Farm and Ranch Survival Kit

Working Together to Create a Hopeful Future For Family Farms

Issue 2

Financial Planning...those two words can create sweaty palms and heart palpitations for farmers and ranchers. We don't like to talk about money, unless it is in generalizations such as the price of apples or hay or the cost of fuel. But understanding your financial position is vital to the success of your farm. A financial plan can tell you about the long-term health of your business, unleash the creativity to start a new enterprise or tell you when to market your crop. It makes approaching a lender for a real estate loan or an operating line of credit seem less intimidating and managing your income for taxes at the end of the year a breeze. If done correctly, a financial plan can make you profitable and isn't that what we all want? By studying this issue of the Farm and Ranch Survival Kit and utilizing the resources at the end of this issue, you will be on your way to a profitable future.

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Loan Applications: What Lenders Look For

An entire article could be written on almost any single piece of information that a lender needs in order to make a loan decision. The information contained in the 5 Cs, character, repayment capacity, collateral, capital and conditions are considered keys to evaluating any type of loan. In this article, we will apply this formula to agricultural lending.

First, a lender must have a complete application package before a lending decision can be made. Contrary to popular opinion, loan officers are no more fond of paperwork than are applicants. Therefore, only that information which is absolutely necessary for a complete analysis and quick-as-possible decision is needed. Remember that most lenders do not make any money until a loan is approved and funded, so lenders are just as interested as applicants in quick decisions. Simplistically, lenders are in the rental business. They just rent money! If they do not "rent" money from depositors and "rent" money to borrowers, they are not going to be in business very long. Lending can be a beneficial and profitable relationship between lenders and applicants.

If this is your first application to this lender, the loan officer is going to ask for what seems like an exorbitant amount of information. Not only will this information be used for the current request, but it will establish a foundation for future requests. Most requested information is directly related to the loan request. Other information is required to meet the regulatory requirements placed on the lender. Lenders, like other businesses, must comply with applicable regulations.

We're not going to discuss regulations here, just what lenders look for in order to make a decision on an application. As mentioned earlier, the lender concentrates on the 5 Cs of credit, character, repayment capacity, collateral, capital and conditions. They are in this order for a reason. We're going to briefly discuss each of them.

When it comes to lending, an applicant's **character** is defined by the applicant's credit score, which is based on the applicant's credit history. Even for those lenders who still define "character" the old fashioned way, credit history is still extremely important. The majority of agricultural loans are to sole proprietorships and partnerships. Loans to other entities normally require individual guarantors. Therefore, personal (consumer type) credit and the business credit can not be separated when a loan request is being considered. Both show on the credit report. Both are critical to the loan decision.

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Loan Applications : What Lenders Look For (continued)

Repayment capacity is measured by ability to repay all financial obligations **after** loan approval. The lender wants the applicant/customer to pay all financial obligations from normal business income, not the liquidation of assets. Balance sheets, credit reports, historical and projected income, expenses and production are not only important to the applicant's business, but critical to the lender's analysis. Balance sheets (commonly referred to as financial statements) are compared to credit reports. Interestingly enough, many applicants do not include personal assets or liabilities on the balance sheets with their applications for business credit. The lack of this information is normally not a character issue, but is usually just a misunderstanding on the part of the applicant. Applicants who do not include personal assets (family vehicles, household, etc.) and/or personal liabilities (family vehicles, credit cards, charge accounts, etc.) normally understate their net worth. They also misrepresent their repayment capacity. Incomplete information requires the loan officer to make assumptions, and assumptions normally do not favor the applicant. When in doubt, ask your loan officer for assistance. It will help you both!

In the repayment analysis, the lender is looking at some key ratios. One is the "**current ratio,**" which compares the current assets (CA) to the current liabilities (CL). Are the current assets sufficient to repay the current liabilities and have a margin for the unexpected? A 1:1 ratio means all current assets equal current liabilities. There is no margin. Less than a 1:1 current ratio **may** indicate a weakness. A second comparison is total assets to total liabilities; a representation of the applicant's overall financial strength. The lender prefers that the applicant own more of the business than do the creditors. Net worth needs to exceed total liabilities. The reverse, again, may reflect a weakness. The word "may" is used here because this is only part of the total analysis. But any potential weakness must be considered in the final loan decision. The emphasis is to include **all** financial information so the lender can use the tools available to provide the applicant with the best financial package available.

Collateral is only a type of insurance policy for the lender. If the lender misjudges character and/or income becomes insufficient to meet all financial obligations, those assets pledged as security for the loan become the means by which the loan, hopefully, is paid in full. The applicant must realize that assets pledged are part of the contract with the lender. If the applicant is not prepared to use those assets for loan repayment, then the assets should not be pledged as collateral. This is an "old fashioned" measure of character.

Capital, noted on the balance sheet, represents the owner's financial stake in the business. It is the difference between the total assets and total liabilities, or net worth. The net worth represents the applicant's ability to meet all liabilities, regardless of type, and provide risk protection to the lenders. A greater net worth (in relation to the total assets) provides greater ability to meet the applicant's financial obligations, thereby decreasing the risk of the lender. The lender's comfort level on any loan has a direct correlation with the risk.

Conditions simply state the terms under which the lender is willing to make the loan. Some conditions are pertinent to all loans, i.e. repayment amount and terms. Others relate to weaknesses, actual or potential, which are discovered during the loan application analysis.

A condition can relate to collateral. A common example is the lender may be willing to approve the loan subject to specific assets offered as collateral and the value of said assets offered. The applicant may offer only crops to secure the loan. The lender may also require equipment with a specified minimum value. If the applicant agrees to the conditions, then the lender can approve the loan. If the applicant has concerns and options, he/she should always discuss those with the lender. Alternatives may exist. Only when the applicant and the lender agree can the requested loan be approved and funded.

An article could be written on each of the 5 Cs of credit and how each relates to information needed by lenders. This has been a short discussion of those. The applicant must remember that he/she, not the lender, is the expert. The lender must remember that the applicant is not normally an expert in completing financial information. Each must help the other if a complete application is to be achieved. The completeness of the application has a direct correlation to the speed of the credit decision. The loan decision is only as good as the information provided by the applicant and gleaned by the lender. The applicant should not hesitate to ask for assistance; neither should the lender. If your loan officer seems unwilling to assist you, you may want to shop for a lender the same as you shop for fertilizer, fuel, equipment, etc. Loan officers are being paid to (a) find a way to make, not decline, loan requests and (b) do so in a way that is the least risk to the lender and, subsequently, the applicant. The plan and the hope is that by working together, the applicant and the lender both become successful.

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Farm and Debt Risk: How Personality Influences Farm Decisions

Do all agriculture producers approach risk management the same? Will they come to the same conclusions when presented with various risk management strategies? Probably not.

Producers are different in how they approach and analyze problems, as well as how they act on information presented to them. Individuals who work with producers need to realize that personality type, thinking styles and attitude toward debt may cause a producer to make risk management decisions that are different than we proposed or expected.

Personality Type

Farmers' and ranchers' unique personality traits influence their risk management decisions and how the operation responds to changes in agriculture. Various personality models can help us understand human behavior. The Myers-Briggs Type Indicator (MBTI) is one of the most widely used models.

The MBTI is based on the belief that we all have certain preferences, including:

- whether we prefer the outer world of things and people (Extrovert) or the inner world of thoughts and ideas (Introvert);
- whether we perceive our environment in a literal, factual way (Sensing) or by using intuition, creativity and imagination (Intuitive);
- whether we reach our decisions in a logical, rational, objective way (Thinker) or in a value based, subjective way (Feeler); and
- whether we take action in an orderly and planned manner with deadlines and schedules (Judging) or in a spontaneous, changing and adaptable manner with options and possibilities (Perceiving).

The MBTI has been used with ranch and farm families to increase the understanding of agricultural decision making. Research indicates that farm men are more likely to have an ISTJ personality type. That is, they like facts and figures, prefer to think and make decisions logically and want things planned and scheduled.

Farm women are more likely to be an ISFJ. The are very similar to farm men except they prefer to make decisions with their "hearts;" whereas farm men prefer to make decisions with their "heads." ISTJ and ISFJ producer strengths lie in being hard working, realistic, conservative and traditionally oriented. Their challenges lie in their resistance to change, dislike of risk, pessimism and strong ties to tradition.

Agriculture is undergoing tremendous change in production, global competition, structure, technology and risk management strategies. These changing events and conditions present a real challenge to ISTJ and ISFJ producers because their most effective way of operation comes from careful accumulation of solid experience.

Situations in which they have no experience (as in new or nontraditional risk management strategies) can seem confusing. They need time and the opportunity to use their knowledge and expertise to understand changes.

Attitude Toward Farm Debt

Economists who work with agriculture families often see farm debt as a business issue and believe all ranch or farm goals should be aimed at maximizing profit. However, many agricultural families see farm debt as a personal issue.

For those producers who view farm debt as a personal issue, confidence to make risk management decisions can be adversely affected. With less confidence, these producers may be less likely to be risk takers and may actually be "risk avoiders."

The farm and ranch family's attitude also impacts farm debt decisions. If the family views the situation as a challenge or opportunity to learn and grow instead of a threat or crisis, members are more likely to cope and adapt. In other words, farm or ranch families that perceive farm debt as necessary are more likely to take a positive view of debt management.

Personality characteristics can make risk management decisions complex. And for many ranch or farm families, doing something worthwhile, being one's own boss and having a good quality of life are more important than maximizing profit.

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Financial Ratios and Quality Indicators: What They Can Tell You About Your Business

Lenders like to evaluate risk by using several sets of ratios as tools that determine the health of your business. Recognize that ratios are indicators and that only you can tell the full story about your business. So the more adept you are at explaining your financial ratios to your lender, the better she'll understand your business as she makes a credit decision.

LIQUIDITY. Financial ratios in this category measure the company's capacity to pay its debts as they come due.

Current Ratio
Definition: The ratio between all current assets and all current liabilities; another way of expressing liquidity.
Formula: Current Assets/Current Liabilities
Analysis: 1:1 Current ratio means; the company has $1.00 in current assets to cover each $1.00 in current liabilities. Look for a current ratio above 1:1 and as close to 2:1 as possible. One problem with the current ratio is that it ignores timing of cash received and paid out. For example, if all the bills are due this week, and inventory is the only current asset, but won't be sold until the end of the month, the current ratio tells very little about the company's ability to survive.

Quick Ratio
Definition: The ratio between all assets quickly convertible into cash and all current liabilities. Specifically excludes inventory.
Formula: Cash + Accounts Receivable/Current Liabilities
Analysis: Indicates the extent to which you could pay current liabilities without relying on the sale of inventory -- how quickly you can pay your bills. Generally, a ratio of 1:1 is good and indicates you don't have to rely on the sale of inventory to pay the bills. Although a little better than the Current ratio, the Quick ratio still ignores timing of receipts and payments.

SAFETY. Indicator of the businesses' vulnerability to risk. These ratios are often used by creditors to determine the ability of the business to repay loans.

Debt to Equity
Definition: Shows the ratio between capital invested by the owners and the funds provided by lenders.
Formula: Total Farm Liabilities/Total Farm Equity
Analysis: Comparison of how much of the business was financed through debt and how much was financed through equity. For this calculation it is common practice to include loans from owners in equity rather than in debt. The higher the ratio, the greater the risk to a present or future creditor. Look for a debt to equity ratio in the range of 1:1 to 4:1. Most lenders have credit guidelines and limits for the debt to equity ratio (2:1 is a commonly used limit for small business loans). Too much debt can put your business at risk but too little debt may mean you are not realizing the full potential of your business -- and may actually hurt your overall profitability. If you think that you might be in this situation, talk to your accountant or financial advisor.

Debt coverage ratio
Definition: Indicates how well your cash flow covers debt and the capacity of the business to take on additional debt.
Formula: Net Profit + Non-cash expenses/Debt
Analysis: Shows how much of your cash profits are available to repay debt. Lenders look at this ratio to determine if there is adequate cash to make loan payments. Most lenders also have limits for the debt coverage ratio.

“Opportunity is missed by most people because it is dressed in overalls and looks like work.”
Thomas Edison

Financial Ratios and Quality Indicators (continued)

PROFITABILITY. The ratios in this section measure the ability of the business to make a profit.

Sales Growth
Definition: Percentage increase (or decrease) in sales between two time periods.
Formula: Current Year's sales - Last Year's sales (Note: substitute sales for a month or quarter for a shorter term trend.)
Analysis: Look for a steady increase in sales. If overall costs and inflation are on the rise, then you should watch for a related increase in your sales... if not, then this is an indicator that your Prices are not keeping up with your costs.

COGS to Sales
Definition: Percentage of sales used to pay for expenses which vary directly with sales.
Formula: Cost of Goods Sold/Sales
Analysis: Look for a stable ratio as an indicator that the company is controlling its gross margins.

Gross Profit Margin
Definition: Indicator of how much profit is earned on products without consideration of selling and administration costs.
Formula: Gross Profit/Total Sales where Gross Profit = Sales less Cost of Goods Sold
Analysis: Compare to other businesses in the same industry to see if your business is operating as profitably as it should be. Look at the trend from month to month. Is it staying the same? Improving? Deteriorating? Is there enough gross profit in the business to cover your operating costs? Is there a positive gross margin on all your products?

SG&A to Sales
Definition: Percentage of selling, general and administrative costs to sales.
Formula: Selling, General & Administrative Expenses/Sales
Analysis: Look for a steady or decreasing percentage indicating that the company is controlling its overhead expenses.

Net Profit Margin
Definition: Shows how much profit comes from every dollar of sales.
Formula: Net Profit/Total Sales
Analysis: Compare to other businesses in the industry to see if your business is operating as profitably as it should be. Look at the trend from month to month. Is it staying the same? Improving? Deteriorating? Are you generating enough sales to leave an acceptable profit? Trend from month to month can show how well you are managing your operating or overhead costs.

Return on Equity
Definition: Determines the rate of return on your investment in the business. As an owner or shareholder this is one of the most important ratios as it shows the hard fact about the business -- are you making enough of a profit to compensate you for the risk of being in business?
Formula: Net Profit/Equity
Analysis: Compare the return on equity to other investment alternatives, such as a savings account, stock or bond. Compare your ratio to other businesses in the same or similar industry.

Financial Ratios and Quality Indicators (continued)

Return on Assets
Definition: Considered a measure of how effectively assets are used to generate a return. (This ratio is not very useful for most businesses.)
Formula: Net Profit/Total Assets
Analysis: ROA shows the amount of income for every dollar tied up in assets.
Year to year trends may be an indicator ... but watch out for changes in the total asset figure as you depreciate your assets (a decrease or increase in the denominator can effect the ratio and doesn't necessarily mean the business is improving or declining.

EFFICIENCY. Also called Asset Management ratios. Indicator of how efficiently the company manages its assets.

Inventory Turnover
Definition: Number of times that you turn over (or sell) inventory during the year.
Formula: Cost of Goods Sold/Average Inventory
Analysis: Generally, a high inventory turnover is an indicator of good inventory management. A high ratio can also mean there is a shortage of inventory. A low turnover may indicate overstocking, or obsolete inventory. Compare to industry standards.

Sales to Total Assets
Definition: Indicates how efficiently your business generates sales on each dollar of assets.
Formula: Sales/Total Assets
Analysis: A volume indicator that can be used to measure efficiency of your business from year to year.

Adapted from SBA Online Women's Business Center. For more information visit: http://www.onlinewbc.gov/docs/finance/fs_ratio1.html

If a profitable ranching business is a your goal, then join presenter Dave Pratt for a dynamic three hour presentation entitled "Generating Wealth: Keys to a Profitable Farm Business" on November 17th from 6-9 pm in The Dalles, Oregon. This informative workshop will be held at Columbia Gorge Community College, Building 2, Room 2.384. Participant costs are $25 per person or $35 per management team. To insure your seat, please **pre-register by Tuesday, November 15th.** To register contact OSU Extension Service, 400 East Scenic Dr., #2.278, The Dalles, Oregon 97058 Phone: (541)296-5494 e-mail: Brian.Tuck@oregonstate.edu.

Resources

Websites and Internet Resources:

SBA Online Women's Business Center
Downloadable Financial Ratios as featured in this newsletter
http://www.onlinewbc.gov/docs/finance/fs_ratio1.html

"Financial Management: The Key to Farm-Firm Business Management"
An Kanasas State University Extension Bulletin detailing the financial planning process.
http://www.agmanager.info/farmmgt/planning/
Finacial%20Management.pdf#search='Farm%20and%20Ranch%20Financial%20Planning'

Western Risk Management Library
Generous information on all aspects of managing risk. Contains a special section with resources on financial planning and management.
http://agecon.uwyo.edu/RiskMgt

Small Business Administration
An online library full of downloadable documents designed for small business.
http://www.sba.gov/lib/library.html

Software

Integrated Farm Financial Statements Software
IFFS generates financial statements (projected or actual) useful in decision making and evaluating performance.
http://www.agecon.okstate.edu/iffs/

Books and Print Resources

Savory, Allen and Jody Butterfield.. ***Holistic Management: A New Framework for Decision Making.*** *Washington D.C.: Island Press, 1999.*

*Leza, Richard and Jose F. Placencia***.** ***Develop Your Business Plan,*** *Oasis Press, Milpitas, 1988*

Watch For These Topics in Upcoming Issues!

The Tax Man Cometh! How Do You Handle Him?

What Are The Secrets to a Successful Marketing Campaign
(Hint: Do You Know The 4 P's?)

How Do You Handle Stress?

Can You Name Ten Things Break Up Farm Families?