Business Update – Long-Term Borrowing and Fixed Rate Loans

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- Long-term rates are currently very attractive
- Fixing can be a good solution, but once fixed you are locked into the agreement
- You should take independent advice on the best strategy for your specific circumstances

What is long term borrowing?

- Borrowing money from a bank or other financial services provider with repayment terms of 10 years or over.
- This type of borrowing is normally undertaken on farms to aid the purchase of land and/or buildings as well as developing long term infrastructure such as livestock buildings/parlours etc.
- Long-term borrowing should not be taken for the purchase of shorter-term assets such as cows and machinery, nor should it be taken as a cashflow aid.
- Structure is also a consideration. Repayment or interest only? Either can work, but the key consideration is affordability. If the business is taking interest only borrowing because it cannot afford capital and interest repayments on the borrowing, then you should question whether this is appropriate.
- A business that can afford capital and interest repayments may choose to take an interest only loan as they feel they can utilise the cash freed up by not repaying capital to grow their business and generate a better return. In all cases, the money must be repaid at some point and in some way.

Risk management on borrowed money

- In most cases managing interest rates on borrowed money means fixing the interest rate on the borrowing.
- Fixed rate loans allow you to fix the interest rate on your borrowing for a certain period.
- It also fixes the amount borrowed on the loan, the repayments, and the time of the fixed rate.
- This provides certainty to your business and allows you to budget on a set repayment amount over the term of the fixed rate.
- Different banks offer different fixed rate products.
- In general, you can fix loans above £25,000 for longer periods of time. Some providers will offer loan terms of up to 25 years and will allow you to fix the rate for the whole 25 years whilst others may only offer maximum fixed rate terms of 10 or 15 years.
- The borrower decides how much and how long to fix the rate for. You will get very little advice from the bank in this regard and they may ask you to speak to someone independent, like a financial specialist, to advise you.
- Once you have decided on the amount and the fixed rate term, the bank will generate fixed rate for you based on that information.
- If you do take a fixed rate loan you should be aware that there are often penalties (break costs) if you repay the loan early or want to change it in any way.

Should I take a fixed rate loan?

Care is required here.

- Fixing a loan is about much more than just the interest rate.
- There are several areas to consider before agreeing to enter a fixed rate loan.

There is no simple formula for this, however, with interest rates at historically low levels, fully considering fixed rate loans is something any responsible business should do.

1. Consider your attitude to risk as well as what risk your business can afford to take:
    a. To help consider how you really feel about the debt risk in your business, what is the actual interest cost to the business and does your level of debt concern you.
    b. If your business borrows and operates with a tight cash surplus after everything is paid, then any upward movement in interest rates may expose the business to losses. It is worth testing how sensitive your business is to increased rates.
    c. A business with high levels of borrowing per cow, but with a comfortable cash surplus may feel happier carrying more risks. However, it should model the impact of interest rises on that cash surplus to make sure they remain aware of the risk.
    d. Loss-making businesses should be very wary about entering into fixed rate loans without having a clear pathway to profitability. Should borrowing need to be restructured to accommodate changes to a loss-making business any fixed rate loan restructure may carry a penalty/break cost to do so.
    e. All businesses should consider scenario planning around their exposure to interest rates to help them judge what their risk looks like.

2. How much money do I fix the interest rate on?
    a. That will depend on how you feel the business will perform.
    b. Fixed rate loans limit flexibility compared to variable rate loans, so if you expect to make any changes to borrowing structure then take great care when considering fixed rates as any changes to a fixed rate loan may attract a penalty/break cost.
    c. If you feel that your business may have a lump sum of cash to repay borrowing at some point in the future, then you should carefully consider whether fixing borrowing on that amount of money is sensible.
    d. If you expect to be able to accelerate repayments on borrowings, you should also consider whether fixing your borrowing is the correct direction for your business.
    e. Businesses should consider only fixing rates on borrowings that they expect to remain unchanged for the duration of the fixed rate loan.

3. How long do I fix the interest rate for?
    a. Providers may offer different fixed rate terms and the important thing to remember is that you do not have the fix the borrowing for the full term of a loan. For example, you can fix the first 10 years of a 20-year term loan.
    b. The decision around term will rest with several other factors such as those covered in points 1 & 2 above.
    c. You may also wish to consider 'blending' your fixed rate strategy. This could mean breaking your loan down into separate blocks and fixing smaller elements for different terms so that you have a 'portfolio' of borrowing arrangements to spread risk.

4. With low fixed interest rates how can fixing be wrong?
    a. If you are happy to significantly reduce the flexibility in your borrowing arrangements for a certain period, then fixed rates may be worth considering.
    b. You must remember that if you fix your interest rate you are fixing your entire loan, including term and repayments so making any changes could be costly.