Module 6
Understanding Lending Decisions

Module Outline

Introduction
The Five “C’s” of Credit
    Roadside Chat #1
1. Character
    - Adapting to Change
    - Management Ability
    - Commitment to Loan Repayment
    - Sound Production Practices
    - Risk Management Plans
    - Market Planning
    - Strong Financial Management Foundation
        Roadside Chat #2
    - Other Factors
2. Capital
    - Liquidity
        Roadside Chat #3
    - Solvency
3. Capacity
    - Term Debt and Lease Coverage Ratio
        Roadside Chat #4
    - Capacity Risk’s Link to Capital
4. Collateral
    - Criteria for Collateral Evaluations
5. Conditions
    - Purpose of the Loan
    - Conditions and Restrictions
    - Loan Covenants
    - Structuring Loans
        Roadside Chat #5

Conclusion

Learning Objectives

The learning objectives for this module are for participants to:

- Be able to define each of the Five “C’s” of Credit which many ag lenders use in approving credit requests.
- Be able to calculate and interpret some of the key ratios utilized in analyzing loan requests.
- Be aware of the importance of non-financial factors, such as character and management attributes that are examined by financial professionals in business decision making.
- Increase their knowledge of key variables and factors that can be used to identify and offset financial weaknesses in a credit request.

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Introduction

Let's journey to the other side of the table and get a better understanding of how a lender makes the decision to offer a loan to a potential borrower. While this process may be a mystery to you, the standards used by most lenders are actually designed to assist the borrower in achieving his or her goals.

Every lending institution has a set of credit standards or guidelines and policies that are used to analyze and approve loans. The goal of these guidelines is to ensure the extension of credit within certain financial risk parameters to protect the interests of stockholders of the institution. Interest rates and terms offered on loans are to ensure the financial soundness and sustainability of the financial institution is preserved. Overall, loans are made to borrowers who have proven financial, production, and general management capabilities and who are believed to be long-term contributors to agriculture and rural areas.

The Five "C's" of Credit

Financial standards may vary due to the goals and objectives of the particular institution. However, most standards fall under the categories of the Five "C's" of Credit. These "C's" are Character, Capital, Capacity, Collateral, and Conditions.

Let's take a journey into the mind of your ag lender, explore the Five "C's," and see how they are used. Realize that loan analysis focuses on the strengths and weaknesses of the five credit factors (Character, Capital, Capacity, Collateral, and Conditions). While the weight given to each factor may vary depending on unique circumstances of the loan request, in some cases weaknesses in one factor may be offset by strengths in another factor. This journey will enable you to be better prepared when meeting with your ag lender, regardless of the size of your loan and your tenure in the business.

ROADSIDE CHAT #1: Can you give an example of some offsetting factors or unique circumstances that could improve my chances of obtaining a loan?
Yes. Usually young and beginning farmers and ranchers have little equity because of their short tenure in the business. In such a case, a well-prepared and thought-out business plan with a sound execution strategy, including proven profitability and cash flow potential may be used to offset lack of equity. Financial character can be demonstrated through strong credit scores (above 700) by the manager and spouse, which may offset another factor that is not quite as strong.

Character

A lender must answer this basic question about every borrower: Is the borrower of sound character? Is he or she a capable enough manager to run the operation and repay the loan? While financial statements can provide insight into the projected earnings and collateral available for loan security, these documents may not adequately reflect a borrower's capacity for making sound business decisions and/or the ability to withstand financial, operational, or family crises. Character can be revealed in a person's ability to adapt to change, passion for the business, attitude toward the

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industry, and ability to work with people. Simply stated, it is doing what you say you are going to do, regardless of the circumstances.

<u>Adapting to Change</u>
Character is the catalyst that transforms expectations, goals and projections into realities. A key factor in the long term success of a business is how well the owner can vision into the future, understand the dynamics of the marketplace, and chart the best direction for the business. Since even the best-laid plans can change, a person's true character is revealed in how well he or she can adapt to change and make adjustments to the business when needed.

<u>Management Ability</u>
Your management ability and your record or history of performance are part of your character. Since earnings from the business are generally required to repay loans, a borrower's ability to manage a profitable operation, or one that cash flows with the use of non-farm income, may be a necessity. Farmers and ranchers make numerous decisions regarding production, marketing, and financing; and each decision has an impact on both profitability and risk management. How decisions have been made in the past along with current attitudes and practices towards managing risk are key indicators of a borrower's management ability. As financial risk increases, the management execution and follow through strategies that are required increase as well.

Some producers' character changes as financial obligations increase. Will you and your partner mentally handle a commitment of larger debt loads for an extended period of time, regardless of the economic or weather cycle? This is a question which must be answered in major expansion considerations.

<u>Commitment to Loan Repayment</u>
Specifically, for the purpose of making lending decisions character is defined as the borrower's willingness and determination to repay the loan, regardless of any unforeseen adversity. As you might think, character includes such qualities as honesty (the borrower's willingness to cooperate with the lender), openness, integrity (acting in good faith), and self-discipline. Also, any family and other personal issues that could have an impact on the overall stability of the operation can affect a borrower's loan performance. Realize that most farming operations will experience growing pains, liquidity problems, production losses, and adverse market conditions. The borrower's ability to withstand different sources of stress simultaneously, and still make sound business decisions, is an indicator of good character.

Character is often assessed not only of the primary borrowers, but also of family members, employees, customers and the people they associate with who can have an impact on the operation and its ability to repay debt. Your ability to build strong business alliances and relationships that enhance the business and leverage the strengths of that business is essential to character.

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<u>Sound Production Practices</u>
A producer's demonstrated ability to produce crops and livestock, and use resources for production management information are key to the future success of the operation. Producers must be able to accurately assess the quality of production resources, such as land, facilities, breeding stock, etc., in order to make sound production decisions for the business. Disease, adverse weather events, and pest infestations are all production risks that constantly threaten crops and livestock. Successfully managing these risks is an indication of sound production practices.

<u>Risk Management Plans</u>
A lender will assess the management ability of a producer by evaluating which strategies have been implemented to manage production risks. Diversification of production practices is one way of reducing risk. In addition, crop insurance is a way of managing risk by guaranteeing a specific return from production. Crop rotation, use of conservation practices, and progressive environmental stewardship are other risk management tools.

<u>Market Planning</u>
An often overlooked part of marketing management is market planning, which blends a producer's marketing expectations with the financial requirements of the business. This plan should be generated in conjunction with a projected cash flow statement. However, to be useful, the borrower's projected cash flow statement must project future prices and planned sales. A lender will analyze the borrower's historical use of market planning as an overall management tool, to match his or her cash flow needs.

Forward contracting and the futures markets are examples of making pricing decisions before the commodity is actually delivered. Regardless of commodity or value added business models, producers need to know the break-even costs of production in order to effectively negotiate and execute marketing strategies. Past performance is also an indicator of whether producers include such alternatives in their decision-making framework and also demonstrates the presence or absence of risk management ability.

In some instances, a manager may not possess an individual strength in marketing and pricing the commodity he or she produces. However, the ability of that producer to recognize that deficiency and to then seek and secure the advice of a marketing consultant is also an indicator of sound business decision-making management ability.

A producer's ability to manage their marketing risk through direct retailing, processing, packing, or by forming cooperatives, alliances, partnerships, and short and long term contracts will be assessed especially for value-added and vertically-integrated businesses.

<u>Strong Financial Management Foundation</u>
The ability of a producer to withstand or overcome and manage adversity and capitalize on windfall profits is evaluated as part of overall management ability and character. Most business managers make the poorest decisions during the good times when there

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are windfall profits, without regard for their long term consequences. An example of a possible flaw in character is frivolous spending on “killer toys,” like big boats, recreational vehicles, and exclusive vacations.

Here are three things that you can do that will demonstrate strong financial management and character to your lender:

- Maintain sound financial records and related financial tools such as business and personal cash flow statements, budgets, business inventories, enterprise accounting, etc., which provide a sound base for financial management.

- Have a history of monitoring and managing expenses and evaluating operational efficiencies (cost/unit, etc.).

- Handle business and personal obligations responsibly, and structure debt so your business can invest in capital items.

Overall, the lender will assess how well the producer understands his or her financial position and what the operation can and cannot do.

<u>You, Inc.</u> – Please take the time to assess yourself concerning the three factors just mentioned:

1. Do you maintain sound financial records, including cash flow statements, budgets, inventories, etc.? **Yes** **No**

2. Do you have a history of monitoring and managing expenses and evaluating operational efficiencies (cost/unit, etc.)? **Yes** **No**

3. Do you handle business and personal obligations responsibly, and structure debt so your business can invest in capital items? **Yes** **No**

ROADSIDE CHAT #2: What is one question a lender will frequently ask to provide insight into management abilities?
Do you know your cost of production for the whole operation? and by enterprise? Be prepared to answer this question! If not, you will be placed into the “pure production manager” camp. This usually requires pledging more collateral, and superior production results. Good production managers might still have cash flow and profit difficulties due to lack of business management and marketing abilities.

<u>Other Factors</u>
In general, sound character is viewed as a necessity, but it is not the only condition for acceptable loan performance. The importance of character is always balanced against the level of financing and overall risk to the lending organization. In addition to character, management ability, yields and other factors are considered during the loan

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analysis. The best intentions in the world cannot repay a loan when earnings are not generated from the operation.

Capital

Now let's move to the second "C" of Credit: Capital. The next module addresses this area in depth, so I will just provide you a quick "drive by" look at this section.

Capital refers to the borrower's financial position and progress, asset quality, liquidity, working capital, and debt structure. The analysis of these factors involves historical as well as current balance sheets so that changes in net worth can be evaluated. Part of the analysis of capital is to determine if the borrower's financial position has improved or deteriorated over time. In this analysis, the lender will evaluate whether an improvement in financial condition is the result of true earnings, or just appreciation or revaluation of the prices assigned to assets.

Liquidity

Liquidity can be defined as the ability or ease at which an asset can be converted to cash. Current assets that are not required to cover operating expenses and current liabilities, and that can be easily converted to cash, are an important source of reserves. Liquid reserves can be used to ensure that loans are repaid on time and that the operation can either manage through adversity or take advantage of opportunities for growth or investment. Liquidity helps manage risk and position for opportunities.

Several financial ratios are used to describe a borrower's liquidity position. The two most common are Working Capital to Revenue and the Current Ratio.

Working Capital to Revenue

The calculation of working capital is provided below:

Working Capital = Current Assets – Current Liabilities

The ratio of Working Capital divided by Revenue is a measure of liquidity. As the amount of an operation's working capital increases, the owner's ability to explore options, withstand risks and take advantage of opportunities increases. To a lender, this liquidity assures that the operation has money for investment beyond the funds being loaned and a reserve for future payments. Liquidity is often your second line of defense if your earnings and/or cash flow diminish.

Current Ratio

The current ratio provides similar financial information and is another measure of liquidity. It is calculated by dividing current assets by current liabilities.

Current Ratio = Current Assets /Current Liabilities

For example, a current ratio of two indicates there is twice as much cash and cash equivalents as there are obligations due within a 12 month period. A current ratio of one

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or lower indicates the potential for serious liquidity problems. This ratio measures the operation's liquidity and thus, its flexibility and ability to operate independently. It is important to note that the cash flow for different types of businesses (i.e., dairy versus wheat) will impact what level of the current ratio is needed for adequate cash flow. Liquidity ratios will be discussed in more detail in the next module.

ROADSIDE CHAT #3: Why is liquidity so important for a young farmer or rancher?
Frequently, liquidity is a secondary source of repayment if you face earnings adversity. Young farmers and ranchers are often highly financially leveraged, which takes away the option of refinancing using equity. Liquidity is a fallback. My advice is always to build liquidity reserves in profitable years.

You, Inc. – Please take time to calculate your Working Capital to Revenue Ratio and Current Ratio using your balance sheet and income statement:

Working Capital / Revenue: $\frac{\text{(Current Assets - Current Liabilities)}}{\text{Total Revenue}}$

Your Working Capital Ratio: __________

Current Ratio: $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

Your Current Ratio: ________________

Solvency

Again, I want to mention that the next module will take you in depth in the area of capital, which includes measuring solvency. Solvency is one of the most important risk measurements for a lender. It is an indication of the operation's risk-bearing ability. Solvency compares asset values to loan obligations. If the owner's equity is maintained or improves, the borrower's options increase. Three measures of solvency that indicate the relationship between total assets, total liabilities, and the owner's equity are: leverage ratio, debt-to-asset ratio and owner-equity ratio. Each of these will be discussed in the next module.

Overall, young and beginning farmers and ranchers will typically have higher financial leverage compared to tenured farmers. This often reduces your flexibility and adds more stress to debt servicing ability. Solvency is your third and last line of defense after earnings and liquidity, which is often evaluated more strictly during economic or financial downturns. Also, solvency often provides the collateral base and equity necessary to pledge during an expansion.

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Capacity

Let's drop in on our third "C" of Credit: Capacity. Capacity refers to the borrower's ability to: generate sufficient earnings to meet current obligations; repay any new debt; and provide an adequate margin for family living, replacement of capital items, accumulation of a reserve for adversity, and possibly meet long term retirement needs.

Realize that earnings capacity is not the same as cash flow. Accrual adjustments, such as changes in inventories, accounts receivable, and investments in growing crops, must be made to cash income records to accurately determine net income or changes in net worth earned. In that regard, an operation can have sufficient cash flow to meet current obligations without having positive net earnings. However, the reverse can also be true. An operation could have positive net earnings, but have insufficient cash flow to meet current obligations. This is because the operation can liquidate inventory and assets or increase payables to enhance cash flow or it can accumulate assets and inventory or reduce payables to diminish cash flow. Earnings capacity takes into account accumulation of sustainable cash flow from earnings. It also takes into account the effects of asset and inventory liquidation, which could hinder the intermediate and long term earnings base.

Net cash income is used to cover living expenses, repay capital debts, interest, or replace capital assets. Income not used for these purposes is available to expand, invest or build a reserve.

Historical and projected cash flows and income statements or changes in earned net worth are used to analyze repayment capacity. Over the long term, the repayment capacity margin must be sufficient to cover occasional operating losses and unforeseen expenditures.

<u>Term Debt and Lease Coverage Ratio</u>

The Term Debt and Lease Coverage Ratio is frequently used to measure capacity for loan repayment. It is calculated by taking the accrual net farm income from the income statement and adding back non-farm income, interest paid, and depreciation expense. Living expenses and income taxes are deducted to generate an amount that can be used for debt service and investments. Divide debt service commitments, including both principal and interest, into the amount to arrive at the Term Debt and Lease Coverage Ratio. If the ratio is above 100%, you can meet your commitments, since the money available exceeds the principal and interest commitments. For a simple example, if $80,000 is available for debt service and investments; and principal and interest payments for the year are $40,000; then the Coverage Ratio is 2:1, or 200%, which would make both a lender and borrower smile.

The next module will provide a process for calculating this ratio and discuss in depth benchmarks that lenders and borrowers need to aspire for.

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ROADSIDE CHAT #4: I hear some of my neighbors are able to obtain a loan on a handshake and a pledge of collateral. Why am I put through this maze of analysis?
Remember that cash flow and earnings pay back the loans, not collateral. Easy credit is often the demise of business people. By going through the Five "C's" of credit analysis, you are in a better position to identify your own strengths, areas for improvement, and possible strategies that can enable you to be a better business person.

Capacity Risk's Link to Capital
The risks associated with capacity are closely related to capital. As the probability of a low Term Debt and Lease Coverage Ratio increases, it takes a correspondingly stronger capital position to ensure that sufficient repayment reserves are available should there be an earnings shortfall.

Capacity analysis is accomplished by analyzing the income statement with further confirmation coming from evaluating the changes made on the balance sheet. If these two statements do not reconcile, the lender will work with the borrower to determine the most accurate number that can be used to report changes in earned net worth.

Collateral
The fourth element of the Five "C's" of credit is Collateral. If other credit factors are determined to be strong, some short-term and operating loans only require the signature of the borrowers on the loan agreement. For most operating and real estate loans, collateral is required as a condition to receive the loan. While loans are not written with the expectation that collateral will be liquidated for repayment, this is the lender's last resort source of repayment. Consequently, collateral must be evaluated to ensure that an adequate security margin or equity in the pledged asset will exist throughout the term of the loan. In general, all property taken as security for a loan will be evaluated by a qualified individual, who may be an institution employee or contract appraiser.

Criteria for Collateral Evaluations
All valuations of real estate must: (1) be based on market value, (2) be presented in written format, (3) take into consideration the property's intended use, and (4) contain sufficient detail to reflect the complexity of the property and market. Qualified individuals should complete evaluations of personal property. Valuation resources can include equipment guide-books, auction sales, etc.

Conditions
Let's introduce the final "C" of Credit: Conditions. The credit factor called conditions relates to the purpose of the loan as well as other items over which the lender has direct control, i.e., the loan amount, use of funds, and terms of repayment.

Purpose of the Loan

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The amount and purpose of the loan must be constructive and repayment terms must be practical for both the borrower and the lender, so the borrower will have the best chance possible to repay the note. Questions directed toward the purpose of the loan can include: Is the purpose reasonable for the farm business? Does the purpose satisfy the true financing need (i.e., short-term operating versus intermediate-term money for capital asset purchases)? The lender should be comfortable with the purpose of the loan and that it will be used to satisfy the financial needs of the business. Realize that the actual "amount" of the loan is carefully considered during the loan process. Is the amount requested adequate to complete the project, operating cycle, etc.? Is the amount of the loan reasonable considering the size and scale of the operation?

Conditions and Restrictions

The loan decision-making process also takes into account conditions where the applicant may be moving farther away from the definition of a bona fide farmer or the risk-bearing ability of the borrower may be declining. Conditions of approval may need to be supported by a letter of concern, additional collateral, appropriate insurance coverage, and other special covenants as the situation warrants.

Loan Covenants

A borrower may be required to follow special loan covenants such as submitting quarterly financial statements so your lender can monitor ongoing progress. For example, an agreement may require no new large capital purchases or sales of assets without the prior consent of the lender.

Structuring Loans

The overall goal is to structure the loan in the best interests of the borrower and the institution. Short-term loans are structured to coincide with the production and marketing cycles of the operation. Normally, repayment cycles will not exceed 18 months on operating loans and three years on revolving loans. Structuring intermediate and long-term loans takes the following into consideration: the length of the loan terms and if those terms are appropriate for the repayment capacity of the business; the need for monthly, semi-annual or annual payment or periodic renewal requirements; and the loan terms assure that principal is reduced at a rate consistent with depreciation of collateral. Generally, intermediate-term loans will not exceed 10 years, and most long-term loans secured by farmland have a term of no more than 20 years, but some may go out to 30 years when justified.

Conditions of a loan also might include developing an appropriate repayment schedule. On short-term loans, considerations include: source of repayment, timing of repayments, and amount of repayments. On intermediate- and long-term loans, a lender will consider the following: repayment capacity; useful life of the security; security that may warrant a shorter term loan; future capital replacement needs; and loan monitoring capabilities offered by payments or periodic renewal requirements.

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<u>You, Inc.</u> – Please assess the following:

	Yes:	No:
1. Are the terms of your operating loans less than 18 months?	________	_______
2. Are the terms of your intermediate loans one to ten years?	________	_______
3. Are the terms of your long term loans ten to thirty years?	________	_______

ROADSIDE CHAT #5: Why should a spouse or business partner go through this Five "C's" analysis?
As you may know, if your spouse or business partner signs a loan agreement he or she is responsible for paying back the loan as well. This is why a spouse or partner needs to be aware of the financial position and conditions of the business before they sign on the dotted line. They may be called upon to ante up in the case of adversity.

Lenders also consider who signs on the loan, who provides the repayment ability, who owns assets reported on the balance sheet, and who is managing the operation. Some partners may not be actively involved in the operation, but may have an ownership interest, so they may be required to sign the loan. Sometimes loans are enhanced by Farm Service Agency guarantees or the assignment of proceeds from private or government sources.

Conclusion

Each borrower and each loan is unique. The Five "C's" analysis allows the lender to individually focus on the strengths and weaknesses of each credit factor and make decisions for loan approval and renewal. It is important to discuss the Five C's with your loan officer to get a good feel of what that loan officer values in the credit relationship and potential mistakes to avoid, such as omissions from a financial statement or purchasing capital assets without notifying the loan officer. A better understanding by lenders and borrowers can be a critical step in fulfilling goals and enhancing communication between both parties.

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