

# Being Prepared to Borrow

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Given the size and capital intensity of today's commercial farms and ranches, it is almost impossible to operate a business or to grow without using credit. But the changing structure of the agricultural lending industry, along with the increasing importance of risk management, makes it harder for agricultural producers to get credit. The situation will become even more critical for producers nearing the end of their eligibility for Farm Service Agency loan guarantees.

Lenders are now treating agricultural businesses more like any other commercial businesses, with expectations that they satisfy a performance-based approach to lending.

The following questions cover the essential documentation you will need in a loan application package. Developing these documents will help you be better prepared.

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**1.**  
**How much money are you going to need?**

Not just initially, but over the period of and for the purpose of the loan request? Lenders don't want to loan all they feel comfortable with and later find they need to loan significantly more in order to see the situation through to completion.

**2.**  
**What will the money be used for?**

Be specific. It's not enough to say the loan will be used for "operating expenses." In the past, too many operating loans were used to subsidize lifestyles, refinance and/or pay carryover debt, or finance capital purchases. Your plans should be supported not just by budgets but also by historical documentation of past experience.

**3.**  
**How will the loan affect your financial position?**

It is obviously important to know what your net worth, financial structure, historical cash flows, profitability, and risk exposure are at the time of the loan request, but what will things look like after the loan is made?

#### 4.

**How will the loan be secured?**

Collateral is adequate only if, under the worst conditions, it will generate enough cash to repay the loan and cover all the costs involved. Except for control, the primary purpose of collateral is to ensure against default; therefore, the lender is concerned not with what the collateral is worth at the time of the loan request, but with what its value is expected to be at the due date of the note or at the date of the next scheduled payment. In determining the value of collateral the lender will consider the length of time involved, potential changes in collateral value and condition, legal and selling costs, and the fact that a distress sale will bring less than a sale under normal market conditions. The changing nature of security has become one of the most significant factors affecting agricultural lending. More loans are now based on soft rather than hard assets (that is, contracts and leases versus land and chattel). There are also more joint ownership arrangements and more market risks related to specific raw materials offered as collateral rather than straight commodities. All of this makes it harder for the lender to assess a net realizable value.

#### 5.

**How will the loan be repaid?**

Will it be from operating profits, from non-farm income, from the sale of the asset being financed, from refinancing, or from the liquidation of other assets? When you estimate your ability to repay a loan be realistic and conservative. Include typical contingencies in your cost estimates. Too often, repayment ability is based on unrealistic expectations rather than actual performance levels achieved in the past.

#### 6.

**When will the loan money be needed and when will it be repaid?**

This two-part question should be answered by the projected cash flow budget. Answering this question ensures that both you and the lender know how the business operates. Almost as many credit problems result from a lack of understanding and communication as from unrealistic expectations. Marketing plans and trigger points, contract terms and conditions, and various pooling arrangements often are not adequately communicated or documented.

#### 7.

**Are your projections reasonable and supported by historical documentation?**

Too many producers still do not have the production, marketing and financial records to demonstrate their track records and support their numbers. Many loans have not been made that probably could have been repaid simply because of a borrower's inability or unwillingness to provide the lender with complete and well documented historical information on financial position and performance.

**8.**

**How will alternative possible outcomes affect your repayment ability?**

In production agriculture, actual cash flow is often very different from projections, especially on the revenue side. The importance of making sound projections and analyzing “what if” scenarios is even more important considering the price and yield volatility producers have to deal with. Even under marketing and production contracts with established price bases, quality discounts and premiums can still cause a great deal of uncertainty. But the most frequent error is one that occurs when borrowers and lenders do no more than evaluate the effect of standard scenarios such as a 10 or 25 percent decrease in revenues. For some businesses this practice overstates the risk involved, while for others it may seriously understate the potential risks. Done correctly, such an analysis will consider the business’s actual historical performance variability as well as the range of current forecasts.

**9.**

**How will you repay the loan if the first repayment plan fails?**

No commercial lender wants to enter into a situation in which foreclosure is the only alternative if things do not go as planned. Contingency planning is critical. Every plan should have a back-up plan and every entry strategy should have an exit strategy. The latter is particularly true where niche markets are involved.

**10.**

**How much can you afford to lose and still maintain a viable operation?**

There are several factors to consider here. First you must recognize that a viable net worth is not simply anything above zero. Most commercial lenders require some minimum equity position—for example, 30 percent—below which they will not continue financing without an external guarantee. With this in mind, the answer to the question must be based on the effect of various combinations of both operating losses and declines in asset values. Then both the borrower and the lender need to determine how likely it is that any of these situations will occur.

**11.**

**What risk management measures are or will be in place?**

This can cover anything from formal risk management tools to management strategies. The major issue is to make absolutely sure that both the borrower and the lender understand how these measures work. It is also critical that the lender be supportive and committed. For example, the incorrect use of commodity futures and options can increase rather than reduce risk. A lender’s unwillingness to finance margin calls can also destroy a successful hedge.

## 12.

### What have been the trends in the business's key financial position and performance indicators?

Do you know? If not, you need to develop this information. If the trends are adverse, what specific short- and long-term plans do you have for turning things around? Your ability to take action at the right time and to manage problems is hard to measure, but it is critical to the lender when deciding whether or not to loan you money.

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There are four main points for agricultural borrowers to keep in mind. First, a lender's request for more accurate and complete information should not be viewed as a questioning of your character; it is just good business. Second, any time a lending institution comes under new ownership/management tougher credit standards will almost always follow. This doesn't mean that the new management is too demanding, but that the former management was too lax (which often is the reason there is new management). Third, many of the stricter credit standards being adopted can be directly attributed to 1) legislation that provides for additional borrowers' rights, 2) increased food safety and environmental risks, and/or 3) increased risk of lender liability lawsuits. Because most litigation arises from situations in which borrowers are highly leveraged or in financial trouble, it has become more difficult for higher risk borrowers to qualify for credit. Just as malpractice lawsuits have changed the practice and raised the cost of medicine, the threat of legal action has changed the lending environment. Finally, borrowers need to be able to provide all the information and documentation mentioned in the twelve questions above. Becoming complacent because your lender has never required it before could be risky should the management of your lending institution change.

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