ABOUT FINANCE

Continue to learn

Keith Jaynes looks at the best way to make your, or the club's money, work the hardest.

It would be easy to fill the pages that follow with a list of all the features of the different financing options available to clubs and businesses. Drawing up such a list would be simple. Just include everything from cash to mortgages and hire purchase to operating lease. However, selecting the 'best' finance option for all the different types of investment would be impossibly complicated because every club and business is different, and what is best for each depends on their individual circumstances.

FINANCING CAPTIAL EXPENDITURE

More important is to understand some general principles that lie behind the choice of finance for different types of club expenditure – in particular, new machinery.

WORKING CAPITAL

Expenditure has two components – working capital and fixed capital. Working capital is the finance required to meet the day-to-day commitments of the club. Items like wages, diesel, food and drink served to members. Paying these bills requires cash, which usually comes from the bank account, which holds income from subscriptions, green fees and food and bar takings. Sometimes it may also mean drawing on the overdraft if there is a short-term mismatch between expenditure and income.

FIXED CAPITAL

Fixed capital is expenditure on new machinery and other items with a longer term payback for the club. An important distinction is the period of payback. Items like machinery, buildings or land normally carry a substantial price and have an anticipated 'working life' of more than 12 months.

It can often make sound commercial sense to match fixed capital investment to repayment periods that relate to a realistic working life (say, three to five years for new machinery). This may mean spreading the cost rather than paying cash on day one.

THE THREE C'S

Three C's highlight some important considerations for a club in making cost effective capital investment choices. These are: Capital Budgeting, Cost, and Cash-flow.

CAPITAL BUDGETING

New investment should always be cost justified. In industry, where capital is a scarce resource, accountants use sophisticated techniques to calculate the net cost of alternative projects and balance these against the projected returns to decide which ones will get the capital funding. The same concept, if not the same techniques, should also apply to a golf club.

COST JUSTIFY NEW INVESTMENT

Cost justification means asking questions like: Will it do the job we want done? What are the alternatives? and What is the cost? It is important to distinguish clearly between cost and price, because the lowest price may not always have the lowest cost! You know the price of everything on the day you buy it, but you can only tell what something cost on the day it is sold. That's after you take into account factors like running and financing costs, maintenance and the disposal price, etc.

FIX THE COSTS OF INVESTMENT

Budgeting also implies trying to fix the costs in advance as accurately and predictably as possible. This may be one reason why an increasing number of clubs are turning to contract hire, a form of operating lease, to rent the equipment they need. This enables them to pay a fixed monthly amount which can also include an optional amount for service and maintenance over a fixed period, say 36 months, to hire the machinery they need. Apart from accurate budgeting, there is the added benefit for some users of being able to keep up to date with the latest developments in machinery.

Once the decision to invest has been made, the question remains as to the best way to fund it, which means turning to the C's of Cost and Cash-flow.

CASH-FLOW

Dickens' Mr Micawber was an early enthusiast for the concept of cash-flow management. Annual income of £20 coupled with expenditure of only £19 19s 6d was, he mused, happiness itself. But spend say £20 and six pence and the corresponding result was misery.

LIQUIDITY IS IMPORTANT

A survey in the mid-1990s conducted by Cranfield University concluded that small and medium-sized businesses in the UK placed a far heavier dependency than their European neighbours on short-term sources of funding – eg, cash and the overdraft – to finance capital investment with longer term payback. Such a loss of liquidity can be a major reason why often 'profitable' businesses fail. They simply run out of cash to cover working capital requirements. In a members' golf club this may mean a special call for additional funds to support a specific project, but for clubs run on a purely commercial basis, managing cash-flow is very important.

LESS FUNDING OPTIONS – LESS FLEXIBILITY

Borrowing to finance new investment may be alien to many clubs that look only at the interest they pay. Some may view income from members and visitors as free capital, thinking it therefore has the lowest cost. However, the investment decisions these clubs can make are limited by the amount of surplus cash and time that is available. This may force 'either/or' choices – eg, should we refurbish the locker rooms or buy the new fairway mower? Both may be desirable to maintain membership and visitor income, but the hike in annual membership to accommodate both is unlikely to be popular with members. In addition, the timing could be wrong and why should the members pay in advance for investment that will deliver the benefit over a longer time frame?

CASH IS NOT FREE

Of course, some clubs may be able to call on substantial cash reserves. If the reserves are sufficient this provides a solution, but the cash can only be spent once and the word 'reserve' implies prudence in its application!

This means if a sudden, unexpected opportunity or crisis arises, perhaps to buy additional land or the need to replace a machine in the event of a sudden major failure, a cash-only investment policy is unlikely to help and finding a short-term solution to a long term need will compound pressure on cash-flow and is likely to have a higher cost.

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Matching the funding to the investment could mean that the club chooses a mortgage or secured loan over 10 to 15 years for additional land, something similar for buildings or building improvements but, perhaps, over a shorter period and hire purchase or a lease for the machinery.

COST

Cost is the final 'C'. A number of factors influence the cost of borrowing. First is the rate of interest. Interest can be calculated and applied in different ways. This is often confusing with flat rates, effective rates, nominal rates and APRs – a quick look at the pages of the Financial Times is enough to tell you this!

INTEREST RATE CONFUSION

Interest is the charge for borrowing money. It can be calculated and expressed in a number of different ways, which can lead to confusion – as the table shows! The most meaningful measure of cost is how much you pay and when you pay it. At a given rate of interest, acceleration of repayment of the amount borrowed will reduce the interest paid while deferment increases this.

To enable consumers to compare the terms of one finance agreement with another, the Consumer Credit Act requires the APR (Annual Percentage Rate of charge) to be shown on regulated agreements. The APR uses a standard formula to express the rate of interest for a particular transaction irrespective of how it was originally calculated or applied.

CHANGING YOUR CAR

To change your car you need to borrow £5000. You want to make 36 monthly payments, commencing next month. You are looking for the best interest rate you can find. Which would you choose? Answers at the foot of the page.

Source of Finance	Interest Rate % pa
1. Joe's Bargain Bangers	3.65% Flat
2. Superstore Loans	7.10% APR
3. Honesty Autos	6.88% True

FIXED & VARIABLE RATE OPTIONS

However, there are other components that affect the cost of finance. One is whether the interest rate is fixed or variable. Money market rates of interest change daily based on the view the market has of the future. In addition, the Bank of England uses interest rates to influence economic activity. Some types of facility, particularly longer- term borrowings on mortgage tend to use variable rates although rates can be fixed too. For shorter-term funding, say, three to five years, from finance companies that specialise in machinery, fixed interest facilities tend to be the norm, although bank loans may still be offered at variable rates.

The benefit of fixed rate finance for machinery is that it enables the club to budget with great accuracy for machinery it purchases, confident that the costs are fixed at the outset and will not change over the life of the agreement, whatever happens to interest rates in the same period. Often, there is the additional advantage of being able to lock into low interest offers from the manufacturer.

INCREASED SPENDING POWER

Spreading the cost also has another very simple benefit that is often overlooked. One pound today has more purchasing power than that same pound in five years time. One reason is inflation, which erodes spending power each year. Even at three pe cent per annum inflation, the value of a pound today falls to £0.86p over five years. This begs the question: Should a club use its own cash reserves for longer-term investment?

Other factors to consider may be the availability of any grants, tax incentives or deferment of VAT that are available, depending on the type of facility chosen. For example, some clubs that are unable to reclaim VAT, in part or in full, may find that leasing machinery takes some pressure off cash-flow. This is because under a lease the club pays VAT on each rental as it arises, rather than in advance if it chooses to buy.

BUY OR HIRE? - A CHOICE OF OPTIONS

In broad terms there are only two routes for capital investment, buying or hiring – although each has a range of different alternatives as can be seen from the table below. The table ignores longer-term options such as mortgages and other long-term loans.

TITLE/OWNERSHIP RIGHTS

Title to goods, ie, legal ownership, is what distinguishes between purchase and lease. Purchasers gain title to goods by paying the purchase price. The point at which title passes to the purchaser may vary according to the type of finance selected, whereas a lease is a rental agreement where title to goods never passes from the lessor (the owner, normally a finance company) to the lessee (the hirer, ie, the club).

PURCHASE OPTIONS

- **Cash / Bank Overdraft:** Cash is a scarce resource essential for day to day working capital requirements. Overdrafts subject to agreed limits and can be withdrawn without notice.
- **Bank Loan / Credit Sale:** Finance provided by bank or finance company. Important where a business requires immediate title to goods by paying cash but wants to spread the cost using fixed repayments. Additional security may be required.
- **Hire Purchase / Conditional Sale:** Hire agreements where title to goods passes to the hirer at the end of the period.

LEASING OPTIONS

- **Finance Lease:** Divided into primary and secondary periods. In primary period, lessee (the club) pays rentals based on amount financed plus interest. At the end of the primary period, lessee can dispose of goods acting as agent of lessor (the finance company). Lessee normally benefits from rebate of rentals (major percentage of sale proceeds).

  Lessee can extend lease into secondary period on completion of primary period. Annual Secondary Period Rentals (SPR) paid each year equipment is retained. SPR is small percentage of original equipment cost.
- **Operating Lease:** Aimed at hirers who merely want the use of a machine without the risks and rewards of ownership, eg, responsibility for repairs, disposal proceeds, etc.

  Period of hire and rentals fixed in advance. Normally 24 to 60 months. Rentals are based on equipment cost less projected future disposal value.

  At the end of the agreement the equipment is returned to the lessor.
- **Contract Hire:** Operating lease that includes costs of service and full maintenance.

FINANCING THE CAR – ANSWERS

The monthly payment is what counts! In fact, all three are identical with a monthly payment of £154.11. It's important to always compare 'apples with apples'. Comparing one finance quotation with another means taking into account factors like the size and timing of repayments, deposit, etc. This is where the APR is designed to assist consumers.