The Long-Term Loan

Both you and your partners should approach the manager of the bank or building society of your choice. Look around for the best financial institution to suit your needs. Find out how much interest they expect you to pay on your loan, and if they will be able to manage your loan account effectively.

When applying for a loan, make sure to show the bank manager your sales plan. It should include the initial budget, sales estimates and cost estimates of your cooperative. Explain to him how the cooperative will be managed. On the grounds of this presentation, the bank will either agree to lend you the money or send you home empty-handed.

The bank manager will also want security for the loan. For a small loan the bank may accept the signatures of the partners as surety for the loan. When it is a loan of a substantial amount the bank will expect better security for the loan, for instance fixed property or shares in a company. The bank will then mortgage the fixed property in their name.

Note that if you give surety for your cooperative and it goes bankrupt, the bank will call up those sureties you have given and sell it to pay off your loan. Be very careful about giving too much or unnecessary sureties to the bank for you may not only lose your business but also your own home.



The Short-term Loan

This type of loan is usually given as a bank overdraft. The bank does not give this loan to be used for any specific purpose. It functions as a capital supplement or to cover any cash flow shortage that may occur.

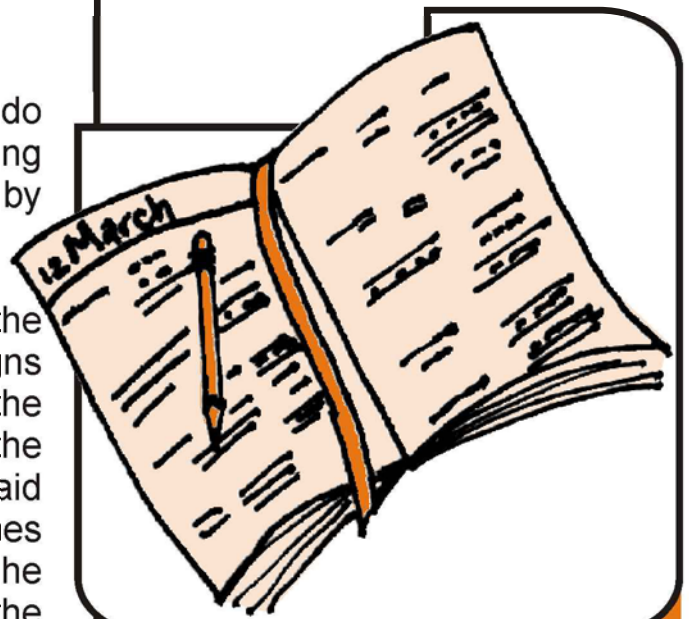
Note that the same procedure regarding the supplying of security is followed as with long-term loans.

Interest on loans

It is obvious that you'll have to pay off your loans, usually in instalments. A very important question is if these instalments form part of your operating cost for the month. Operating cost implies costs such as salaries, water and electricity, and stationery. In other words, it involves those expenses you have to pay each month to ensure that your business is running smoothly.

It is important to note that loan instalments do not form part of your business' operating cost. The reason for this can be explained by the following example:

Bongani takes out a loan to finance the buying of a building for R 50 000-00. He signs a surety which mortgages the building to the bank. Note that the building is now the property of the bank until Bongani has paid off the loan in full. After 10 years he finishes paying off the loan with some of the profit he makes from sales. Now Bongani owns the building and his share capital increases by R 50 000-00.



Loans

... continued



Note that Bongani has not spent his money idly. He has gained a valuable asset, which he can sell to somebody else in the future.

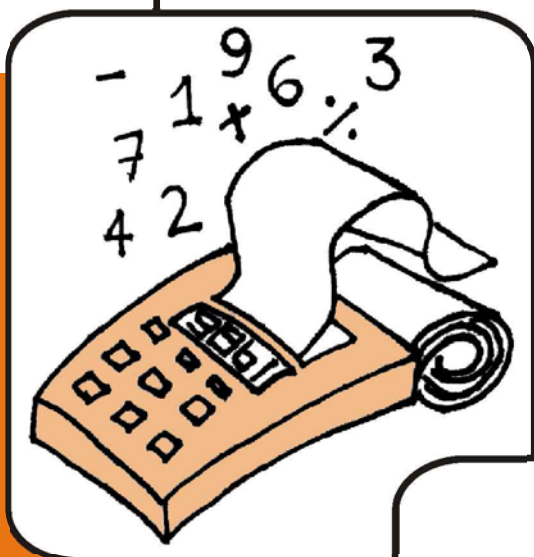
The interest you pay on a loan form part of your costs because it is an expense for which you receive no asset in return. Interest is the amount of money the bank charges you extra for the period it loans you the money. For example:

Bongani takes out a long-term loan to buy a building for R 50 000-00. The bank manager tells him that he may get the loan if he pays 5% interest. Bongani works out the interest using the following method:

$$\frac{\text{Interest}}{100} \times \text{The total of the loan} \\ = \text{Amount to be paid as interest}$$

He will calculate the amount of interest as follows:

$$\frac{5}{100} \times \text{R } 50\,000-00 = \text{R } 2\,500-00$$



Loans

... continued

The Amount of Capital Needed



The amount of operating capital needed, can be estimated by drawing up a budget for your cooperative. The budget will be explained in detail in Book 11: Financial Management. A quick overview of budgeting is none the less necessary and will be explained through the following example:

Bongani wants to start a cooperative. Before he applies for a bank loan he must work out how much capital he will need to run his cooperative. Firstly, he works out what expenses he has to incur initially to put up his new cooperative. He makes the following list of expenses:

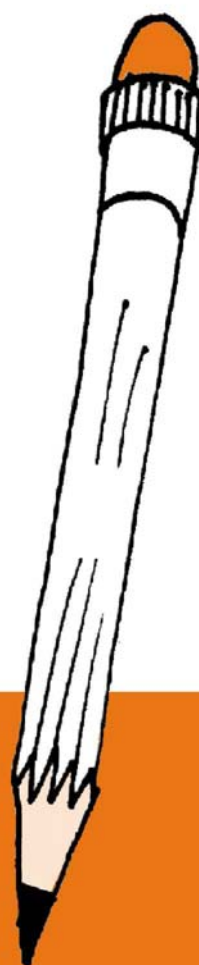
1. Fixed Assets	Instalments	R 2 500-00
	Purchase of premises (Long-term bank loan)	

2. Movable Assets	(Equipment)	R 28 850-00
	Cash Register	R 100-00
	Checkout counter	R 250-00
	Aisles x 5	R 2 500-00
	Packaging machine	R 3 000-00
	Pick-up truck	R 23 000-00

3. Operating Costs		R 17 370-00
	Water & electricity	R 150-00
	Telephone bill	R 400-00
	Salaries	R 8 000-00
	Stationery	R 50-00
	Petrol	R 450-00
	Interest on loan	R 2 500-00
	Depreciation, repairs and maintenance	R 5 820-00

Working Capital	(Stock)	R 40 000-00
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Total:	R 86 220-00
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Note that the expenses are just estimates and may differ from the total amount of expenses when Bongani starts running his business. Bongani tries to keep the estimates as realistic as possible. He tries to take into account any factor that may affect his budget, such as an increase in the petrol price or high inflation.

Thus, apart from needing money to buy the building, Bongani also needs a loan of R 86 220-00. He decides to apply for two loans, namely:

- A long-term loan of R 50 000-00 to cover the purchase price of his new premises
- A short-term loan of R 86 220-00 in the form of a bank overdraft to cover his initial operating cost, his first purchase of stock and equipment and the interest on his bank loan. Note that the instalments you pay off on your loan do not form part of your operating cost.

Remember that Bongani should pay off the long-term loan in monthly instalments. He talks to his bank manager and finds out that he will be charged R 2 500-00 per year. This also forms part of your expenses for the month but not your operating costs.

Before applying for the loans, Bongani should estimate his profit margin. He should consider the following:

1. Is there a market for his goods?
2. Are there enough resources for inputs? In other words, will he be able to easily refill his stock and other materials he needs from his supplier, and at a reasonable price?
3. Has he done enough market research?
4. Will he show a surplus? In other words, will he be able to make a big enough profit to cover his expenses and still have some of it left to re-invest in his business?

The Amount of Capital Needed

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Asset Management



To be able to run a business you need assets. Assets are the equipment and facilities a business needs to do business with. There are two types of assets: fixed assets and movable assets.

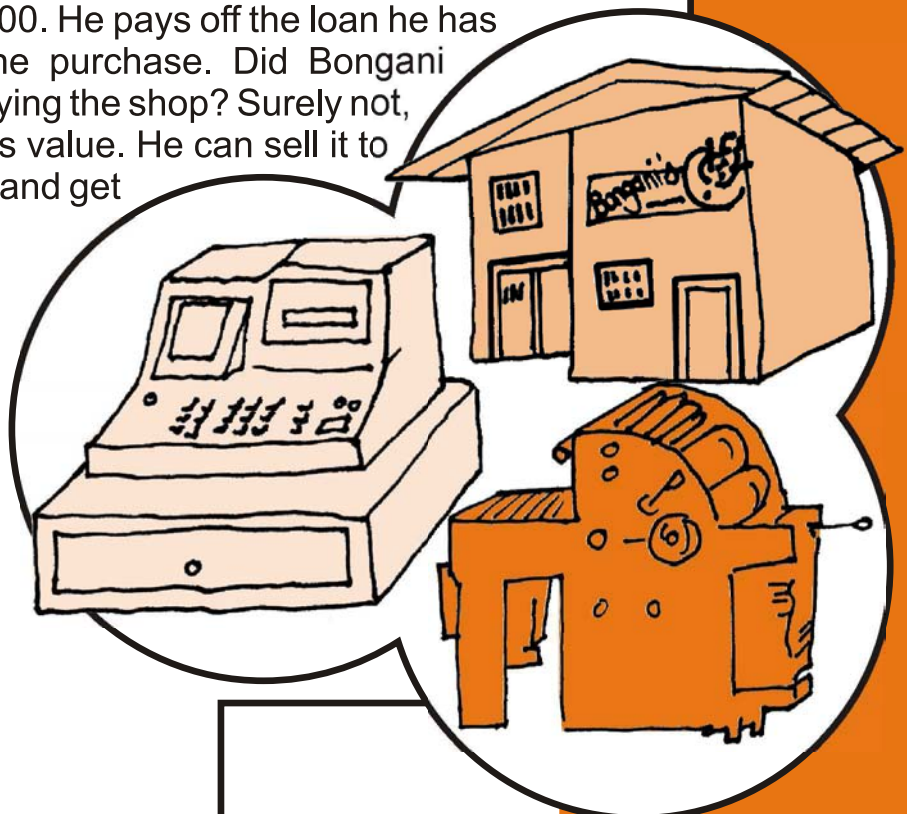
Fixed assets are immovable property such as buildings and your premises. It can also include investments such as shares in another company.

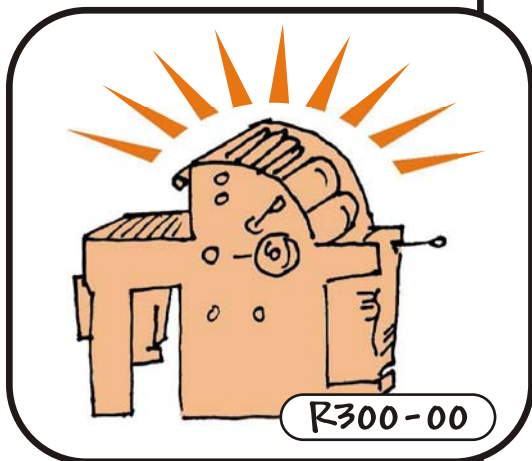
Movable assets, such as a pick-up truck or a cash register, are the equipment you need to do business with.

You have to plan which assets you will need to run your business carefully, to prevent unnecessary expenses on things you do not really need. Spend your money wisely and not on assets that you will never use.

Spending money on assets is not a loss as such, because assets have value. By acquiring assets, your business grows. For example:

Bongani buys a building to use as his shop. The cost of the building is R 50 000-00. He pays off the loan he has taken out to finance the purchase. Did Bongani lose R 50 000-00 by buying the shop? Surely not, because the building has value. He can sell it to somebody else one day and get his money back.





The same is true of equipment although they depreciate in value as they get older. For example:

Bongani buys a packaging machine for his business for R 3 000-00. After he has used it for two years, he sells it to Thabo for R 2 000-00. Why doesn't he sell it to Thabo for R 3 000-00? The answer is quite easy if one takes the following into account:

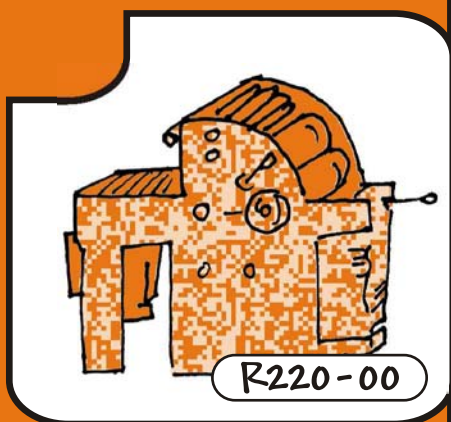
- Bongani has used the machine; therefore it is not in the same condition as it was when he bought it.
- The value of the machine has decreased in the past two years because of new technology that provides better packaging machines.

As you can see, assets lose some of their value over time through depreciation. This is one of the reasons why you should make sure you do not buy unnecessary equipment because depreciation can be described as a loss. It may happen that some of your assets' value increases, for example the building's value through maintenance and repairs, but it almost never happens.

It is therefore important to include depreciation, maintenance and repairs in your cost estimate when you want to buy assets, for example:

Bongani wants to start a cooperative. He needs a building and some equipment for his new business. He wants to buy:

- a building for R 50 000-00;
- a cash register for R100-00;
- a packaging machine for R 3 000-00; and
- a pick-up truck for R23 000-00



Asset Management

... continued

Bongani works out the depreciation, repairs and maintenance as follows:

Estimating the depreciation of a building

Bongani now has to work out the depreciation cost of these items. He knows that the expected lifetime of a building is 20 years. He will work out depreciation over this period. Although the building may still be used after 20 years, no further depreciation will be deducted after this period.

Bongani works out the depreciation of the building as follows:

He divides the sales price of the building by the building's expected lifetime

$$\frac{\text{R}50\,000-00}{20} = \text{R}2\,500-00 \text{ (yearly depreciation)}$$

Estimating the depreciation of equipment

Bongani knows that equipment usually depreciates over 5 years. However, some equipment may depreciate over a longer period of time, such as the pick-up truck.

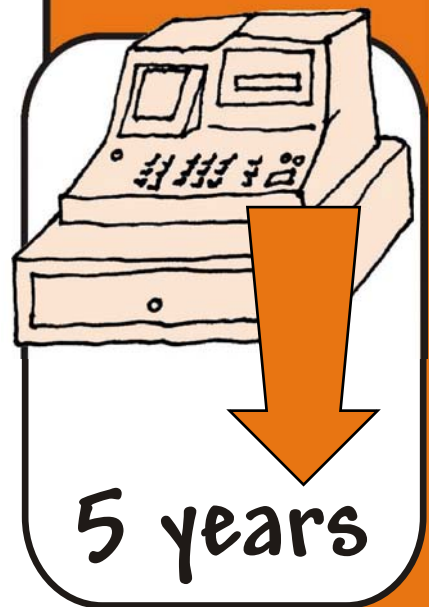
The cash register and packaging machine will depreciate over five years.

The total cost of this equipment is R 3 100-00. Bongani works out the depreciation of this equipment by the same method as the building's depreciation:

Total cost of equipment divided by their expected lifetime.

$$\frac{\text{R}3\,100-00}{5} = \text{R}620-00 \text{ (yearly depreciation)}$$

The pick-up truck depreciates in about 10 years; thus its yearly depreciation will be R 2 300-00.





Repairs and maintenance

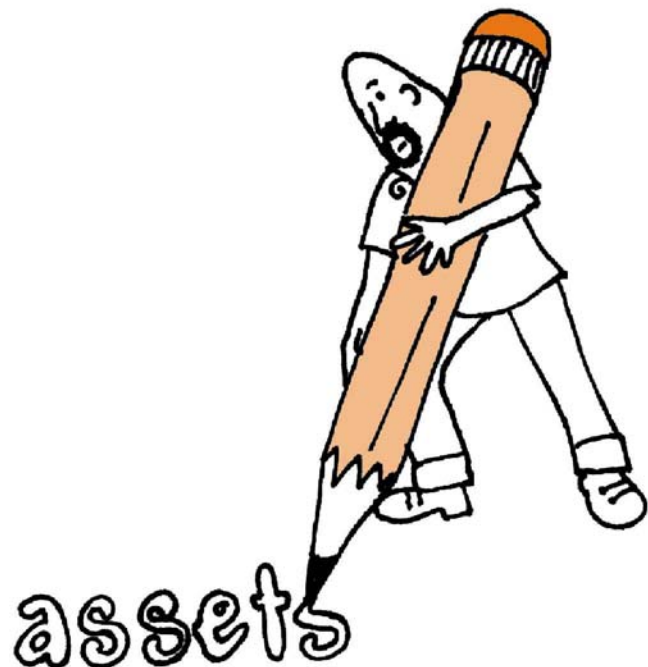
Bongani estimates that the repairs and maintenance of the building and equipment will cost him R 400-00 this year.

The total cost of depreciation, repairs and maintenance

Bongani simply adds the building and equipment depreciation cost as well as the repairs and maintenance cost:

	Depreciation of building		R 2 500-00
	Depreciation of equipment		R 2 920-00
+	<u>Repairs and maintenance</u>	+	<u>R 400-00</u>
	Total cost for the year		R 5 820-00

Depreciation cost forms part of the expenses you have to budget for when working out the amount to finance your business with.



Asset Management

... continued

Operating Cost



Operating cost is all the expenses you make from day to day to run your business. This includes items such as salaries, interest on loans, water and electricity, telephone accounts and petrol.

It is necessary to add these costs to the budget. Try to keep the operating cost as low as possible because then you will save money to spend on extra stock and keep your cash flow healthy.

When looking at operating costs, try to estimate how much money you will spend on each item. Try to make a reasonable estimate otherwise your budget won't be realistic and problems will occur later.

Operating cost gets paid out of the profit you have made from sales. This will be dealt with in Book 11: Financial Management.

The following situation serves as a quick overview:

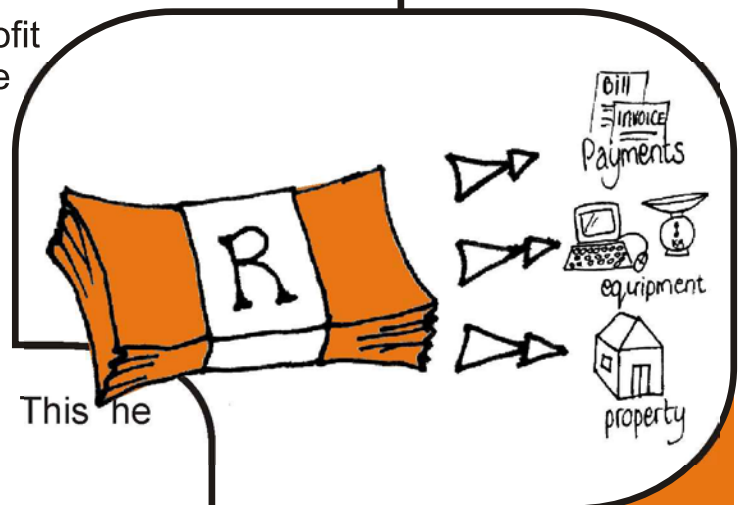
Bongani buys stock for R 40 000-00 and decides to make a 50% profit. This he calculates as follows:

$R40\,000-00$ (total stock) $\times$ 50% (percentage profit)
= $R20\,000-00$ (profit)

Bongani's operating cost is R 17 370-00. The next month's operating cost will be paid from the amount of profit he makes. He pays the expenses from the R 20 000-00 profit he makes.

Remember that Bongani has to buy new stock with the R40 000-00 he started with.

Therefore, Bongani pays for his initial operating cost, initial stock and equipment with the money of the short-term loan for which he applied, namely R86 220-00.





Bongani pays the instalments of his long-term loan with his surplus. Surplus is the amount of money left over after Bongani has paid his operating cost. This is calculated as follows:

$$\begin{aligned} & \text{R20 000-00 (profit)} - \text{R17 370-00 (operating cost)} \\ & = \text{R2 630-00 (surplus)} \end{aligned}$$

Wages

It is essential to look at how salaries are calculated. Look at the following example:

Bongani wants to employ Simon as courier in his new business. He agrees to pay Simon a salary of R 1 300-00 per month. Is that the only money Bongani will be spending for Simon's salary? No because Bongani should also consider the following:

- Bongani must provide Simon with a blue card. For this reason Bongani must pay 1% of R1 300-00 to the Unemployment Insurance Fund (UIF). This is R13-00.
- If Bongani provides a pension plan for his workers, he should also work out what contribution he should pay to the pension fund. Usually this is 50% of what Simon would have paid if he contributed alone. If Simon has to contribute R200-00 to the pension fund, Bongani should pay half of it which is R100-00.

So, Bongani has to pay the following amount:

$$\begin{aligned} & \text{R1 300-00 (Simon's salary)} \\ & \text{R 13-00 (UIF)} \\ + & \text{R 100-00 (pension)} \\ & \text{R 1 413-00 (total cost)} \end{aligned}$$

Take note that Bongani should only employ workers he really needs otherwise his cost on salaries will increase dramatically and he may be unable to pay them.



Operating Cost

... continued

Working Capital



Working Capital is the money used to buy stock with. For example:

Bongani buys stock for R40 000-00. He sells the stock to clients and receives R60 000-00 income from these sales. He makes R20 000-00 profit from which he pays his operating cost. The R40 000-00 that does not form part of his profit can be used to buy new stock. This is called working capital.

Remember that working capital never forms part of your profit.





Assessment

1. Describe the different possibilities that exist to get capital to finance your business.
2. Discuss the difference between long-term and short-term loans.
3. Bongani takes out a loan of R35 000-00 from XYZ Bank to finance his business. The instalments are payable over a period of 24 months. If an interest rate of 20% applies, what amount should Bongani pay to the bank each month as instalment?
4. What factors should be taken into account when you determine your profit-margin?
5. What is the yearly depreciation of the following items over a period of 10 years:
 - * A building to the value of R285 000-00
 - * A computer bought for R7 500-00 at a computer hardware store
 - * A tractor valued at R35 000-00. (You paid R40 000-00 for the tractor.)
6. Give a short definition for the term operating cost. Does profit received from sales form part of your operating cost?
7. Why is the term UIF important and what does it mean? Describe the answer by using a salary of R3 000-00 as basis for your discussion.
8. Discuss the term working capital. Is there a difference between working capital and operating cost?

