EFSE
EUROPEAN FUND FOR SOUTHEAST EUROPE
DEVELOPMENT FACILITY

A practical guide for farmers

MAKING FINANCIAL DECISIONS

How to choose the best financial solutions for your agricultural business

About the brochure

This brochure has been developed to assist micro- and small-sized Romanian farmers in understanding and choosing financial products that best suit their specific business needs. If you are a farmer who is likely to need credit for investing in your agricultural business, whether it be investment in equipment, inputs, or land, this brochure will provide you with guidance on topics such as:

- How to analyse and choose financial products that match your business plan
- How to compare financial products' conditions
- How to choose the best available offer
- How to determine how much debt is too much debt
- How to avoid liquidity problems
- How to increase competitiveness, while saving energy costs

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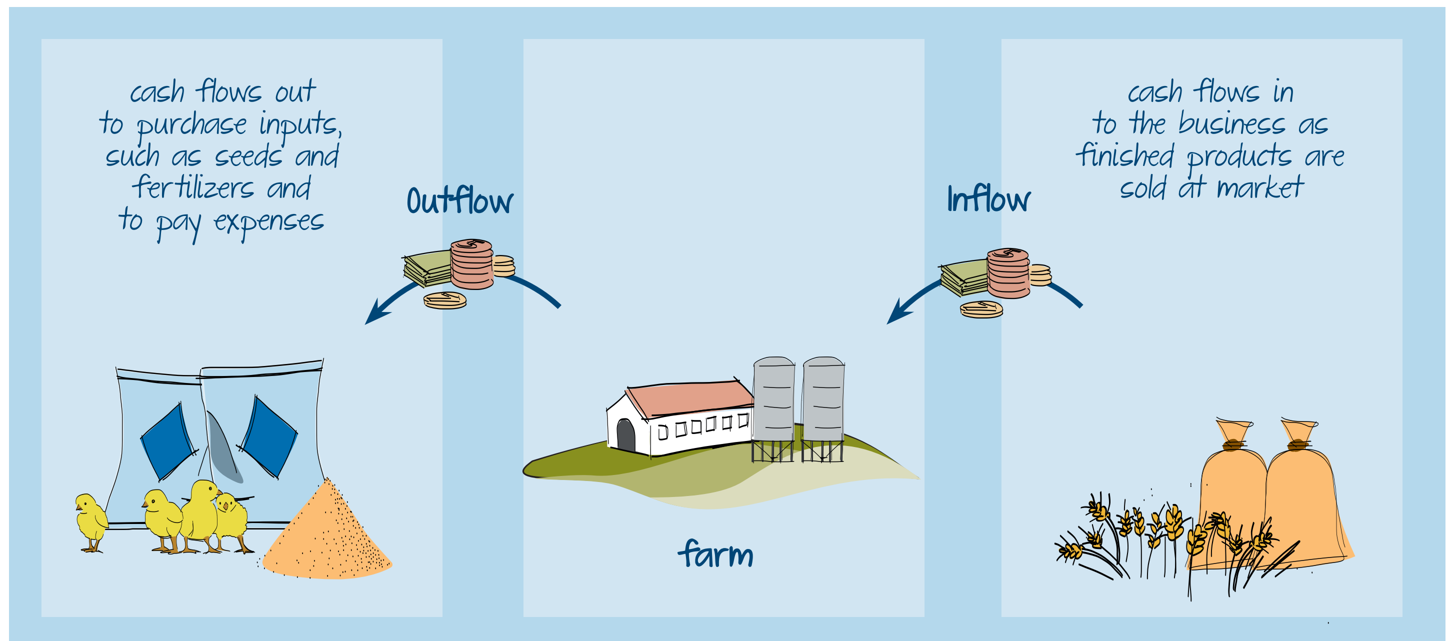
Farming and agricultural business: how to correctly assess your financing needs

As most farmers would agree, it is very difficult to do agricultural business without credit. There is always a need for more funding, whether it is for inputs, such as fertilizers and seeds or renewing equipment such as tractors or combine harvesters. However, it has been traditionally difficult for farmers to secure financing because farming is considered a risky business: poor harvests, pathogens that can kill crops or animals, and fluctuating sales price are all risks that make agricultural businesses' cash flows unstable and unpredictable.

Since Romania's accession to the EU, advances have been made in the area of agricultural finance to offer credit and other products to farmers. These products were created to give farmers the opportunity to access larger amounts of credit needed to keep pace with the overall rising demand for agricultural products. However, given that so many new products, new suppliers and even new financial institutions are appearing in the market, it is helpful to provide a clear overview of what financing solutions exist for farmers in Romania and how to make efficient use of these.

Definition

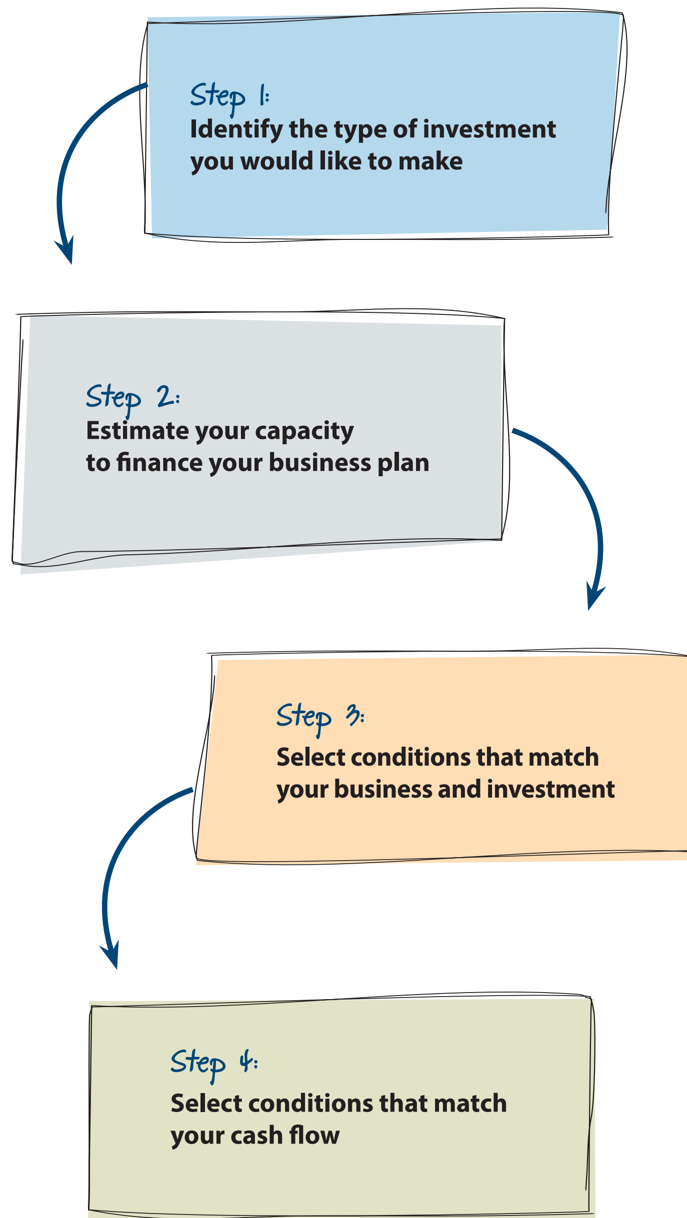
Cash flow is the movement or "flow" of money into or out of a business.



Four steps to financial decision making

The starting point for making good financing decisions is always the analysis of your own business's financial situation and needs. Whether you are engaged in grain production, dairy farming or any other type of agricultural activity, the process of analysing your business's needs is the same. **First,** you need to determine which type of investment you would like to finance. **Second,** you should double check that you have the capacity to support the amount of debt you want to take out. **Third**, you need to choose financial solutions that match your business needs. This includes choosing a financial product with an appropriate maturity at an acceptable cost. **Fourth**, you should select conditions that match your cash flow to ensure you will be able to comfortably repay your loan. This means that the currency of the loan should ideally match the currency of your incoming cash flow and that the proposed repayment schedule of the loan should place payments in the months when you have extra funds available to cover the loan repayment.

By following these steps you can weigh the advantages and disadvantages of different financial products which will allow you to make a better financial decision that matches your business and helps it to grow and prosper.



Step 1: Determine the type of investment you would like to make

The type of loan you take will depend largely on the type of investment you would like to make in your business. There are two main types of loans: **working capital loans** and **fixed assets loans or leases:**

- **A working capital loan** is used to purchase **inputs** such as seeds, pesticides and fertilisers as well as to cover any other immediate **operational costs**, such as purchase of fuel or payment of workers' salaries, for example.
- **Fixed assets loans** are used to purchase **equipment**, such as ploughs, combine harvesters or tractors and also for **other long-term assets** such as construction of warehouses and silos, purchase of land, or any other type of asset you will use for production over several years.

It is also possible to obtain a **mixed purpose loan**, which means that you need the loan for both fixed assets and working capital needs.

Sample balance sheet for a small-scale farmer

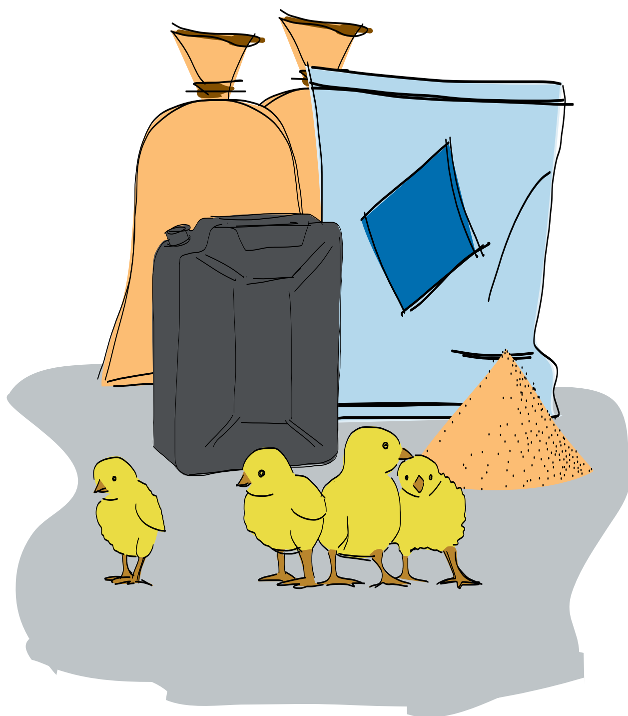
In the balance sheet below, on the left (Assets side), you can see the working capital and the fixed assets. On the right you can see the "short-term debts" which are generally working capital loans (<24 months maturity) and the "medium- and long-term debts" which are generally for fixed assets and have maturities longer than two years.

Assets		Liabilities	
Working capital	220,700	Short-term debt (<24 months)	120,000
Cash	20,000	Debt to input suppliers	40,000
Stock of inputs (seeds, fertilisers and pesticides)	700	Short-term facilities from financial institutions	80,000
Crops in the field	200,000	Other short-term debts	0
Fixed assets	380,000	Medium- & long-term debt (>24 months)	150,000
Land and buildings	80,000	Long-term loans from financial institutions	100,000
Tractors, combines and other equipment	300,000	Debts to leasing companies	50,000
		Other medium- & long-term debts	0
		Total liabilities	270,000
		Equity	330,700
Total assets	600,700	Total liabilities and equity	600,700

All Values in RON

I need working capital

Whether you need working capital for inputs or for other costs of operating your farm, such as paying salaries or fuel, you can find a number of institutions in Romania that offer short-term financing to farmers for working capital purposes. There are two main options for financing your working capital needs: either directly purchasing from your input supplier on credit, **supplier credit**, or taking a **working capital loan** from a financial institution to pay suppliers and cover other expenses. Which option suits your needs?



Financing option 1: Supplier credit

Supplier credit for inputs can be a very important financing tool for many farmers who would not have enough capital to plant their fields otherwise. Suppliers sell both on credit and on an up-front cash basis. For up-front cash purchases, suppliers generally give a discount. However the prices of the inputs are not always clearly explained. Discounts of 10-35% can be observed, varying based on several factors, such as the brand and quality of the inputs, supplier pricing strategy and client relationship with the supplier.

Pros of using supplier credit:

- simple credit procedure, resulting in quick or instant decision
- no collateral or only a promissory note usually required
- additional benefits from some suppliers such as repurchase agreement for unused inputs or free delivery of inputs

Cons of using supplier credit:

- usually more expensive to purchase on supplier credit than to pay for inputs up-front in cash
- typically only a limited range of inputs available for purchase with supplier credit

Financing option 2: Working capital loan from a financial institution

Depending on the offer from your input supplier and your relationship with your financial institution, it could be more advantageous for you to take a loan for your working capital needs. You can also use a working capital loan if you need to pay for items or services that you cannot purchase with a supplier credit. Loan maturities usually range from one production cycle up to two years, and interest rates currently range from 5% up to 10% per annum. Fixed and variable interest rates are available for short-term loans.

Pros of using a working capital loan:

- discount with input supplier for upfront cash payment
- possible to use funds for other working capital needs, such as paying salaries, rent or taxes
- generally cheaper than supplier credit

Cons of using a working capital loan:

- collateral required
- time required for application processing (no instant approval)

Why would you take a loan for inputs instead of purchasing on supplier credit?

Virtually all input suppliers sell on credit, however they also offer discounts when farmers pay for the inputs upfront in cash. One option for taking advantage of discounts for paying upfront for inputs is to take a loan from a financial institution. Taking a loan to purchase inputs makes financial sense when the total costs of the loan are offset by the discount for making upfront cash payment for the inputs.

Example

Mr. Dobrescu needs to purchase RON 40,000 worth of inputs. His input supplier tells him that he can offer a 10% discount if the inputs are paid for upfront in cash. He can get a loan to purchase the inputs but must pay 12% per annum plus all of the loan fees. Does it make more sense to take the loan or should he take the inputs on credit from his supplier?

Option 1: purchase on supplier credit

Cost of inputs purchased on supplier credit: RON 40,000

Option 2: take a working capital loan

Cost of inputs purchased in cash with 10% discount: RON 36,000

Loan detail:		
	Amount	RON 36,000
	Interest rate	12% per annum
	Interest paid	monthly
	Fees	2% of principal amount (RON 720)
	Maturity	6 months

Demonstration of cashflow of working capital loan

April	May	June	July	August	Sept
disbursement fee & monthly interest	monthly interest	monthly interest	monthly interest	monthly interest	capital repayment & monthly interest
-1,080	-360	-360	-360	-360	-36,360

Conclusion

In this case, the total cost of the inputs if purchased on supplier credit is RON 40,000 and the total cost of the inputs purchased with a loan is RON 38,880. Purchasing the inputs with a loan therefore results in savings of RON 1,120.

I want to invest in fixed assets

How to find the best solution for a fixed asset investment depends largely on the type of asset you would like to finance. For example, if you would like to purchase a piece of equipment that has an option for lease, such as a tractor, combine harvester or plough, there are multiple options for financing available through the equipment supplier. However, if your business plan is more complex and involves purchasing land or construction, the options for financing your investment are fewer and usually limited to a loan from a financial institution.

Good to know...

What is a residual value in a leasing contract?
A residual amount is like the down payment common in leasing contracts but it must be paid at the end of the contract in order for the client to fully own the asset. Residual values can range from 1-20% of the value of the equipment purchased. Always ask the leasing company and look closely at the contract to see if a residual amount is required.

Financing option 1: Financing from a leasing company
Financing from leasing companies for the purchase of equipment such as tractors, combine harvesters or other farming implements are a common choice for many farmers in Romania. Leasing companies have direct relationships with equipment suppliers and are a convenient option if your business plan only involves purchase of equipment and you are under time pressure.

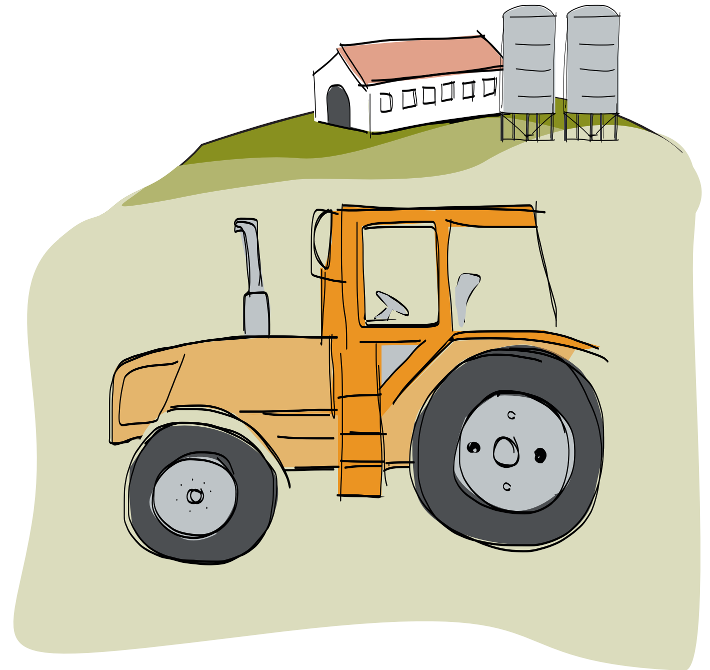
Pros of financing from a leasing company:

- very fast, usually less than one week processing time
- few documents required
- no new bank account required
- usually no additional collateral required
- some equipment suppliers offer service contracts for new equipment

Cons of financing from a leasing company:

- full costs not always clear (mandatory full coverage insurance, administrative fees and residual amount); generally more expensive ranging from 10%-16% per annum
- up-front payment required, typically 10-20% of the equipment's value
- repayment schedules are standardised (no estimation or matching to your particular cash flow)
- generally only available for new equipment or only slightly used equipment; no option to purchase equipment from abroad

Financing option 2: Loan from other financial institutions
In case of fixed assets investments that are not possible to be financed through a leasing company, such as the purchase of land or construction of silos or a warehouse, loans from credit institutions and other non-bank financial institutions are usually the only other option for farmers.



Pros of a loan from other financial institutions:

- possibility for longer maturities – currently up to 15 years
- possibility to purchase used equipment and equipment directly from abroad
- possibility to finance a large part of your business plan – in some cases even up to 100%
- more flexible repayment schedules with payments matching your cash flow and grace periods on capital repayment of up to 12 months
- more flexible collateral policies; some lenders accepting personal assets, other business assets, crop insurance and/or a guarantee from a guarantee fund as collateral
- all income is taken into account, e.g. private income or income from other businesses as well as agricultural business income

Cons of a loan from other financial institutions:

- processing time of several weeks or more
- additional costs and fees - obligatory insurance, administration fees
- bankable collateral and/or additional guarantees requested
- client must have a current account in the institution – additional paperwork required during first loan application to open an account

Investments to increase energy efficiency and save costs

As your farm grows larger, higher efficiency and lower production costs will become more and more important in your operations. There are several ways to improve efficiency on your farm, such as better inputs and technology to increase yields. One of the major trends in global agriculture that is catching on in Romania is the trend towards new farming technologies and techniques that minimise fuel and input consumption. These are known as **energy efficiency investments**. The ultimate goal of energy efficiency investments is to reduce the amount of energy required to produce the same amount of product. The savings from reduced fuel consumption pays for the investment and reduce costs in the long-term. Energy efficiency investments include for example tractors and combine harvesters with efficient fuel consumption as well as multistage or "one-pass" farm equipment.

Definition

Multistage or "one-pass" farm equipment is equipment that covers multiple field preparation steps. The equipment is fuel efficient because it reduces the number of times the tractor must pass over the field by performing multiple steps in one pass over the field, for example seeding and applying fertiliser.

Attention:

Multistage equipment is a large investment, usually starting at RON 220,000 or more. Considering the current prices, the fuel savings by multistage equipment justifies the investment cost for land holdings of **800 hectares or larger**.

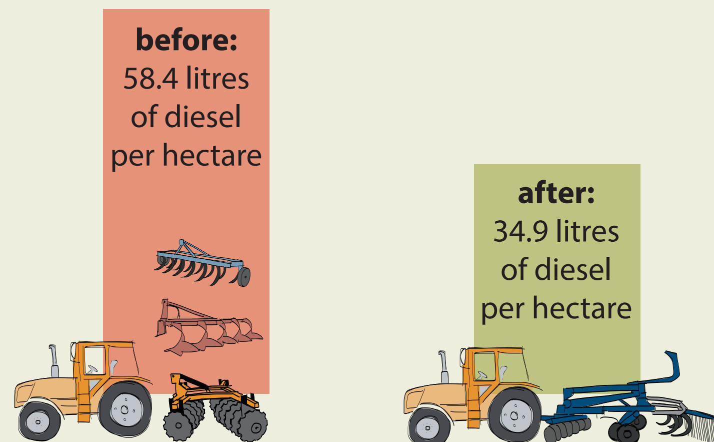
Example of energy efficiency investment

Mr. Cioban has 800 hectares of wheat cultivation. He wants to introduce alternative multistage equipment in order to increase the productivity and lower fuel consumption.

Mr. Ciorban previously passed over the field **four times with a mouldboard (20 cm), chisel plough, disk harrow and seeder**. Total fuel consumption was 58.4 litres of diesel per hectare or about RON 165,390 per annum at current diesel prices.

He has chosen to invest RON 275,000 in a piece of multi-stage equipment that combines 3 steps of soil preparation: sub-soiler, chisel plough and disc plough. Now during soil preparation the tractor only **passes over the field twice: once with the (heavier) multi-stage equipment and another time with the seeder.** This requires 34.9 litres of diesel per hectare or roughly RON 98,840 at current diesel prices.

The total annual savings in fuel costs is about RON 66,550. Considering the cost of the multistage equipment (RON 275,000) and the annual savings (RON 66,550), the equipment's fuel savings "pays" for the investment in approximately 4 years. Additionally, time is saved because fewer passes must be made over the field.



Calculation:

Field preparation	Conventional tillage	Use of one-pass equipment
Total conventional tillage fuel consumption, L/ha	58.4	-
Total minimum tillage fuel consumption, L/ha	-	34.9
Area of the farm, ha	800	
Total fuel consumption, L	46,720	27,920
Av. diesel price 2014 incl. subsidy, in RON/L	3.54	
Annual energy costs, in RON	165,390	98,840
Annual energy savings, in RON	-	66,550
Investment costs, in RON	-	275,000
Pay back period of equipment, in years	-	4.1

Good to know...

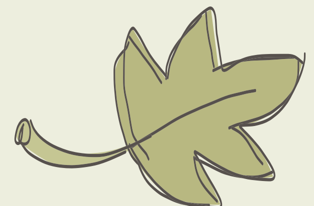
Other benefits of multistage equipment
More efficient equipment can have additional benefits besides saving fuel, such as more precise application of fertiliser and seeds, which saves inputs and increases yields. For detailed information and additional benefits, consult a trustworthy equipment supplier.

Financial support programmes for energy efficiency investment

Energy efficiency in agriculture is also a main objective in EU policy. At the time of publication of this brochure, there were several energy efficiency programmes with subsidies available in Romania:

- European Bank for Reconstruction and Development (EBRD) and the EU are currently offering the Romania SME Sustainable Energy Finance Facility (RoSEFF) programme. The programme offers a 10-15% grant (excl. VAT) to SMEs for investment in energy efficiency and renewable energy investment projects of EUR 25,000 up to EUR 1 million. The programme is offered through selected financial institutions.
- The European Investment Bank (EIB) through its Energy Efficiency Window is offering investment loans for small- and medium-sized enterprises (SMEs) wishing to invest in energy efficiency projects. The Energy Efficiency Window offers financing up to EUR 12.5 million for energy efficiency projects with a grant component of up to 12%.
- There are additionally Romanian financial institutions offering products with preferential interest rates for eligible energy efficiency and renewable energy investments. These are usually advertised as "Eco" or "Green" loans.

For all programmes, ask your bank representative whether the bank participates and which products are offered.



Step 2: Estimate your capacity to finance your business plan

The next step in financial decision making is determining your business's limits in repayment and debt capacity. Lenders have limits to how much debt they can give a single client and usually determine the maximum amount of debt they can give by calculating the client's so-called equity ratio. This ratio reflects how much of the business this client is supporting with his/her own funds or equity.

Definition

Equity is the sum of the value of all your assets minus all of your debts both formal and informal, including debts to suppliers or private individuals. **Another term for equity is net worth.**

Equity ratio reflects how much of your assets are financed by shareholders' own funds. It is calculated by **dividing equity by total assets**.

Good to know...

Equity ratio
If the equity ratio reaches zero or becomes negative, this means that equity is zero or negative and that the business has debts equal to or greater than the business's total asset value. If the debt is too high and the equity ratio is too low, the business is eventually no longer economically viable. If a sale is not possible, a business with zero or negative equity typically results in bankruptcy.

Rule of thumb

If you are planning a large investment for expanding your business, it is very important that you are able to determine yourself if your investment is within your **maximum debt capacity**.

Maximum debt capacity is the maximum amount of debt that you can afford to have at one time, regardless of how low the instalment is. A rule of thumb is that **the equity ratio should not be below 30%**. Therefore when determining your maximum debt capacity you should estimate your current equity ratio as well as check that your equity ratio does not fall below 30% when you take on additional debt for a new investment.

30%

Example calculation of equity ratio

Mr. Alexandru farms 400 hectares. He sees two opportunities to invest at the moment: First he would like to invest in the construction of a silo to save expenses on silo rental. Second, he believes that he needs to diversify his activity and that the dairy market will expand in the next years in Romania, so he thinks he should start a dairy operation.

In order to determine his debt capacity, first, Mr. Alexandru must compile his current balance sheet:

Assets (at fair value)		Liabilities	
Working capital	501,600	Short-term debts	450,000
Cash	0		
Inputs (fuel, fertiliser) on-hand	1,600	Debt to suppliers	450,000
Current value of crops in field	500,000		
Fixed assets	760,000	Medium- & long-term debts	360,000
3 tractors	225,000		
Implements	65,000		
Farm land and other fixed assets	70,000		
Combine harvester	400,000	Loan for combine harvester	360,000
		Total assets	1,261,600
		Total liabilities	810,000
		Equity	451,600
Total assets	1,261,600	Total liabilities & equity	1,261,600

All Values in RON

Good to know...

Fair valuation of assets

In order to determine your asset value for calculating your current total asset value or equity, it is important that you consider the **fair value** of your assets, or, in other words, a realistic price you would expect to sell the asset for in the local second-hand market. A good method for determining the fair value of a piece of equipment is by comparing the prices of similar equipment for sale in the second-hand market.

Based on the balance sheet,
he must then calculate his current equity and equity ratio:

$$\frac{\text{Equity RON } 451{,}600}{\text{Total assets RON } 1{,}261{,}600} = 36\% \text{ current equity ratio}$$

Current investment plan

Mr. Alexandru would like to construct a silo (RON 200,000) and start a dairy operation (RON 450,000) that he would like to finance with a loan (loan amount RON 650,000). In order to calculate the expected equity ratio after the investment is made, Mr. Alexandru must adjust his balance sheet to reflect both the assets (new silo and all assets related to the dairy operation) and the loan:

Assets (at fair value)		Liabilities	
Working capital	501,600	Short-term debts	450,000
Cash	0		
Inputs (fuel, fertiliser) on-hand	1,600	Debt to suppliers	450,000
Current value of crops in field	500,000		
Fixed assets	1,410,000	Medium- & long-term debts	1,010,000
3 tractors	225,000		
Implements	65,000		
Farm land and other fixed assets	70,000		
Silos	200,000	Loan for investment plan	650,000
Dairy equipment & livestock	450,000		
Combine harvester	400,000	Loan for combine harvester	360,000
		Total assets Total liabilities	1,911,600 1,460,000
		Equity	451,600
Total assets	1,911,600	Total liabilities & equity	1,911,600

All Values in RON

$$\frac{\text{Equity RON } 451{,}600}{\text{Total assets RON } 1{,}911{,}600} = 24\% \text{ expected equity ratio}$$

The amount of equity remains the same because no funds would be contributed to the project by the owner. However, the expected equity ratio would change to 24%.

Since the original investment plan put the expected equity ratio below 30%, Mr. Alexandru must adjust his investment plan so that it is an amount of credit his business can currently support.

Adjusted investment plan

Mr. Alexandru adjusts the high investment plan by deciding only to construct the silo for RON 200,000. To adjust his balance sheet Mr Alexandru adds RON 200,000 to his fixed assets and RON 200,000 to his medium- and long-term liabilities in his current estimated balance sheet. The adjustment leads to total assets of RON 1,461,600, total liabilities of RON 1,010,000 and equity of RON 451,600.

Mr. Alexandru's calculation:

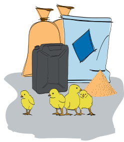
Total assets	RON	1,461,600
– Total liabilities	RON	1,010,000
= Equity	RON	451,600

$$\frac{\text{Equity RON } 451{,}600}{\text{Total assets RON } 1{,}461{,}600} = 31\% \text{ expected equity ratio}$$

When the investment plan is altered, the equity ratio remains at an acceptable level.

Step 3: Select conditions that match your business and investment

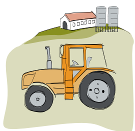
After you have determined which financial product suits your investment and that you have capacity to repay the loan amount, it is time to request offers from potential lenders and make an application. Either at the time of application or when you receive the proposals, you will need to verify the conditions of the products offered and namely the loan maturity, the interest rate and the cost of borrowing.



Working capital loans

Interest Rate: Working capital facilities can have either a fixed or variable interest rate. Not all institutions offer fixed interest rates, however, some institutions have recognised a demand for fixed interest rates because it makes it easier for small businesses to predict their cash flows. There is an explanation of fixed and variable interest rates on page 16.

Maturity: The maturity of your loan will depend on the type of investment you are making. Working capital loan facilities are by nature short-term ranging from one crop cycle for temporary needs up to one or two years for permanent working capital needs. Most lenders offer revolving loans or credit lines for temporary working capital.



Fixed asset loans

Interest Rate: Fixed interest rates are rarely offered for maturities longer than three or four years in Romania, and some financial institutions do not grant any facilities with fixed interest rates for maturities above one year. Therefore, for investment loans, it is important that you understand how a variable interest rate works. See the section “fixed versus variable interest rates” on the page 16.

Maturity: Investment loans are generally medium- or long-term loans. Medium- or long-term loans are more appropriate for investments in fixed assets because the cost of the asset is usually large in comparison to the profit the asset generates, but the asset will generate profit for many years.

Definition

A **revolving facility** is a facility that is renewed regularly, each season or annually, given that repayment was on-time and the business’s condition is stable.

Mixed purpose loans

Mixed purpose loans are usually for a business plan that includes both working capital and fixed asset investment. Not all financial institutions offer mixed purpose loans. Institutions that do not offer mixed purpose loans may alternatively offer you two loans: a working capital facility and an investment loan. The institutions that do offer mixed purpose loans usually offer a maximum maturity of three or four years for a mixed purpose loan. Mixed purpose facilities could have a fixed or variable interest rate. If you need working capital and to make an investment at the same time, explain this to your partner financial institution and ask about your options to receive a mixed purpose facility or to combine different loan products in order to finance your business plan adequately.

Understanding interest rates

When a financial institution makes you an interest rate offer, the institution take into consideration its cost of funding plus several factors that could cause you to default or not repay your loan: the overall situation in the economy, the situation of the agricultural sector as well as your individual risk. When the financial institution assesses your individual risk, it is generally looking at the financial stability of your business (i.e. length of time in operation, profitability, liquidity), your credit history, quality of collateral and the collateral's personal importance to you, and your relationship with the institution. The more stable your business, the stronger your credit history, the more valuable and important your collateral, and the better your relationship with the financial institution is, the lower the interest rate offer should be.

Fixed versus variable interest rates

Choosing between a fixed and variable interest rate can be difficult. In short, it is impossible at the beginning of a contract to know if a fixed or a variable interest rate will be cheaper over the life of the loan. In this section, the basic differences as well as pros and cons of both fixed and variable interest rates are presented.

Definition

A **fixed interest rate** is a rate that remains the same over the life of a loan.
A **variable interest rate** is a rate based on a "reference" interest rate and fluctuates over the life of the loan.

Good to know

Reference rates in Romania

In Romania, the reference rate is the Romanian InterBank Offered Rate (ROBOR) for loans denominated in RON or European InterBank Offered Rate (EURIBOR) for loans granted in EUR.

Attention:

In the case of loans with maturities over two years, usually only variable interest rates are offered.

Why do variable interest rates change?

The rate is variable or fluctuates because the cost the bank has for obtaining funds is also constantly changing. For example, when a 3-month term deposit expires, the interest rate must be renegotiated. The rate could increase, remain the same or decrease. This will impact the costs that the financial institution has to support in order to continue to lend to clients like you.

Pros and cons of a fixed rate

- generally higher than a variable rate at the time of contracting the loan.
- remains the same over the entire maturity of the loan so your monthly payments remain the same over the entire maturity of the loan.
- if you choose a fixed rate and the reference rate falls, your monthly payments will be higher than if you had chosen a variable rate; if the reference rate rises, your monthly payment will be lower than if you had chosen a variable rate.

Pros and cons of a variable rate

- generally lower than a fixed rate at the time of contracting the loan.
- may rise or fall as the reference rate changes. This means your payments may vary on a monthly basis.
- if you choose a variable rate and the reference rate rises, your monthly payments may become higher than if you had chosen a fixed rate; if the reference rate falls, then your instalment will become lower than if you had chosen a fixed rate.

If you have difficulties understanding a variable interest rate or do not understand the variation in your instalments, do not hesitate to consult your partner financial institution for an explanation. You as the client should ask for clear information so that you can make the right choices for your business.

Effective cost of borrowing: how to choose the loan with the lowest cost

Tip 1:
When comparing two offers, compare the effective interest rate or the effective cost of borrowing, rather than the nominal interest rate.

Lenders typically quote their **nominal annual interest rates**. However, the nominal interest rate does not include all of the costs related to the loan. These other costs such as management fees or the analysis fee can vary significantly from lender to lender and increases the real cost of loans by 1.5% to 4.5%. The nominal interest rate plus all other costs related to a loan charged by the financial institution is called the **effective interest rate.** Usually, but not always, all of the charges related to the loan can be found in the repayment schedule or can be requested from the financial institution. Besides the fees charged by the financial institution, there may be other obligatory costs such as insurance. In this case, you must also take into consideration any additional expenses of taking the loan besides the fees and interest charged by the financial institution. The sum of the expenses from the financial institution and any additional expenses is called the **effective cost of borrowing.**

Tip 2:
Choose a repayment schedule that minimises your effective cost of borrowing.

Another factor that has an especially large impact on the total effective cost of borrowing for farmers is the **repayment schedule**. Since farm's income is irregular, the instalments of agricultural loans are usually also irregular with payments only one to four times a year. For the same amount, maturity and effective interest rate, a loan with fewer instalments such as a bi-annual repayment schedule, will have a higher effective cost of borrowing than a loan with more instalments, such as a quarterly repayment schedule.

Although it may be necessary to take a bi-annual repayment schedule because it matches your cash flow, it is important to understand that the effective costs of borrowing will be higher. When faced with the decision to choose between different repayment schedules that you can comfortably repay out of your cash flow, you should choose **more frequent repayments to reduce the effective cost of borrowing**. To clearly see the impact of the repayment schedule on the effective cost of borrowing, you can calculate the total interest and charges appearing in the repayment schedule provided by the financial institution.

Maturities:
How to match maturity with the investment

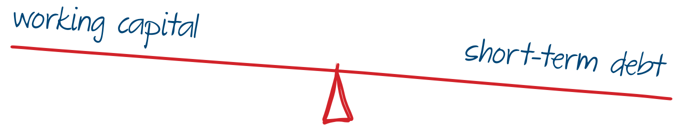
Business opportunities sometimes come up on short notice with a very short time frame to make a choice. The most common example is when the owner of the land you rent wants to sell the land. In this case, you have a short time to pay the owner before she/he sells to another buyer. When opportunities like this arise, you need money fast to make a purchase but don't always have time to wait for an approval from the bank. So you take the money you have to pay for the investment, usually from your working capital. Then after a short period of time your working capital is low, so you request refinancing for your working capital. But wait. Aren't you actually financing then the purchase of land, a fixed asset, with a working capital loan facility? Shouldn't you allow yourself to pay for this investment over a longer period of time?

The situation described above is what lenders call "depletion of working capital" which simply means you have used your working capital for longer-term investments. This is a problem because working capital funds are the funds that need to circulate in your business, transforming from inputs, into crops, into cash and back into inputs to replant. So if working capital is depleted, then you may not have enough funds available to plant your next crop.

This is a problem for both you as a farmer and your financial partner because it puts stress on your business when you finance long-term investments with short-term financing. If this is the situation that has occurred, it is better to discuss with your financial partner options to avoid refinancing the investment with short-term facilities. A longer-term investment loan to reimburse the funds you used to make the investment out of your working capital or a permanent working capital loan would be more appropriate to replenish your working capital and ensure that you do not run into refinancing problems in the future.

Example of a balance sheet with "unbalanced" liabilities

In this balance sheet example, the business has significant higher short-term liability than working capital (short-term) assets. The farmer has taken several short-term loans to finance the purchase of fixed assets. If the short-term facilities expire without being renewed, the farmer will have a problem finding enough cash to finance his/her next crop. In addition, the farmer faces the risk that interest rates for future credits could be higher than in the past which in turn would increase the overall cost of financing the purchase of the fixed assets.



Assets (at fair value)		Liabilities	
Working capital	220,700	Short-term debt	340,000
Cash	20,000	Debt to input suppliers	40,000
Stock of inputs	700	Short-term facilities from financial institutions	300,000
Crops in the field	200,000	Other short-term debts	0
Fixed assets	380,000	Medium- & long-term debt	50,000
Land and buildings	80,000	Long-term loans from financial institutions	0
Tractors, combines and other equipment	300,000	Debts to leasing companies	50,000
		Other medium- & long-term debts	0
		Total liabilities	390,000
		Equity	210,700
Total assets	600,700	Total liabilities & equity	600,700

All Values in RON

Example of a balance sheet with balanced liabilities

In this example, the farmer has balanced his short- and long-term assets with his short- and long-term liabilities. The farmer has the same total amount of debt (RON 390,000) and equity ratio (35%), but he is in a better position because he/she does not depend as heavily on the renewal of short-term loans to finance the business.

Assets (at fair value)		Liabilities	
Working capital	220,700	Short-term debt	120,000
Cash	20,000	Debt to input suppliers	40,000
Stock of inputs	700	Short-term facilities from financial institutions	80,000
Crops in the field	200,000	Other short-term debts	0
Fixed assets	380,000	Medium- & long-term debt	270,000
Land and buildings	80,000	Long-term loans from financial institutions	220,000
Tractors, combines and other equipment	300,000	Debts to leasing companies	50,000
		Other medium- & long-term debts	0
		Total liabilities	390,000
		Equity	210,700
Total assets	600,700	Total liabilities & equity	600,700

All Values in RON

Attention:

Try to match the maturity of the investment with the maturity of the financing. For working capital loans, the maturity should correspond with the planting cycle that the funds are used for, and for fixed asset investment, the maturity should correspond to the expected useful life of the asset.

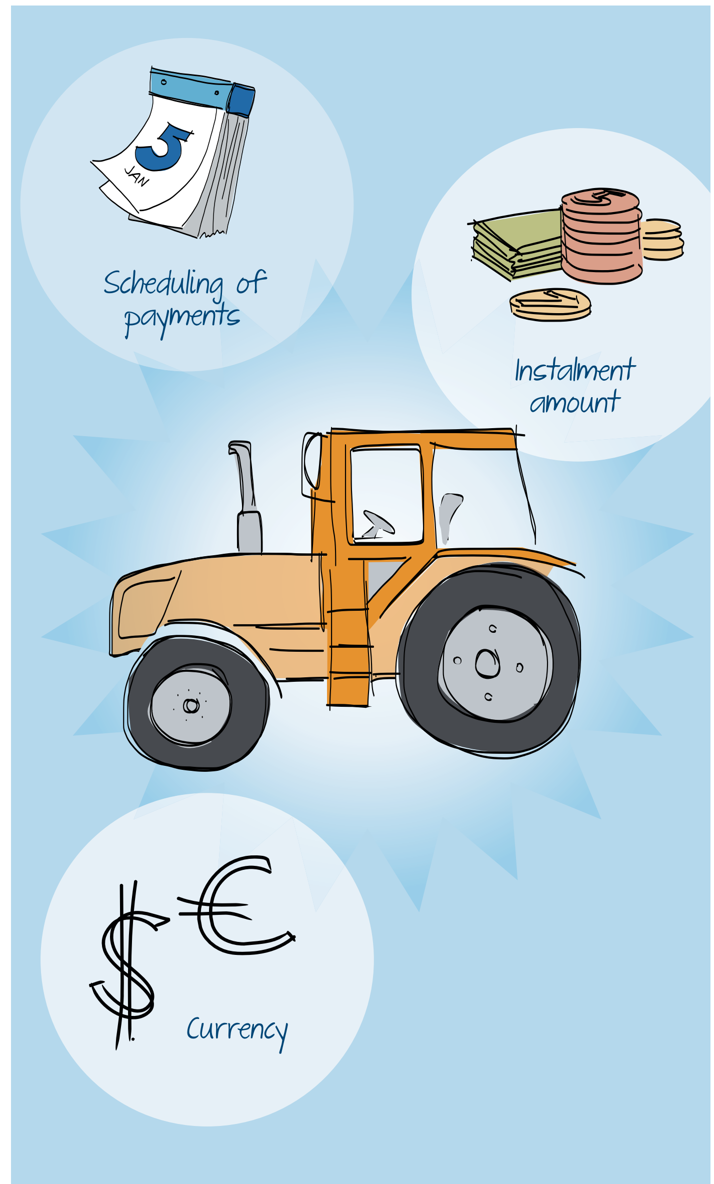
Step 4: Select loan conditions that match your cash flow

After you have agreed to a loan amount and interest rate, usually you are presented with a repayment schedule. When checking if a repayment schedule is right for you, it is most important that the repayment schedule **corresponds to your expected cash flow**. There are three aspects you especially need to pay attention to when it comes to your business's cash flow:

Scheduling of payments – Payments must be planned for time periods when you have inflows in your business. This seems like a "no-brainer" but if financial institutions do not understand your activity well, they may give you a generic monthly, bi-monthly or quarterly repayment schedule based on the assumption that sometime during the period between payments, you will have some income you can save to pay the loan at the end of this term. A financial institution that knows your activity well will make an effort to properly forecast and plan your instalments in accordance with your cash flow to ensure that repayment is convenient for you and that you do not have problems repaying the loan.

Instalment amount – Besides ensuring that the payments are scheduled for the right time, it is also important to ensure that you can afford to pay the amount of the instalment. This means that you know you will have enough available funds after selling your crop to repay all short-term debts, replant the next crop and finally repay any additional loans you may have. If you will take a long-term loan of more than 3 years, you should also allow yourself to have additional funds after all repayments. You will need additional funds available because other investment needs will come up in a 4 or 5 year time period.

Currency – The currency of the loan and repayment should be in the same currency as your inflows/income. Some people think that just because they need to pay for their new tractor in EUR that they have to take a EUR loan even though they always receive all payments for their crops in RON. This is not the case. You can avoid possible losses from fluctuations in the exchange rate by taking your loan in the same currency as your income.



Agricultural insurance and other financial products

As a farmer, there are many risks and uncertainties in your business: you can't predict the weather, your yield, the possibility that your livestock become diseased or at what price you will be able to sell your crop. These have been age old problems of agriculture around the world, but over the years, farmers and lenders have developed financial products to help farmers to make their cash flows more predictable. This section provides information about some financial products which are becoming increasingly available in Romania and the potential benefits of using these products.

Insurance

Insurance is the most common financial product that all types of business and households can use to make their cash flows more predictable. By paying a monthly, quarterly or annual premium, you avoid having an unexpected loss due to problems with crops, livestock or other property. Insurance is required by law in Romania under Government Decree 756 for crops grown on rented land, and the Ministry of Agricultural and Rural Development offers a 50% subsidy for the obligatory insurance premiums. The basic obligatory insurance covers only some of the weather risks that you are exposed to, mainly hail, fire, landslide, and late spring frost. Besides the basic obligatory insurance, there are several other types of insurance policies available such as late autumn and winter freeze insurance, property insurance for the buildings on your land, as well as others. The range of insurance products is not the same in all regions. The availability and price varies depending on the history of the weather events in your particular region. To get a full overview of what is offered in your area, consult your insurance broker.

What is an insurance deductible?

Most insurance contracts have what is called a **deductible amount**. The deductible in an insurance contract is the amount you have to pay out-of-pocket for damages before the insurance company will cover the remaining costs. For example, if the deductible on your insurance against winter freezing is RON 90,000, and your loss due to winter freeze is only RON 60,000 as valued by the insurance company, then the insurance company will not pay you anything. However, if your loss was estimated by the insurance company at RON 130,000, then the insurance company would pay you RON 40,000 which is the difference between the total loss and the deductible (RON 130,000-RON 90,000).

Forward contracts

Besides insurance, there are other products that are coming onto the market that also help to make farmers' cash flows more predictable. Some integrated input and grain purchasing firms are offering **forward contracts**, also known as forward purchase agreements. A forward contract is an agreement made early in the planting cycle between the farmer and the purchasing company that obliges the farmer to deliver a certain quantity of grain or oilseed (for example 120 tons) at a certain price in the future (for example RON 80 per ton). If you choose to enter into a forward contract, the main benefit is that you will secure the price at which you will sell your future crop, giving you more confidence in forecasting your future cash flow. However, if the price in the market is very high at the time of sale, you may earn less income because you are obliged to sell at the price which is stated in your contract.

Guarantee funds

The purpose of a loan guarantee fund is to provide additional collateral to secure your loan when you do not have sufficient collateral to cover the full loan amount. Usually you must pay an annual fee for using the guarantee fund. In Romania there are both national and European guarantee schemes available to assist you in securing a loan, as follows

Attention:

There are also many other products being offered in the market, such as contracts with average indexed pricing or index-linked loans with interest correlated with an index such as the Marché à Terme International de France (MATIF) index. Make sure you fully understand any new financial product and the possible disadvantages before you sign a contract.

Guarantee funds in Romania

FNGCIMM, the National Credit Guarantee Fund for SMEs, is a private guarantee fund offering a standard guarantee covering the risk of default on up to 80% of a contracted loan amount and up to EUR 2.5 million or the RON equivalent. The guarantee is available for all types of business purposes, both working capital and fixed asset investment. The guarantee amount and maturity can be up to the total amount and full maturity of the loan. The guarantee has an annual commission starting at 1.5%, increasing depending on the credit risk classification of the client's business. For more information ask your bank if it cooperates with the FNGCIMM or go to their website: http://www.fngcimm.ro/

FGCR, the Rural Credit Guarantee Fund, is a state-owned guarantee scheme offering guarantees specifically for agricultural producers and processors for both working capital and fixed asset investments. The FGCR guarantee also covers the risk of default on up to 80% of a contracted loan amount and up to EUR 2.5 million or the RON equivalent. The annual commission ranges from 1.25%-6.3% depending on the credit risk classification of the entity contracting the guarantee. For more information ask your bank if it cooperates with the FGCR or go to their website: http://www.fgcr.ro/

European Investment Fund Guarantee is offered to SMEs by the European Investment Fund (EIF) through cooperating banks. The guarantee covers up to 80% of the financed amount with no commission or additional expense. The guarantee covers the risk of default on a loan up to EUR 1.5 million or RON equivalent. The guarantee is offered only for businesses with good performance. To check if you qualify for the EIF guarantee, contact your financial partner to ask if it participates in the programme.

Case Study

Mr. Lăzărescu has been in the agricultural business for 15 years and currently runs his company LazerRom on 465 hectares (40 ha owned by Mr. Lăzărescu, 425 ha rented) near Giurgiu. He currently cultivates wheat, sun flower, rape and barley.

Step 1:
Identify the type of investment you would like to make

Mr. Lăzărescu is looking for a way to finance a two part business plan to invest in **fixed assets**. First, he would like to purchase 10 hectares of land which he currently rents. The land is offered up for sale at RON 15,500/ha or RON 155,000 in total.

Second, Mr. Lăzărescu would also like to construct an additional 700 ton silo. Mr. Lăzărescu has an acquaintance who travels often to Western Europe who has offered to import and install the silo for a total cost of RON 65,000. Therefore, to complete the investment plant, he needs a financing of RON 220,000.

He therefore asked for offers for RON 220,000 from two different financial institutions in order to compare:

Offer from financial institution #1

ROBOR 3m* + 6.5%, maturity of four years; analysis fee of RON 150, 1.5% disbursement commission. Only offering quarterly repayment.

Collateral requirement: real estate or other real guarantees as collateral. Can be supplemented by a guarantee fund.

Quarterly repayment
Effective interest rate: 9.25%
Quarterly instalment amount: RON 16,508

Total fees/Overall effective cost of borrowing:
RON 44,128

** ROBOR 3m= 1.48% on date of calculation*

Offer from financial institution #2

ROBOR 3m* + 6%, maturity of 3 years; 1% disbursement commission and 0.15% monthly management fee.
Quarterly or bi-annual repayment, 4 year maturity possible upon request.

Collateral requirement: real estate or other real guarantees as collateral. Can be supplemented by a guarantee fund.

1. Quarterly repayment
Effective interest rate: 10.35%
Quarterly instalment: RON 21,440
Total fees/Overall effective cost of borrowing:
RON 37,280

2. Bi-annual repayment
Effective interest rate: 10.35%
Bi-annual instalment: RON 43,410
Total fees/Overall effective cost of borrowing:
RON 40,460

** ROBOR 3m= 1.48% on date of calculation*

Step 2:
Estimate your capacity to finance your business plan

Now that Mr. Lăzărescu has decided on a concrete investment plan, he must check his equity ratio to test if his business can support the debt.

Estimated balance sheet

Mr. Lăzărescu already has an estimated balance sheet based on his accounting information and his own estimates. First he calculates his current equity ratio from his estimated balance sheet:

Assets (at fair value)		Liabilities	
Working capital	650,000	Short-term debt	460,000
Cash	25,000	Debt to input suppliers	180,000
Stock of inputs (seeds, fertilisers and pesticides)	5,000	Short-term facilities from financial institutions	280,000
Crops in the field	620,000	Other short-term debts	0
Fixed assets	1,665,000	Medium- & long-term debt	545,000
40 ha of land, av. value of EUR 3,200/ha applied, also buildings and silo	650,000	Long-term loans from financial institutions	100,000
Tractors, combines and other equipment	1,015,000	Debts to leasing companies	445,000
		Other medium- & long-term debts	0
		Total assets Total liabilities	2,315,000 1,005,000
		Equity	1,310,000
Total assets	2,315,000	Total liabilities & equity	2,315,000

All Values in RON

$$\frac{\text{Equity RON } 1{,}310{,}000}{\text{Total assets RON } 2{,}315{,}000} = 57\%$$

equity ratio well above the 30% threshold

Now he must calculate his expected equity ratio assuming he takes a loan of RON 220,000. To do this, he takes the total assets from his balance sheet and adds the value of the investment RON 220,000 to the fixed asset section under land, buildings, silos (since the investment will be in land and a silo) to reach a new total assets of 2,535,000. Then he must also add the corresponding liability of 220,000 to the medium and long-term loans from financial institutions since it has a maturity of >24 months to come to the new total liabilities of RON 1,225,000.

Expected balance sheet

Now that he has adjusted his balance sheet, he can calculate the expected equity ratio:

Assets (at fair value)		Liabilities	
Working capital	650,000	Short-term debt	460,000
Cash	25,000	Debt to input suppliers	180,000
Stock of inputs (seeds, fertilisers and pesticides)	5,000	Short-term facilities from financial institutions	280,000
Crops in the field	620,000	Other short-term debts	0
Fixed assets	1,885,000	Medium- & long-term debt	765,000
40 ha of land, av. value of EUR 3,200/ha applied, also buildings and silo	870,000	Long-term loans from financial institutions	320,000
Tractors, combines and other equipment	1,015,000	Debts to leasing companies	445,000
		Other medium- & long-term debts	0
		Total assets Total liabilities	2,535,000 1,225,000
		Equity	1,310,000
Total assets	2,535,000	Total liabilities & equity	2,535,000

All Values in RON

$$\frac{\text{Equity RON } 1{,}310{,}000}{\text{Total assets RON } 2{,}535{,}000} = 52\%$$

equity ratio still comfortably above the 30% threshold.

Step 3:
Select conditions that match your business and investment

Interest rate, maturity and effective cost of borrowing: There is no fixed interest rate offer for the investment Mr. Lazarescu would like to make. The effective interest rate offered by institution #1 is slightly better at ROBOR 3m+6.5% (currently 9.25%) than the interest rate offered by institution #2 at ROBOR 3m+6% (currently 10.35%). After analysing the offers and their effective cost of borrowing, Mr. Lazarescu realises that the maturity has a higher impact on the effective cost of borrowing than the interest rate. Financial institution #2 offers three year repayment options which are effectively cheaper than taking the loan in four years with financial institution #1.

To double-check that the three year maturity matches his balance sheet structure, he looks at the expected balance sheet he made in step 2. His short-term debts (RON 460,000) do not exceed his working capital (RON 650,000), and his medium- & long-term debts (RON 765,000) are also much less than the value of his total fixed assets (RON 1,885,000). Since neither the short-term nor the medium to long-term assets and liabilities are unbalanced, Mr. Lăzărescu is confident he will not have refinancing problems. In sum, he decides after speaking with both financial institutions that he has a preference for financial institution #2. Although financial institution #1 offers a slightly better interest rate, institution #2 is offering him a lower effective cost of borrowing by offering him the option to repay the loan in three years. He also feels like the representative of the financial institution #2 was more knowledgeable and reassured him that in case of any problems, institution #2 would be more flexible in solving the problems. In the end, he is more comfortable with institution #2's offer.

Step 4:
Select conditions that match your cash flow

In step 4, Mr. Lăzărescu needs to make sure that the repayment schedule matches his cash inflows.

Repayment schedule: After the financial institution processes his application, they suggest a bi-annual repayment schedule with one instalment in the month of July and the other in the month of November. He knows that in these months he generally has higher inflows than in other months due to the rape and wheat harvest.

Instalment amount: To verify the instalment amount, he double checks his accounts and records of purchases, sale of crops, receipt of subsidies from the Agency for Payments and Subsidies in Agriculture (APIA) and other sources as well as VAT payment and reimbursement from last year. The previous year was an average to below average year for income and he plans to plant the same number of hectares of each crop this year, so he considers these figures conservative. In July-August of the previous year, after all inflows and outflows for replanting, Mr. Lăzărescu had about RON 70,000 left over to reinvest. In November-December of the previous year, after paying all debts, he had an even larger amount of RON 150,000 left over from the wheat and barley harvest to reinvest. Considering an instalment amount between RON 40,000-45,000 for a loan with a maturity of three years, Mr. Lăzărescu sees that he can comfortably repay the loan and also have some cash left over for other needs that may come up.

Currency: Athough part of the loan amount will be needed to make payments abroad in EUR, Mr. Lăzărescu has all of his income in RON. Therefore, he will take a loan in RON because there is no need to taking the loan in EUR.

Other products: After discussing his collateral situation, Mr. Lăzărescu agrees to supplement the collateral he has offered (fixed assets) with a guarantee from a guarantee fund for part of the loan amount, RON 80,000. The financial institution informed him that FGCR guarantee would be the cheaper option for him, adding an additional expense of 2.8% per annum charged over the amount guaranteed, RON 80,000. Mr. Lăzărescu considers this expense acceptable and agrees to finalise the loan with the financial institution.

Final result:
A loan from financial institution #2 for RON 220,000 with an interest rate of ROBOR 3m + 6%, maturity of 3 years; 1% disbursement commission and 0.15% monthly management fee. Effective interest rate: 10.35%. Bi-annual repayments of RON 43,410 in July and November. Overall effective cost of borrowing: RON 40,460. Collateral – fixed assets and RON 80,000 guarantee from the FGCR with an annual fee of 2.8%.

Flowchart for professional financial decision-making in four steps

Step 1: Identify the type of investment you would like to make

- Are you interested in working capital, fixed assets or both?
- Which institutions offer financing for the type of investment you would like to make?
- Which financial product best fits your business plan?

Step 2: Estimate your capacity to finance your business plan

- You should double check that your business can comfortably borrow this amount without running into potential difficulties.
- A good rule of thumb is to remember that **you should maintain your equity ratio above 30% at all times**.

Step 3: Select conditions that match your business and investment

- Make sure that your financial institution offers you an appropriate product for your investment.
- Remember that the maturity of your financing should match the **maturity of your investment.**
- **Negotiate with your financial partner to finance fixed asset investment with longer-term financing at affordable rates** to ensure that you do not run into liquidity problems in the future.

Step 4: Select conditions that match your cash flow

- Make sure that your repayment schedule matches your cash flow.
- Have the capacity to repay the amount.
- A good rule of thumb is to **only accept a loan with repayment schedule that corresponds with the time and currency of your cash inflows**.
- Additionally, in your own projection calculations, you should always **allow yourself to have extra funds** available after paying all your debts for future unexpected needs or investments.

Don't forget to ask

Finally, we believe that your financial institution should not only offer you loans, but should also provide you with responsible and transparent advice. Below you will find a checklist of important questions that you should discuss with your financial institution before making your financing decision.

- ☐ Does my financial partner offer several specialised products for agricultural finance?
- ☐ Can representatives clearly explain the specific purpose, advantages and costs of the different products they offer?
- ☐ What criteria does the bank apply when assessing if I can use a specific financial product? Are my financial situation, collateral and/or relationship with the bank considered?
- ☐ Does the financial institution make an in-depth assessment of my business or only look at my financial statements?
- ☐ Which financial products does my business qualify for? Are there other special financial products that are affordable and could be beneficial for my business such as guarantee funds or additional insurance?
- ☐ How does my partner financial institution's offer compare to other financial institutions' offers or supplier credit?
- ☐ Have I explored all of the possible financing options to complete my business plan and compared offers from different financial institutions and/or input suppliers?
- ☐ Are fixed and variable interest rates offered for the financing I need? Have I compared and weighed the advantages and risks of taking the fixed or variable interest rate?
- ☐ What are the total effective costs of borrowing of each of the offers received? Are there other fees or expenses that I must pay, such as obligatory insurance? Do I have enough information to make a comparison and informed choice between the different offers?
- ☐ Does the maturity offered match the maturity of my investment and allow me enough time to comfortably repay the loan?
- ☐ Does my partner financial institution offer me repayment schedule options that match my cash flow?
- ☐ Is my partner financial institution flexible with repayment in case of harvest problems or disaster?

Useful contact information

If you would like to see more details on the products and programmes offered in Romania, please refer to the websites of the institutions listed below. Most programme websites will list the eligibility criteria, benefits as well as participating institutions.

For an update on the 2014-2020 European investment and structural fund programmes, see the official website of the Ministry of Agriculture and Rural Development
http://www.madr.ro/ro/programare-2014-2020-pndr.html

For other subsidised loan programmes offered through the Ministry of Agriculture and Rural Development such as the programme for very small family farms (less than 300 hectare) or for farm start-up, please refer to the Ministry of Agriculture and Rural Development website
http://www.madr.ro

European Fund for Southeast Europe
*www.efse.lu**

European Bank for Reconstruction and Development
*http://www.ebrd.com/country/romania.html**

European Investment Bank
*http://www.eib.org/projects/regions/european-union/romania/**

European Investment Fund
*http://europa.eu/about-eu/institutions-bodies/eif/index_ro.htm**

National Credit Guarantee Fund for SMEs
http://www.fngcimm.ro

Rural Credit Guarantee Fund
http://www.fgcr.ro

**site only available in English*

Sound financial decisions are key to business success. We are confident that the advice given in this brochure, coupled with advice and support from your financial institution, will help you to make the right decisions.

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