Borrowing to Cover Operating Losses– Considerations

Given the current climate of prices in various agricultural industries, it is important to consider how money borrowed will affect your future profitability. In a previous article we talked about the different kinds of loans that lenders offer, how they are scheduled, and when it is appropriate to use them. Here we will look at what happens when operating expenses are paid by borrowed funds.

If a farm business borrows $5,000 a month to keep all billing accounts current, this would be $60,000 over the course of the year. This would also indicate (because they are borrowing to pay bills) that they cannot afford any additional debt service (increase in monthly payments). A business could handle borrowing this money in one of two ways:

· **Short Term Revolving Loan-** a loan that becomes re-available as principal is paid down with each payment. When the principal balance on these loans increases, the payments should increase as well. Depending on what your terms are (most are scheduled with monthly payments over 3 years or 5 years), you will be using funds to pay current operating expenses that you then will not effectively pay off for three to five years. While this happens farm to businesses, and can certainly be recovered from, it is important to consider what you will have to forgo in the future. The opportunity cost is most often seen when repairs or new equipment purchases need to be made and instead of having the capacity (both on the line of credit and monthly payments capacity of additional debt to purchase upgrades) the farm is still paying for old operating expenses. In the case of the $60,000, the monthly payments over three years at 4.5% interest would be $1,785. It could be considered that a farm family could have $60,000 in family living expenses in which case, the owner of that business is essentially borrowing to pay their salary. Farm businesses should consider whether or not this additional borrowing is a limited time circumstance, or if it is part of an ongoing pattern.

· **Long Term Non-Revolving Loan-** a loan that has a finite amount disbursed at the beginning of the loan and with principal funds that do not become re-available. Typically a non-revolving loan that is secured by a Mortgage on real estate has terms that are 30 years or less (scheduled over 15, 20 or 25 years). If a farm is in an equity position where they can use real estate value to secure a long term loan they could schedule the additional funds borrowed in the example, $60,000 over 15 or 20 years. In some cases, farm businesses will take portions of or entire short term loans and "term them out" or take a finite amount that can be secured by real estate and stretch out the repayment terms. This can lower monthly payments considerably going forward and provide reprieve or flexibility in future years to allow for capital purchases or repairs. However, it will also limit future ability to borrow additional funds for real estate or if another period of losses occurs.

Either one of these options can work for farms or a combination of both. It is important to consider your options and evaluate your specific situation with whomever you feel comfortable. When reviewing these options, be sure to evaluate what the opportunity cost is. What will your business have to give up in the future because of these additional borrowed funds? Will these additional funds limit or eliminate your ability to be profitable and competitive in the future? During times of financial stress it is difficult to focus on the further off future, but the choices made today will shape your tomorrow. Should you want to review your farm businesses financial position or evaluate financial plans, the Farm Business Management Specialist with the can assist with this, she can be reached at 315-955-2795 or kio3@cornell.edu.