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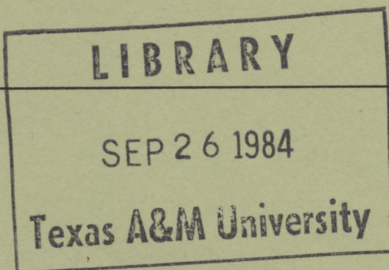

Farm and Ranch Credit

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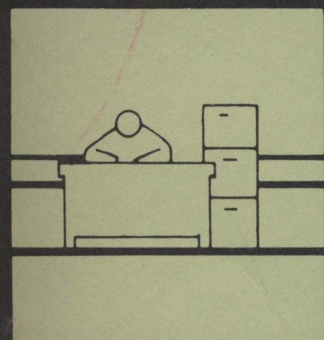
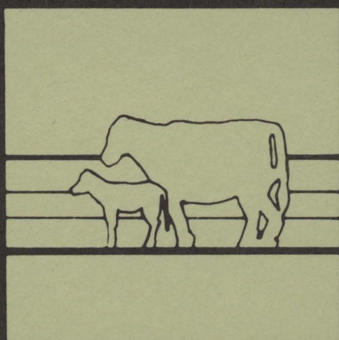
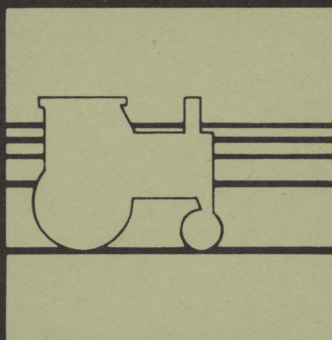
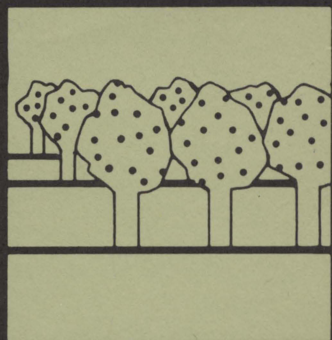
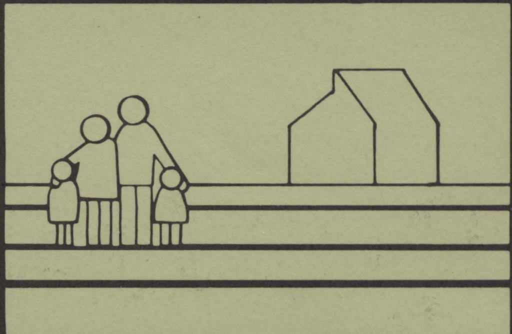








Basic Principles of Borrowing and Lending



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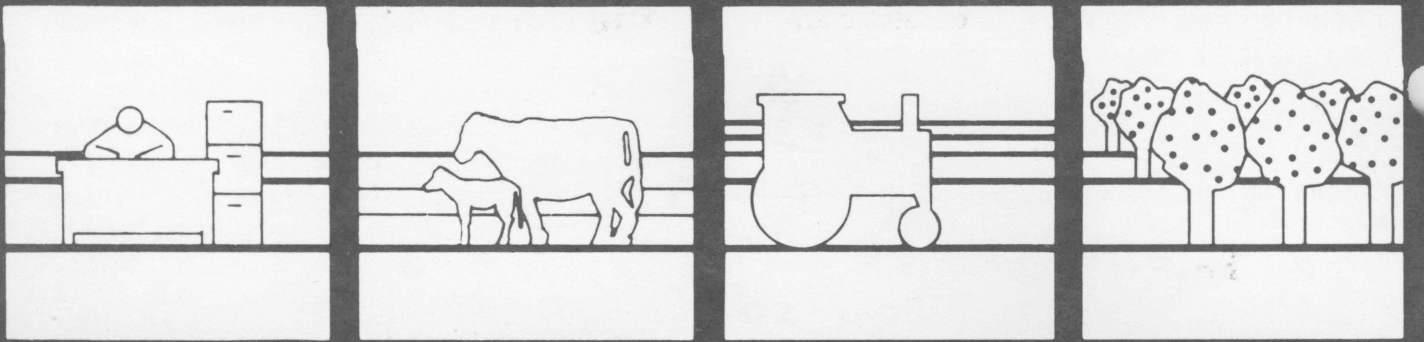
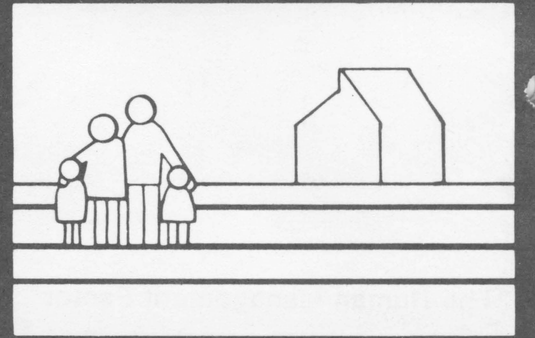


Farm and Ranch Credit



*Richard L. Trimble and Danny A. Klinefelter**

Farmers and ranchers who plan to approach a lender for credit should demonstrate their ability to use and manage money wisely. It is important to understand certain basic principles of borrowing and lending in order to compete successfully with other businesses and individuals for available loan funds.

Many lenders evaluate loan purpose by classifying loan requests into categories of necessities, needs, and wants. Necessities are essential for the continuing operation of the business. Needs could be postponed without a major impact on the business. Wants can be foregone while the operation continues to function in a normal and efficient manner. The more essential the item, the more likely the loan is to be made. It is important that a borrower establish priorities before approaching the lender.

Lenders also consider loan purpose in terms of its effect on the profitability of the business. Ideally, a sound loan is one which enables the borrower to increase his income by an amount significantly greater than the amount needed to repay the loan. The loan purpose also determines the length of the repayment period.

Consideration should be given to how the lender decides whether the loan will be made and for what amount. A lender who provides a loan that is either insufficient or in excess of the amount needed may cause serious problems

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for the borrower. The following questions are often asked by lenders in a loan analysis:

1. How much is to be borrowed?
2. When will the money be needed?
3. What is it going to be used for?
4. How will it affect the borrower's financial position?
5. When will it be repaid?
6. How will it be repaid?
7. And how will the loan be repaid if the first repayment plan fails?

In evaluating a loan request, a lender weighs the strong and weak factors in the request to assess the borrower's ability to repay the loan. To do this the borrower should:

- Obtain correct, adequate, and complete information.
- Compile the information in a useful way.
- Weigh the strengths and weaknesses of each credit factor.
- Consider the strengths and weaknesses of all credit factors in relation to each other and as a whole.
- Analyze the probable performance of the loan.
- Make the loan decision based on technical knowledge, the institution's loan policy, and previous experience.

Basic lending principles can be divided into five categories:

Human/Management Factors

Financial Position and Progress

Repayment Capacity

Collateral

Loan Purpose

The Human/Management Factor

Most lenders consider the borrower's character. Satisfactory loan repayment depends on the intention as well as ability of the individual to fulfill the terms of the loan. The human factor includes characteristics such as honesty, determination to meet obligations, performance record and willingness to cooperate. The individual's attitude toward the lender is significant and helps build the lender's respect and confidence; this can be critical during a period of economic hardship when a lender has to decide how long he can continue backing a borrower.

For farmers or ranchers borrowing for the first time, lenders often contact local agribusinessmen, such as suppliers and purchasers, other farmers and previous lenders to check the borrower's honesty, character and reputation. Lenders may also consider the borrower's relationship with business associates and family members. Family background of first-time borrowers is considered. The reputation and repayment records of a borrower's parents are used as indicators of what can be expected until the young farmer's own credit record has been established.

Continuity of management is another major consideration. A spouse, another family member or an experienced foreman who is actively managing the farm or ranch operation is a form of risk reduction, both for the lender and for the borrower's estate. Lenders like the assurance that the business could continue without undue hardship if something happened to the borrower.

In a loan analysis, an applicant's personal financial history is fully examined. Some factors which may warrant denial of loan requests include the following characteristics:

1. Failure to make a full and accurate disclosure of financial information, particularly all debts, and a realistic estimate of asset value.
2. Reluctance to disclose income or production records.
3. A history of past financial problems such as collection difficulties or bankruptcy.

4. An antagonistic attitude toward other creditors.
5. Existence of judgements, tax liens, mechanic's liens, etc.
6. A borrower who is rated ''slow'' by other lenders, including trade creditors such as input suppliers.
7. Hesitancy or evasiveness in explaining the purpose of the loan.
8. Involvement in speculative financial ventures other than the primary business, or undisclosed contingent liabilities.
9. Overly optimistic estimates of the business's profitability and expected cash flow.
10. Operating the business and living outside the lender's normal trade area.
11. Reluctance to allow the lender to visit the operation.
12. Borrowing from numerous creditors.
13. Frequently overdrawing bank accounts.
14. A borrower who frequently makes purchases before arranging financing.
15. A borrower with serious marital problems.

The borrower's financial management ability is also examined. Evaluation of both the borrower's recordkeeping program as well as the way records are used in the decisionmaking process will be made. A fancy record system is useless unless the borrower understands the information and how it can be used. The ability to use financial information to control costs can be a major determining factor in an operation's success and survival. Lenders often use cost as well as profit per unit of production as key indicators of a borrower's financial management ability. Good financial management, to a large extent, is the ability to manage cash. A capable operator must know how to prepare a projected cash flow, to control expenses, to recognize profit opportunities, and to make wise capital investment decisions.

Management ability during an economic crisis is also evaluated. When commodity prices are high, even a poor manager may do relatively well. The question is how well a manager plans for and handles changing conditions, particularly adverse economic conditions.

A borrower's marketing ability is judged on the development of well planned marketing strategies. Several recent studies of successful farm operators during the last decade have shown that profits were made by those who ''sold right'' almost regardless of how they performed as producers. A lender wants to see foresight and planning, rather than impulsive decisions or forced sales to cover cash deficits.

In evaluating production management, lenders typically consider such things as yields per acre, daily rates of gain, milk production per cow, percent calf crop, and pigs per sow per year. Lenders also attempt to evaluate a farmer's personnel and time management ability—particularly on large operations. Employees' loyalty and job satisfaction have a tremendous bearing on the performance of a business. Whether the farmer establishes time priorities and then follows through is another good indicator of management ability.

Many lenders are cautious about the farm borrower who is unable to see the total picture of the farm business. These farmers are too often concerned with short-term problems they cannot control; such as weather, current prices and the government. They ignore the more important items, such as long-term earnings and long-range production and marketing programs. Such farmers fail to establish priorities and usually blame everything and everybody but themselves for their lack of financial progress.

In summary, a lender normally evaluates a borrower's overall management ability by observing decisions over time, the ability to solve problems, the nature of loan requests, and financial progress.

Financial Position and Progress

The balance sheet is the primary means by which the lender evaluates a borrower's financial position and progress. At a minimum, a borrower should provide the lender with an updated year-end balance sheet. In addition to full disclosure of all amounts owed and realistic values of assets owned, there are two categories of liabilities which many borrowers tend to overlook.

The first category is accrued liabilities (expenses which accumulate over time but have not, as yet, been paid), such as accrued real estate taxes, accrued income taxes, and accrued interest. Accrued liabilities which may not yet be due, should be reflected on the balance sheet to present an accurate picture of the business's financial position.

The second is contingent liabilities. These are potential liabilities created by the borrower either as a co-signer or guarantor, such as the guaranty of the debts of others, and liabilities on contracts. Although contingent liabilities may only be footnoted, it is important to record their existence. Lenders also consider the potential tax liability on assets if they were sold. Land which has appreciated in value is a prime example. Taxes on income and capital gains would have to be deducted from the revenue generated by the sale of most assets before using the proceeds to cover loans.

Borrowers need to list unavailable asset equities, such as homestead equity, co-op stock, and spendthrift trusts. A prudent lender will deduct these items from net worth to arrive at adjusted or attachable net worth available for protection of the lender's interest.

Lenders will probably request a copy of the borrower's annual income statement or income tax return. A new borrower should be prepared to provide income and expense figures for several recent years. This information is useful in reconciling changes and understanding trends in financial position, while also providing an evaluation of business performance. When analyzing the proportion of earnings that are reinvested in the business, many lenders want to know whether the borrower is willing to cut back on his or her personal standard of living during an economic crisis.

The borrower's net worth or equity provides a measure of his or her risk-bearing capacity. It represents the funds which are available to creditors as a cushion against loss. Increasing net worth over time is the principle indicator of financial progress. Most lenders evaluate the ability of borrowers to handle risk by the amount of debt relative to net worth, or what is commonly known as the leverage ratio. For example, if one's debts were $200,000 and net worth $400,000, the ratio would be .5 which is usually considered good. A ratio of 1.0 is fair, and above 1.5 often serves as cause for concern. However, in a seasonal business like agriculture, the firm's borrowing peak may exceed its net worth without jeopardizing the financial soundness of the firm. These standards may also vary with the level of risk associated with the business. For example, higher and more volatile interest rates have led to increased instances of borrowers with leverage ratios in excess of 1.0 running into financial difficulty. Although borrowers often are irritated by what appears to be overly conservative attitudes on the part of lenders, once the ratio of debt to net worth exceeds 1.0, the lenders have more invested in the business than the borrower and, therefore, have more to lose.

The type and location of the operation also helps determine risk-bearing capacity. A diversified business can get by with a lower equity in many instances because it is less vulnerable to a downturn in prices than a specialized operation because the risk is spread over more enterprises. Weather patterns, soil fertility levels, and irrigation cause variations in production risks in different regions of the country. Whether or not a borrower contracts for the sale of products and/or the purchase of inputs also acts to determine risk-bearing ability.

Lenders know that if a business runs into trouble, the borrower's assets tend to shrink. Forced sales often bring lower values. Legal and liquidation costs can absorb a sizeable portion of the proceeds. Equity should be strong enough to allow recovery of the loan funds under the worst possible conditions.

A borrower's liquidity position is a measure of whether the borrower can generate sufficient cash to meet financial commitments as they come due without disrupting the ongoing business. The primary balance sheet indicator of liquidity is the ratio of current assets (cash and assets which will be converted to cash within one year) to current liabilities (amounts due others within one year). This is called the current ratio. If current assets were $100,000 and current liabilities were $50,000, the current ratio would be 2.0. A ratio of 2.0 is usually considered good, while 1.0 is only fair. The trend in this relationship over time and the composition of the assets is important. How readily can conversion to cash be made? How closely does the normal rate of conversion match with the due dates of the current liabilities? If liquidity is deteriorating over time, loan requests, parti-

cularly capital loan requests that have to be repaid over an extended time period, will be scrutinized very carefully and the cause of the decline determined.

Lenders also examine a borrower's capital debt repayment capacity. In ratio form, this can be measured by comparing net funds generated from operations (net after tax income, plus annual depreciation expense, less annual family living expense requirements) to the current principle portion of term debt (that due within one year) plus any short term debts which will have to be carried over and refinanced. Larger ratios are viewed more favorably and also serve as an indicator of whether restructuring debt from shorter to longer term could reduce short run liquidity problems. A ratio approaching 1.0 indicates a potential debt servicing problem.

Repayment Capacity

The borrower's repayment capacity is primarily determined by cash flow projections (estimates of monthly or annual cash inflows as compared to cash outflows). The lender weighs the realism of the borrower's projections and the consequences of alternative outcomes. Another test of realism used by the lender is the borrower's past record for matching anticipated repayments with actual payments made.

Lenders like to see borrowers monitor their cash flows on a monthly and year-to-date basis by comparing projected and actual cash flows as the year progresses. This helps in pointing out potential problems and allows for adjustments in tax management and marketing strategies on a year-round basis.

Borrowers should not expect lenders to fill out their financial statements for them. A lender's job is to analyze the loan request, not to serve as an accountant. Preparing the information and the loan request does three things. It helps the borrower to gain a better understanding of the business from a financial point of view, improves the completeness and accuracy of information, and shows the lender that the borrower has thought the loan request through. Together, these factors help borrowers do a better job of selling their ideas. Often farmers have been turned down because they could not prove loan repayment ability.

In summary, farmers need to understand that production skills alone are no longer a guarantee of success. Financial management and marketing skills are increasingly important. It is no longer enough to analyze the business only in terms of expected or most likely outcomes. A lender expects the borrower to have considered the impact of possible adverse outcomes. Such adversities are a fact of life and operating periods in which such events occur should be given as much consideration as expected outcomes. Particularly important are consideration of alternative prices, yields, percentage increases in major cost items, and finally, but not least, the effect of higher interest rates.

Collateral

In addition to concern for repayment capacity, liquidity, and trends in financial position, lenders will still need security to cover the loan in case of default, death, or disability. A lender will normally require that a loan be secured. Although in case of default, a lender may attach a borrower's property through court action, an unsecured lender's claim would be subordinate to all existing security interests judgements and other liens.

A major concern of both borrowers and lenders is how much of available collateral is adequate. Collateral is adequate, if, under the worst conditions, enough of it can be sold for sufficient cash to repay the loan in full and cover the costs involved. Specific attributes of an asset that affect its value as collateral include the lender's ability to locate and identify it, take possession, prevent its deterioration, establish its value and find a market for it. Most lenders would prefer not to have collateral in which other lenders also have an interest.

Every lender expects and in many cases requires a borrower to carry adequate casualty and liability insurance to protect the value of the assets in case of fire, wind, theft or a liability suit.

Loan Purpose

Once loan terms are agreed upon, it is critical that a borrower abide by the repayment agreement. Written loan agreements specify timing of repayment, source or sources from which

repayment is to come, and how much equity must be maintained before additional collateral or debt reduction is required. Diversion of funds can seriously damage future loan requests. Even if no written agreement exists, borrowers must be sure they fully understand and comply with the verbal agreement. If circumstances prevent a borrower from meeting the terms of the agreement, it is important to inform the lender immediately and cooperate in reaching a solution.

A Final Checklist

Remember that while many lenders look alike on the surface, the services, requirements, terms and quality of advice they offer can be quite different. Before approaching a lender for credit, be aware of the differences and similarities of lenders and the special role played by the individual loan officer.

The following checklist contains some points to keep in mind when dealing with a lender:

1. Lending institutions are lenders using other people's money and not investors in your business.

2. A borrower should not request a loan without all the required information to substantiate the loan or refinancing request.

3. Never expect a loan to be granted immediately. It indicates from the outset that you have done a poor job of planning your credit needs.

4. Know how much you need, why you need it, and how and when you're going to repay it. Then document it. Thorough documentation will impress the lender and aid in processing the loan request.

5. Be prepared with the financial specifics of your operation. Don't get caught not knowing what information you should have at your fingertips.

6. There are standard loan terms and covenants. Be familiar with them, and center your negotiations on the three items of greatest importance: (1) cost of the money, (2) collateral and (3) repayment terms. Don't negotiate on each and every point in a loan agreement. Since many of the terms are standard, concentrate only on those restrictions that you really can't live with. It will show professionalism on your part and give you more latitude to negotitate on the major issues.

7. Don't misuse the loan proceeds. Besides violating the loan agreement, your word and character are immediately in question. You might get away with it once, but it will cost you in the long run.

8. Know your repayment capabilities and structure your credit needs properly. If you need a three year loan and your lender wants to make the loan for only one year, notify him that it will have to be refinanced. It builds your credibility. But, it is also your responsibility to select a lender that is knowledgeable and makes realistic loans with repayment schedules appropriate to the activity financed because a poor lender can cause as many problems as poor financial management.

9. Don't prepare overly optimistic projections that you know can't be reached. Provide expected and conservative cash flow projections and then base your credit needs on the conservative projections.

10. Fully disclose your working relations and loan agreements with other lenders. Frequently it is imperative that common lenders coordinate their lending activities. In many cases, a lender may be influenced by another lender's willingness or unwillingness to stay with you.

11. Most important, communicate with your lender and live up to your commitments. Lenders don't like surprises.

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