

Risk Management Series

Borrowing in a Risky Environment

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Given the size and capital intensity of today’s commercial farms and ranches, it is virtually impossible to operate the business or to grow without using credit. But the changing structure of the agricultural lending industry, along with the greater importance of risk management, is making the process of acquiring credit increasingly rigorous for agricultural producers. This will be an even more critical issue for producers nearing the end of their eligibility for Farm Service Agency loan guarantees. The result is that an agricultural firm will be treated more like any other commercial business. Lenders will take a more performance-based approach to lending and producers will need to be better prepared. The following questions can help you develop the documentation you need in a loan package.

How much money will you need? Not just initially, but over the period of the loan and for the purpose of the loan request. Lenders don’t want to loan all they feel comfortable with and then suddenly find they need to loan significantly more in order to see the situation through to completion. Your estimates of repayment ability should be realistic and conservative, and cost estimates should address typical contingencies.

What will the money be used for? Be specific.

It’s not enough to say “operating expenses.” In the past, too many operating loans have been used to subsidize lifestyles, refinance and/or pay carryover debt, and finance capital purchases. Support your plans not just with budgets but with historical documentation showing that the budgets reflect past experience. Although projections may appear to be based on realistic estimates, further review often shows that they assume performance levels that are out of line with what the business has actually achieved in the past.

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?

How will the loan be secured? Collateral is adequate only if, under the worst conditions, it could generate enough cash to repay the loan and cover all the costs involved. Except for control purposes, the primary purpose of collateral is to provide insurance in the event of default; therefore, the important lending consideration is not what the collateral is worth at the time of the loan request, but what its value is expected to be at the due date of the note or at the date of the next scheduled payment. The lender needs to

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account for the period 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 an arms-length transaction under normal market conditions.

The changing nature of security has become one of the most significant factors in 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 market risks related to raw materials rather than straight commodities. All of this makes it more difficult for the lender to assess a net realizable value.

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 will the 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 will ensure 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 are often not adequately communicated or documented.

Are your projections reasonable and supported by documented historical information? Too many producers still do not have the production, marketing and financial record to demonstrate their track records and support their numbers. Many loans have not been made that probably could have been repaid simply because a borrower was unable or unwilling to give the lender complete and well documented historical information on his financial position and performance.

How will alternative possible outcomes affect your repayment ability? Because many factors affect production agriculture,

cash flow projections frequently vary from the actual outcome—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 that producers have to deal with. Even under marketing and production contracts with established price bases, quality discounts and premiums can cause uncertainty. But the most frequent error is one that occurs when borrowers and lenders actually believe they are addressing the issue, and that is when they 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 potential risks. The alternative outcomes considered should reflect the business’s actual historical performance variability, as well as the range of current forecasts.

How will you repay the loan if the first repayment plan fails? No commercial lender wants to enter 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 backup plan and every entry strategy should have an exit strategy. This latter point is particularly true where niche markets are involved.

How much can you afford to lose and still maintain a viable operation? There are several factors to consider here. The first is to recognize that a viable net worth is not 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 potential operating losses and declines in asset values. Then both the borrower and the lender need to determine how likely it is that this situation will occur.

What risk management measures have been or are to be implemented? This can cover

anything from formal risk management tools to management strategies. The major issue here 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, 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.

What have been the trends in the business's key financial position and performance indicators? The first issue is, do you know? The second is, if the trends are adverse, what are your specific short- and long-term plans for turning things around? The ability to take timely actions and manage problems is hard to measure, but as risk increases it becomes critical in the credit decision process.

There are four important points for agricultural borrowers to keep in mind. First, a lender's request for more accurate and complete information should not be viewed as questioning your character; it is just good business. Second, any time new ownership/

management of a lending institution occurs, tougher credit standards will almost always follow. Such changes usually do not indicate that the new management is too demanding, but that the former management was too lax, which frequently explains why there is new ownership/management. Third, many of the stricter credit standards being adopted can be directly attributed to legislation that mandates additional borrowers' rights, to increased food safety and environmental risks, and to increased risks of lender liability lawsuits. Because litigation usually 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 have the information required to negotiate terms or to find another lender if they have to. Becoming complacent just because your lender has never required all the information mentioned above could be risky if the management or ownership of your lending institution were to change.

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