BUILDING BRIDGES with LENDERS





BUILDING BRIDGES with L·E·N·D·E·R·S

There was a time when lenders knew the financial pressures and capitalization needs of those involved in agriculture. They knew just about every member of the agricultural community by name and probably engaged in agriculture themselves. Lenders actively sought to provide services to those in agriculture . . .

but that was "then." Today, those in agriculture may find themselves competing against lower-risk businesses for the services of a lender. In addition, lenders may not have first-hand knowledge of agriculture, including its unique strengths and opportunities which often outweigh the financial risks. In order to build positive "bridges" with lenders, agricultural producers, processors and direct farmers' markets need to play the dual roles of educator and self-advocate in order to obtain the financial and capitalization services necessary to compete in today's marketplace.

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1 Know what you need

Think about a loan this way: finance "like" with "like." Your real estate is a long-term asset. If you use your farm or ranch to get additional credit, the proceeds from the loan should be used to finance "like" assets. For example, use equity from your farm to purchase additional real estate, refinance, make improvements to land and buildings, or build a new building, instead of using that equity to purchase equipment or finance short-term debt. Long-term debt should not be used to finance short-term assets.

Remember, your lender may not understand your agricultural business or market as well as you. Knowing what you need and communicating that to the lender is key.

Although lower payments may be easier to budget, in the long run you will end up paying more. In addition, you should not use your farm or ranch to finance unpaid operating expenses, unless you are recovering from a non-reoccurring event such as a drought.

2 Organize before you meet

You will need to provide information in order to have your request considered:

- If you plan to purchase machinery or equipment (new or used), provide a complete list of the equipment or machinery, the cost of each piece, their expected service life, names of the suppliers, costs of installation, shipping, and/or other necessary expenses in making the equipment or machinery ready for use.

- If you plan to purchase land, provide a legal description of the property and buildings including a copy of the deed or copy of a survey or a recent appraisal as well as its location and general condition, any known liens, assessed value and amount of yearly taxes, number of tillable acres, and intended use. Also note whether the land is located in an Agricultural Security Area or is Farmland Preserved, and the nature of any available nutrient management plan and/or conservation plan.

- If you plan to build a new building or structure, provide some preliminary information about the cost of and possible financial benefits from the project, the building's dimensions, use, structural plans, and site plans, if available.

- If you have a secondary income source, provide pay stubs (at least the prior three months), W-2 form, or 1099 form.

- Provide your business plan, including a marketing plan and capitalization plan.

- Provide your tax returns from at least the most recent three years.

- Financial statements should be provided and include a Balance Sheet, Income Statement, Cash Flow Statement, and Profit/Loss Statement for the last three years (with the most recent less than 60 days old).

- Provide a proposed repayment plan. This is typically done with your lender, but you should think about how you will repay the loan before you apply.

- Provide any additional information that will help your lender positively evaluate your credit request.

Ask your lender about PA First Industries Fund Loan Guarantees and the USDA's Guaranteed Loan Program and how they may benefit your situation. If your lender does not know about these programs, have him or her contact PAgrows or the USDA Farm Services Agency for more information.

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3 Know what lenders look for in appraising capitalization requests

A – Conditions:
industry trends, market conditions, farm operation(s) and the transaction's purpose and related details

B – The Person:
your management ability, integrity, efficiency, and marketing ability

C – Capital:
your net worth, your financial ability to "weather a storm"

D – Cash Flow:
your ability to meet all obligations on an ongoing basis

E – Collateral:
your available equity, security agreement, non-current assets

4 Be open and honest in your communication

Communicate frequently with your lender with the goal of educating your lender about the issues and trends of agricultural production. Also communicate about yourself to build a personal/professional relationship.

Communicate with your lender before you have a need. Share how things are going and what your vision is for the future of your operation and family.

Arrange to have your lender make farm visits so that he or she can experience your operation first hand. View these visits as opportunities to educate and self-advocate, rather than an obligatory time to "pass inspection."

5 Understand the lender's key concepts through ratios and benchmarks

Financial ratios and margins in assessing, benchmarking and monitoring farm performance have become more common over the last few years. This has complicated producers' efforts to define the economics of producing farm commodities, that is, tying economic performance at the enterprise level to financial performance at the farm level. This section provides definitions and interpretations of the more common ratios and margins used in agriculture. The analogy of traffic signals is used here to indicate your potential for loan approval, based on the various financial formulas outlined. In other words, a "red light" means little, if any, chance of getting the loan you want versus a "green light" which indicates that you will most likely receive the loan. Of course, like all traffic lights, there are various levels between no chance of getting the loan and the "sure thing."

Profitability: Ability to Generate Profit

Value of Production (VOP) = Farm Cash Receipts (+) Change in Value of Product Inventory (+) Change in Value of Accounts Receivable (−) Livestock Purchases; represents the accrued value of commodities during the fiscal or calendar year

Net Farm Income (NFI) = VOP (−) Direct Costs (−) Capital Costs; represents the bottom line

Gross Margin = NFI (−) Depreciation; and represents funds available to cover unallocated fixed costs, returns to unpaid operator and family labor, and returns to owner's equity

Return on Assets (ROA) = Net Income (+) Interest Expense (−) Unpaid Operator and Family Labor (÷) Total Assets; should fall in the range of 1.5 to 2.5

Return on Equity (ROE) = Net Farm Income (−) Unpaid Operator and Family Labor (÷) Total Equity; should fall in the range of 7% to 8%

Operating Profit Margin Ratio = Net Farm Income (+) Interest Expense (−) Unpaid Operator and Family Labor (÷) Value of Production; represents the portion of each dollar that reaches profit

Leverage or Solvency: Long – Run Levels of Equity and Debt

Debt to Asset Ratio = Total Debt (÷) Total Assets; represents level of debt and financial risk

Rule of Thumb:

Above 75% – “Red light”
50% to 75% – “Orange light”
33% to 50% – “Yellow light”
Less than 33% –“Green Light”

Equity to Asset Ratio = Total Equity (÷) Total Assets; represents level of equity

Rule of Thumb:

Less than 30% – “Red Light”
30% to 55% – “Yellow Light”
Above 55% – “Green Light”

Debt to Equity Ratio = Total Liabilities (÷) Total Equity; represents level of debt

Rule of Thumb:

Above 122% – “Red Light”
42% to 122% – “Yellow Light”
Less than 42% – “Green Light”

Debt Payout = Total Liabilities (÷) Net Farm Income; represents the number of years it would take to reduce the debt to zero if all income of the farm could be directed towards principle reduction. It relates the level of debt to the ability of the farm to generate income to repay the debt.

Liquidity: Ability to Pay Obligations

Current Ratio = Total Current Assets (÷) Total Current Liabilities; represents the ability to meet cash obligations coming due in the next year

Rule of Thumb:

Less than 1.00 – “Red Light”
1.00 to 1.50 – “Yellow Light”
Above 1.50 – “Green Light”

Working Capital = Current Assets (–) Current Liabilities; represents the ability to meet cash obligations

Rule of Thumb:

A positive number is desired, but too high of a value may mean too many assets are not providing a return.

California Working Capital Rule (6) = Working Capital (÷) Total Farm assets; and represents adequacy of working capital relative to business expense

Financial Efficiency: Ability to Generate Revenues and Control Costs

Capital (Asset) Turnover Ratio = VOP (÷) Total Assets; and represents capital intensity. Low value is positive with a capital intensive operation with a higher profit margin. If a lower value is combined with a low profit margin it represents an inefficient operation.

Operating Expense Ratio = Operating Expense (excluding interest and depreciation) (÷) VOP; represents the percentage of operating expense that will consume every $1 of revenue

Rule of Thumb:

Above .80 – “Red Light”
.65 to .80 – “Yellow Light”
Less than .65 – “Green Light”

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Interest Expense Ratio = Interest Expense (÷) VOP; and represents interest expense to the farms ability to generate income. A trend upward will lead to eventual financial stress

Rule of Thumb:

Above .20 – "Red Light"
.12 to .20 – "Yellow Light"
Less than .12 – "Green Light"

Financial Debt Coverage Measures: Ability to Generate Funds to Meet Debt Obligations

Cash Flow = Net Residual Income (÷) Total Annual Principle (+) Total Interest Payments

Rule of Thumb:

Less than .20 – "Red Light"
.20 to .50 – "Yellow Light"
Above .5 – "Green Light"

Term Debt Coverage Ratio = Net Income (+) Depreciation (+) Interest Expense (–) Family Expense (÷) Principle and Interest on Term Debt (+) Operating Loan Interest

Rule of Thumb:

Less than 1.10 – "Red Light"
1.10 to 1.50 – "Yellow Light"
Above 1.50 – "Green Light"

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Alberta Agriculture, Food & Rural Development (March 23, 1996). "Comparative Financial-Ratio Analysis for Alberta Farms." Production Economics Branch; Farm Business Management Branch.

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