

## THE LOAN RENEWAL SEASON: YOUR LENDER'S CONCERNS

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Now that harvest is over, farmers are planning for next year's planting season. Lining up operating credit for the upcoming year is one of those tasks. Given the turmoil in the financial markets this past year, lenders are expected to ask more questions and be more conservative in their loan decisions. Knowing your lender's key concerns beforehand can help you better prepare your credit request. So what is on your lender's mind these days, and how can you be better positioned to answer his or her questions?

### Profitability

Lenders are always concerned about the profitability of your business, but they will likely ask more questions and want more details this year compared to previous years. Many farmers document the income they have made using tax returns – particularly the cash-based Schedule F. Schedule F's are notoriously inaccurate in measuring net farm income – in good years farmers frequently delay sales and prepay expenses to reduce taxable income reported on the Schedule F and thus their tax liability. But in years when incomes have not been good, a farmer may reverse this process and actually accelerate sales and delay purchases so as to report at least enough income to use personal deductions and exemptions. So in contrast to many years, the Schedule F may actually overstate farm income for 2009. That is if income was calculated on an accrual basis the business might actually show a loss whereas the Schedule F shows a modest profit. So lenders will be asking for more detail to get a better understanding of the true income of the business. Have crop sales been accelerated this year rather than delayed as is typical? Have fertilizer and chemical purchases this year been delayed to 2010 rather than being made before the end of the year? What is happening to crop and livestock inventories – have they gone up or gone down this year?

And what about projections for next year? Have you done some budgeting to determine what your margins are going to be for the 2010 production season? What is your breakeven price for corn and beans, and have you calculated the breakeven for your hog and/or dairy operation? Showing the lender an accurate statement of last year's income, and sharing your projections of breakeven prices and how much income you expect to make in 2010 can go a long way to convince him/her that you are on top of the business, know your costs, and know what kinds of yields and prices you need to make a profit in 2010.

### Managing Risk

Most of the discussions you have had in the past with your lender concerning risk management may have focused on purchasing crop insurance. And the crop insurance discussion will occur this year as well, but it may be more intense than in the past because your lender may want you to buy up your

coverage, particularly if you have been insuring at the lower levels of 70 to 75% crop revenue coverage (CRC) insurance for example. Lenders would like to have crop insurance protection that will cover cash costs of operations, and in many cases that means a higher percentage – maybe 80 to 85% on CRC insurance. The issue from your perspective is that with this higher level of coverage, the premiums go up substantially; some farmers will suffer “sticker shock” this next year as they look at the insurance coverage their lender would like and the cost of this coverage.

But the discussion of risk management strategies will not stop this year with just a review of crop insurance. Lenders will be asking more questions about whether or not fertilizer has been contracted and at what price. They will want to know if any plans have been made to forward price crop or livestock products using contracting or futures/options strategies. And what about counter-party risk – have you sold any grain on a delayed pricing contract where you don’t have a warehouse receipt but the elevator has already shipped the grain? Or have you paid cash for fertilizer or chemicals but not yet taken delivery? In these cases you have become the “banker” for your product buyer or input supplier, and the lender will want to know how financially solid your buyer/supplier is and whether there is any risk that you may not receive payment for the product or delivery of the input. So expect more questions this year concerning what you are doing to manage the risk in your business.

### Risk Pricing

With the increased risk in agriculture today, lenders are being encouraged/required by their regulators and senior management to be more aggressive in risk pricing – reflecting the higher risk that a customer may have through a higher interest rate. Lenders in general have underpriced risk, but that is changing. Don’t be surprised if your lender says that the base rate for operating loans this year is for example 6-1/2%, but that because of the higher risk exhibited by your farming operation, they need to add a risk premium of 1% to that base rate so that your interest rate would be 7-1/2%. It is a fair and reasonable request for you to ask the lender to explain what makes you a higher risk credit, and what you might do to lower that risk premium. Could you lower it by buying a higher level of coverage on crop insurance? What about a personal guarantee on the note or a FSA guaranteed loan? What if you were able to provide additional security or collateral? What if you did some forward pricing or contracting of your production? Implementing strategies to reduce the risk in your business would be beneficial to you, and could also result in a lower interest rate. Also, even though market interest rates are very low, don’t expect loan rates to go below your lender’s cost of funds plus margin. Some lenders have placed floors on rates to avoid pricing loans at a loss.

### Interest Rates

The interest rate you will pay is not only a function of the type of loan and your lender’s perception of your risk, but it will also depend on whether you are using a variable rate or a fixed rate arrangement. At the current time, the spread between short-term and long-term interest rates is relatively wide, and consequently short-term variable rate loans carry much lower interest rates than longer-term fixed rate loans. But short-term rates typically fluctuate more than long-term rates, and given their current low levels, it is almost a certainty that they will increase rather than decrease. So one of the tough risk

management decisions farmers must make today is whether to maintain their lower variable rate loan, or move to a fixed rate which is likely going to be higher but more certain. Particularly for farmers who have suffered sizeable operating losses and are being encouraged by their lender to restructure their debt and amortize those losses over a 3 or 5 year repayment period, it may be desirable to price that “carry-over” debt on a fixed rather than a variable rate so as to reduce the risk exposure that could result from rising interest rates. And the old adage to “not put off until tomorrow what you can do today” really rings true here. If you have a problem with your debt structure (i.e. repayment schedules that are too short and put undue cash flow pressures on the business), take action to fix it now, not later.

### Working Capital

A fundamental principle of lending is that working capital is the first line of defense against financial stress, so lenders will be very focused on assessing the working capital position of your business this year. Working capital is most accurately calculated as current assets minus current liabilities; some lenders may alternatively look at the liquidity of your business as measured by the current ratio of current assets divided by current liabilities. Both of these metrics provide an indication of the firm’s ability to make payments on debt obligations when due and have an adequate financial cushion to handle unexpected costs or losses. Historically, current ratios of at least 1.5 to 1 and working capital of 15% or greater of the gross revenue of the business have been deemed adequate. But with the increased volatility in product and input prices, lenders have in some cases raised their standards or expectations and want current ratios closer to 2 to 1 and working capital positions of 25 to 30% of gross revenue. For those with low working capital positions, particularly resulting from an accumulation of operating losses, it may be desirable to term out some of the operating loss carry-over as a means of rebuilding the working capital position of the business. And working capital must truly be available – over-valued inventories of grain may result in what appears to be a strong working capital position, but the lender is likely to be well aware that the working capital is overstated, and consequently will require more working capital than might be expected otherwise. Furthermore, current liabilities are frequently understated on farm balance sheets because potential income and self-employment tax liabilities on current inventories are not reported.

### Covenants

Lenders are likely to place more restrictions or covenants on their farm borrowers this year compared to previous years. In essence, a covenant specifies a set of conditions with which the borrower must comply along with the consequences of violating those conditions. A common covenant is a limit on capital expenditures without prior approval – in essence, the lender restricts the borrower from purchasing machinery, equipment or other capital items without having a discussion with and permission from the lender. The purpose of such a covenant is to make sure that cash that could be used for debt servicing or buying operating inputs is not diverted to capital expenditures that do not directly contribute to the cash flow of the operation. In some cases, lenders may also impose covenants with respect to specific financial metrics such as the minimum level of working capital or the debt service coverage ratio.

Borrowers should read carefully the language in the loan agreement on covenants – covenants are frequently presumed to be just legal jargon, and sometimes lenders have not been very forceful in enforcing covenants. But the increased risk in agriculture has changed both the use of covenants and their enforcement. For example, it is increasingly common for covenants to indicate that if they are violated, the lender has the opportunity to reset the interest rate on the loan, increasing it in some cases by as much as 2 or 3 percentage points. So make sure you discuss and understand any covenants in your loan agreement this year.

### Growth and Capital Expenditures

One of the easiest ways for borrowers and lenders to adjust to increased financial stress and risk is to limit the growth of the business and cut back on any capital expenditures. This may be the year when you plan to replace the combine or buy a new tractor; if that purchase will require financing from your lender, you can expect him/her to ask whether or not it is really needed or if it might be prudent to pay any repair bills and use the machine another year. If you plan to make the purchase and borrow the money to do so, make sure you can show your lender how you will repay that debt and that the purchase will not impede payments on current obligations. And this may be the year to pause in terms of your growth strategy and consolidate your operations and improve their efficiency so that when opportunities to expand arise in the future, you are better positioned to do so.

### Liquidating Assets

In some cases, you may have more debt than you or your lender feel comfortable with, and so the discussion turns to selling assets and using the proceeds to pay down debt. In many cases this is a very desirable strategy as long as productive assets that would shrink revenues are not sold, but it may have unexpected tax consequences. The sale of any asset (whether inventory or capital assets) may result in a taxable gain depending on the sale price compared to the tax basis for that asset. The tax may be particularly large in the case of raised grain and livestock products for a producer who has been using the Schedule F to report their taxes. By law, the tax basis for raised grain and livestock for those filing a Schedule F is zero, so all proceeds of the sale of these products is taxable ordinary income.

A farmer who is carrying excess inventory of say a \$100,000.00 of grain and livestock products might logically conclude that it makes sense to pull this inventory down and use the sale proceeds to pay off debt. But this transaction would trigger a \$100,000.00 taxable gain if the products are raised and the farmer files a Schedule F. Unless there is an adequate operating loss in the business to offset this gain, the farmer might be very surprised if he/she finds out that this decision resulted in a \$30,000.00 plus income tax obligation. And social security and self employment taxes are on top of that. Make sure you visit with your tax accountant before you liquidate any assets and use the proceeds for debt reduction.

### FSA Guarantees

In some cases you and your lender may find that a FSA loan guarantee is needed to support the financing request. If that is perceived to be a possibility, it is critical to move quickly to start the process and get the application submitted. Last year FSA had increased demands for loans and was not able to

fulfill all requests, and applications for FSA guarantees are expected to be up 20% or more in 2010. To make sure that you receive approval of your loan request in a timely fashion and that you do not get caught by funding limitations, it is best to start the application process as soon as possible. Many commercial lenders are positioned to facilitate guaranteed loan applications – you don't necessarily have to go to FSA to apply.

Most farmers will be able to obtain adequate funds to finance their operation this upcoming year, but don't be surprised if the lender asks more questions, expects more information and documentation, and imposes some restrictions or limitations on how the funds are used. Knowing what your lender wants and being prepared to sell your credit-worthiness will be important to make this year's loan renewal season less stressful for you and your lender.