

AgriMatters

AIB supporting the Irish Agricultural Industry



Spring 2010 - Special Credit Edition



Special Edition: Helping farms source finance from AIB

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Welcome to this special edition of Agri Matters – Helping farms source finance from AIB

Michael Dowling, Head of Agri Strategy, AIB

These are difficult times in Irish farming – particularly in the dairy and tillage sectors. Thankfully in the case of the former the worst appears to be over as prices are recovering. Furthermore, the longer-term outlook remains positive for most farm sectors. In the short term, however, many farmers are experiencing cashflow problems and, on the other hand, despite the recession, others are anxious to proceed with development projects. AIB has been working with our farming customers through these difficult times. We want to help you manage through the downturn and volatility, and enable you to take the necessary actions to stabilise your farm business.

In each situation it is highly important that farmers keep in early and close contact with their bank and other finance providers. Many find no difficulty in doing this. Others, for a variety of reasons, have concerns about doing it and, in particular, about what is the best way to approach the bank.

Accordingly, we have prepared this short guide to agri credit in order to be of practical help to new and existing farmer customers in their relationship with the bank. It explains the information we may need to make a credit decision. In addition to the general guidelines, we have included an article from Patrick O'Meara, Agri Adviser, giving more specific advice. We have also included a glossary aimed at taking the mystery out of some banking terms. I hope that this edition will be of practical help to many of our readers.

AIB has always been, and will continue to be a strong advocate that banks and farmers must work together in addressing the challenges presented.

We will try to be as accommodating as possible, to meet your needs and respond in a realistic and pragmatic way. We will take personal ownership of your request, and make every effort to respond favourably in as short a timeframe as possible.

In circumstances where we have to say no to a request for credit, we will do so directly, giving a clear rationale for our decision and make every effort to work with you to find an alternative solution.

I would like to end by extending good wishes to all our readers and express the hope that 2010 will be a considerable improvement on the year just past.

Michael Dowling
Head of Agri Strategy

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Our Commitment to You

AIB is fully committed to supporting our farming customers with a comprehensive range of financial products and services to meet your needs. We can also provide you with expert knowledge and advice based on our longstanding experience within the farming community. Our team of specialist Agri Advisers is there to support our branches in delivering services to farming customers. In all our dealings with you, we are committed to acting with integrity and professionalism – in the best interest of both your business and ours. AIB will:

- Approach each lending application on an individual basis, within the background of AIB's values and principles
- Clearly communicate the cost, terms and conditions of credit sought
- Tell you approximately how long it will take to process your lending application and aim to give you an answer as soon as possible
- Give a clear explanation for any decision to decline a formal credit application, and
- Offer all new and existing farmer customers an annual review of credit facilities and supporting security.

Applying for Finance

When you come to AIB for bank finance, we will draw on our experience with farming customers and our knowledge of Irish farming. This is the background against which we will examine your business and farm plans. As to the specifics of your credit application, we focus on five fundamental areas that we call 'the 5 C's' which help us to arrive at a lending decision. It's worth giving some thought to how your farm business will stand up to assessment in each of these areas.

This will help you assess your strengths and weaknesses as they are likely to appear to AIB when assessing your credit application. Preparing backup plans or support for the weaker aspects of your business could make all the difference in accessing finance.

Here's what AIB looks for in each of the "5 C's": Character, Capacity, Capital, Collateral, Conditions

Character

Good character is a basic prerequisite for any borrower. Honesty, integrity and reliability are the qualities that mean you will make every effort to repay your debt. In relation to your farm business, you need to be able to demonstrate that you are an effective manager with a good reputation. It's also important to be honest and upfront about your credit history and any business problems you may have had. How you resolved these will, of course, be helpful in determining how they effect your application.

Capacity

You will need to show how your farm will generate sufficient cashflow to repay the credit facility you are seeking. Detailed financial forecasts must show how repayments will be generated. Beyond this, you will also need to explain your capacity to repay the credit facility if the business does not develop as planned. Other sources of income (such as investments or off-farm income), skills you could use to earn additional income, or the support of an earning spouse could provide a sufficient backup plan.

Capital

Business capital is split between equity (the money that the owners and investors have put into the business) and debt (money borrowed from banks or other sources). Equity capital acts as a cushion to absorb first losses, while debt capital must be repaid to the lender however the business fares. Since debt capital also comes at a cost of interest, the more debt a business has relative to equity, the higher the level of risk. Start-up businesses potentially can be a high risk for lenders, so if you are seeking to borrow

money for a new business, e.g. a green field farm development, AIB will, like most lenders, need to see that you have input a reasonable level of your own funds.

Collateral

Collateral is the security given to a lender for protection in case the business cannot repay the loan. It can be any one of a range of business and personal assets, including buildings, vehicles, machinery and land title. If the farm cannot generate enough cash to repay the credit facility, the lender may have recourse to the collateral. But for AIB, as for most lenders, recourse to collateral is always the last resort. The farm is viewed as a key source of repayment; however, other sources of income may be taken into account (e.g. income from off-farm employment) when assessing an application for credit. It is always advisable to seek independent legal advice before providing collateral against credit facilities.

Conditions

Conditions and trends in the agri-food sector and the overall economy are crucial factors in determining the success of your farm business. Opportunities or threats to your business can arise from external factors such as commodity price fluctuations, weather and disease effects, external regulation and EU policy. You may not be able to control all of these factors, but you must be aware of them and be prepared to respond to change. When you look for bank finance, you need to be able to give your assessment of the agri market and how your farm will cope with potential changes in market conditions.



Applying for Bank Finance - your proposal

Whether you are a young farmer starting out, well-established in your enterprise, or growing or diversifying your farm business, AIB has the financial supports you need. We provide bank finance for sound and viable farm businesses with well-presented proposals, based on a solid appraisal of the farm and its future in the industry. In many instances farmers seek the support of a professional i.e. Teagasc Adviser, consultant or accountant in preparing bank proposals. If the initial proposal contains sufficient information and is well explained it is stronger placed to succeed than the proposal which is incomplete, inaccurate or not effectively presented.

To access bank finance your farm must be able to generate sufficient funds to service interest and proposed loan repayments, while continuing to provide an adequate return to you and support household drawings. Because bank finance is an investment in the future, you will also need to show that your farm can survive in the medium to long term. The process of outlining this to your bank will also provide you with valuable management information for your farm business.

And of course, AIB needs to know that the business owners and managers have the skills and commitment to deliver the projected business results. These key points will be covered in the application process, where, depending on your requirements, we will seek some or all of the following information:

1. Background

Give background details on your farm business, including your farm programme (land farmed, production system, livestock, milk quota), direct payments, labour costs and farm machinery details. You should also include information on the key stakeholders – customers, suppliers, etc.

2. Purpose & Vision

Explain why your farm needs credit finance now. Outline past achievements i.e. improvements in gross margin and technical efficiency, management of your cost base, enterprise diversification activities etc. and provide clear future objectives for your business, both short term and long term.

3. Risks

Show how you understand the risks that affect your farm business and outline the steps your business takes to reduce/mitigate these risks. It's important to address both internal risks (relating to farm activities/enterprise mix) and external risks (regulation, commodity price fluctuations etc.).

4. Financial Information

Provide historical financial information in the form of audited accounts and, where appropriate, the following types of information:

- Audited accounts for the last three years (existing business) and farm budgets for the current year. This will provide the lender with an overview of the farms performance over a period of time and not just a year when the farm may have performed particularly well or particularly poorly
- Cashflow forecast for the relevant period/medium term and details of the supporting assumptions (the cashflow guidelines on www.aib.ie/farming may be helpful here)
- Aged list of debtors/creditors
- Confirmation from the Revenue Commissioners that all your personal and business tax affairs are in order
- Total assets/liabilities (personal and business)
- Other information relevant to your particular industry/business.

If you are developing a new farm business or you have not previously banked with AIB, you will also need to provide:

- Forecast Trading Profit and Loss Accounts for the next three years
- 12 months of any previous business and/or personal bank statements
- Business plan (ideally prepared with your accountant, Teagasc Adviser or farm consultant).

5. Business Plan Document

Your Business Plan is how you will present your farm business to various important stakeholders, as well as to AIB, when you seek bank finance. It should include the relevant information outlined above, laid out clearly and concisely. We do recommend that you seek professional advice from your accountant, farm consultant or Agri/Teagasc Adviser and/or solicitor when preparing your business plan.

6. Financial Requirements

Set out exactly what you need from AIB, including the amount and purpose of the borrowing. If you seek bank finance to fund part of the cost of a project, it is important to include the total cost and details of how you will fund the balance.

It is important to include a detailed budget which is in line with your business plan. Ensure that you have costed your development accurately and made provisions for delays and overruns.

7. Repayment

It is critical to demonstrate how your farm business will repay the finance facility sought. Be clear about the source of repayment and include potential alternatives in the event of the expected source failing. Your budget and cashflow forecasts should reflect realistic business expectations for the period of the facility. In a seasonal business such as farming it is possible to tailor your repayments to suit your farms cashflow cycle.

When setting out your repayment plan, you should ensure that your new investment will not cause short-term cashflow problems particularly where the productive capacity of the asset will not be immediately realised.

Sample Repayment Analysis Table (to be used in conjunction with financial accounts)		
	2009	2008
Net Profit		
Plus Depreciation ⁽ⁱ⁾		
Plus Bank Interest & Charges ⁽ⁱⁱ⁾		
Plus Adjustments		
Cash Available for Living, Tax & Bank Repayments		
Less Drawings		
Less Financial Repayments		
Net Surplus/Deficit for capital investment		

⁽ⁱ⁾ Note: Depreciation is added back to net profit as it is a non-cash item

⁽ⁱⁱ⁾ Note: Bank interest and charges are added back to allow one to calculate the cash generated by the farm before any financial repayments. Full financial repayments are then deducted to calculate net surplus.

8. Security

Provide details of any security you are offering to support your application – for example assets, a personal guarantee, Letter of Pledge or Letter of Lien. Ultimately the lending decision will be based on the capacity of the business to repay the finance, irrespective of any security you may provide.

Finding the right lending product for your business

AIB offers several different types of lending products for farmer customers. Talk to your Relationship Manager to determine the optimum funding structure for your farm business. This is the level that will give your farm business the financial strength as well as the flexibility that it needs.

An Overdraft

A Business Overdraft allows your business current account to go into an overdrawn position, up to a pre-agreed limit. In any 12-month period, an overdraft facility should fluctuate between credit and debit balances.

A Credit Line

A credit line is a credit facility which has been arranged beforehand to meet your working capital and short term funding needs. This facility typically works alongside your current account. Funds can be drawn down in an agreed number of tranches per year. This is an effective facility for planning your seasonal working capital.

Promptpay

Promptpay is a short term loan facility that enables a business to spread the payment of once-off annual costs over 10, 11 or 12 monthly repayments. Typical business expenses such as: preliminary tax, pension contributions, commercial property rates, subscription fees to professional/trade associations and annual audit fees can all be covered.

Customers can benefit from fixed repayments. In addition, interest payments

may be allowable against taxable profits*. Optional Payment Protection is available for self employed people, professionals and company directors**.

Insurance Premium Finance (IPF)

Insurance Premium Finance is a short term loan available for payment of general insurance premiums including: Motor, Fire and Burglary, Employer's Public and Product Liability, Professional or Medical Indemnity Insurance. Repayments are over 10, 11 or 12 months and interest payments may be allowable against taxable profits*.

Loan facilities

Business loan finance can vary in term from one year to as long as 15 years. The repayment term will ideally be designed to tie in with the economic useful life of the asset being funded. The title to that asset will typically be held by the bank as security for the business loan.

EIB Loan Scheme

The EIB Loan Scheme is a particular form of medium term borrowing, made available in partnership with the European Investment Bank (EIB), to help fund business expansion projects of SMEs including farmers. Contact your Business Relationship Manager to find out whether your business qualifies for this competitively priced source of funding.

** It is recommended that customers should seek independent tax advice when considering these products*

*** Terms and Conditions apply*





Some Credit Jargon Explained

Here are some typical terms that you are likely to encounter in the course of applying for finance for your business.

Base Lending Rate

The AIB Base Lending Rate is an Interest Rate which is reviewed and determined weekly and becomes effective from the first business day of the following week. It is determined by reference to the three-month Euribor rate, reflecting a daily average of this rate over the three previous months. It will then be rounded to three decimal places. AIB's Base Lending Interest Rate is quoted to customers on a 365-day count basis.

Funding Premium/Liquidity Costs

Following the significant upheaval in global money markets since 2008, the cost of raising funding for banks and governments increased significantly. When banks borrow money from markets, they now have to pay a premium above the market reference rates.

Since February 2009 AIB has been clearly identifying, in customers' Credit Agreements and Letter of Sanctions, the exact level of Funding Premium applied to affected customers at the time of their credit application or when they are renewing their facility.

Margin

The 'margin' added to the Base Lending Rate is typically calculated to cover: Return on Capital, Risk Return, Operational Costs, Funding or Liquidity Premium and Bank Profit.

Basel II Accord

The Basel II Accord is a set of international standards (in effect since 2007) that dictates the level of capital banks must maintain to support their lending, as well as the way in which they manage their credit portfolios.

A key principle of Basel II Accord is that as credit risk increases, more regulatory capital is required by the bank. If any borrower is in excess of agreed lending limits for 90 days plus, that loan is automatically considered to be in default. This requires an increase in the amount of related regulatory capital that must be held by the bank. It could also potentially compromise the credit standing of the borrower into the future.

This aspect of the Basel II Accord requires customers to manage their finances more closely within agreed limits. Levels of flexibility which might have pertained in the pre-Basel environment can no longer be made available. Nonetheless, AIB is fully committed to working closely with all customers to ensure they can meet their funding requirements and avoid default under the Basel II Accord provisions and the subsequent negative impact on their credit standing.

We strongly encourage customers to talk to us on a regular basis to ensure we are fully up to date on your business and can plan in advance for all your financial requirements.

The Irish Banking Federation has issued a clear guide to the Basel II Accord: "How Basel II impacts on the way that banks deal with business customers". This can be found on their website www.ibf.ie



Successfully Applying for Credit

Patrick O'Meara
AIB Agri Adviser

In general, farmers use accountants to complete their Profit and Loss Accounts, and Teagasc or Agri Advisers/consultants to complete their Single Farm Payment applications. However, in the main, they seek very little help in preparing requests for bank finance whether for additional working capital to buy cattle or term loans for land purchase or other capital requirements. As a result, farmers don't always make as strong a case for their proposition as they could or indeed as other businesses do.

Any lender will require a certain amount of information to process an application. This is detailed in the section above entitled 'Applying for Bank Finance – your proposal'. It is important to present these details, preferably in writing, when meeting with your bank.

In a bank meeting, when the discussion moves onto the lending proposition itself, the lender will look at the likelihood of the investment succeeding:

- What are the strengths of the proposition
- What are the key risks of failure, and
- What is the repayment capacity of the customer.

In farming, the key risks of failure are often items such as over-runs on costs, certain items not included in the costings, not obtaining key requirements such as planning permission, milk quota etc. The interaction with the customer during the bank meeting is key to confirming or allaying the concerns a lender will have relating to these issues.

To support the case, a farmer should complete detailed costings for the proposition, an ongoing income budget and a monthly cashflow projection for the business. Compiling this information allows the farmer to examine the proposition in detail – enabling it to be altered or improved before it is presented to a bank.

In some cases the information will identify key weaknesses at an early stage which may highlight that the proposition is not viable for the farm. When engaging with a bank, it is important to remember firstly that just because a bank is willing to provide the finance sought, does not mean the farmer has to take it. The onus is on the individual to make up his/her own mind as to whether or not this is the right course of action at the particular time. Secondly, if a bank says no to a request, it may be the best response at that time for the business. It is always good advice to review the proposition if it has been declined.

The documents that are presented to the bank, in support of a finance request, will form the basis for the discussion during the bank meeting.

This should help in presenting the case as the farmer will have dedicated a significant amount of time in preparing it. Again, it may be worthwhile to get a second person to review your proposal to provide extra rigour. The lender will be looking for any omissions in the proposal, reviewing the basic assumptions (e.g. grain/milk price), evaluating how the proposition compares to the profit and loss accounts and how it compares to the industry norms for similar scale businesses.

What do the best propositions have in common?

The customers concerned have:

- Up-to-date information – current bank balances and latest set of accounts
- A full understanding of their business – e.g. actual costs of production and the implications on their trading accounts. They can comment on any items that might be out of the ordinary (e.g. high feed costs, land maintenance or drawings)
- In many cases management accounts such as a profit monitor which may show that a farmer has made money from a similar proposition in the past
- Quotations for the work being carried out (from a number of suppliers) and have room in the budget for over-runs. In general projects take longer and cost more than have been planned for
- Full and accurate details of the tax implications of propositions and costed these in the proposal, and
- Analysed the repayment capacity of the proposition and are putting an element of their own capital (equity) into the proposal.

What does a bank consider?

Obviously a bank considers a large number of factors including its experience with similar propositions, how well the proposal has been researched and whether or not the customer has utilised professional assistance in preparing the proposal. The main items a lender considers are included in the 'Applying for Finance' section on page 4. It is vital that customers understand the importance attached by lenders to what has been previously described as the "5C's". When preparing a lending proposition for bank finance, farmers should try to bear in mind these fundamental requirements.

In essence, good preparation is the key to ensuring that a farmer's lending proposal receives the most favourable consideration by the bank. Providing sufficient understanding of the farm business and detail of the proposition as outlined above helps customers convey to a lender that they have thoroughly analysed the proposition and believe that it will be successful. This provides great comfort to any lender.

Important Regulatory Information

Credit Facilities

Lending criteria, terms and conditions apply. Credit facilities are subject to repayment capacity and financial status and are not available to persons under 18 years of age. Security may be required.

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