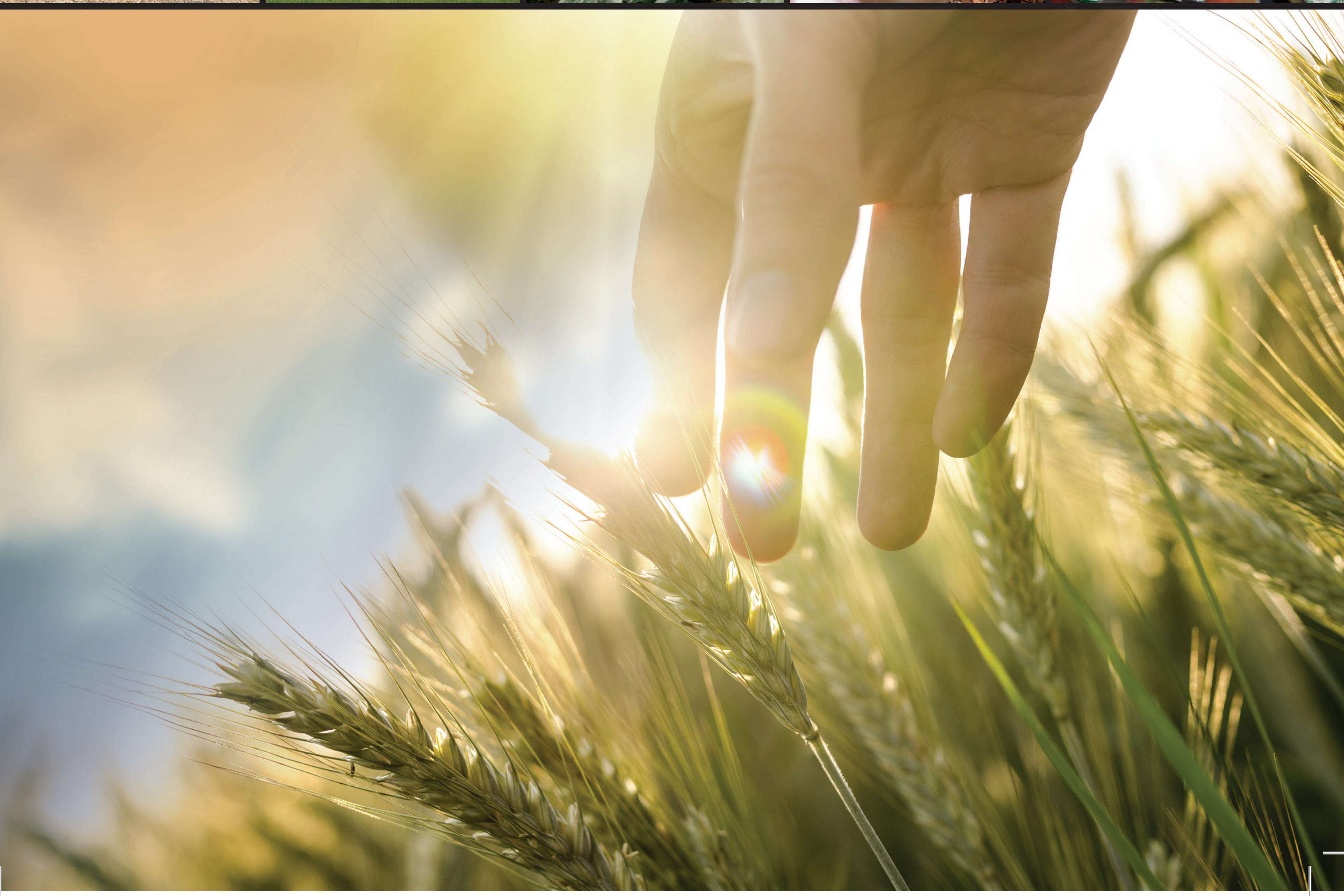
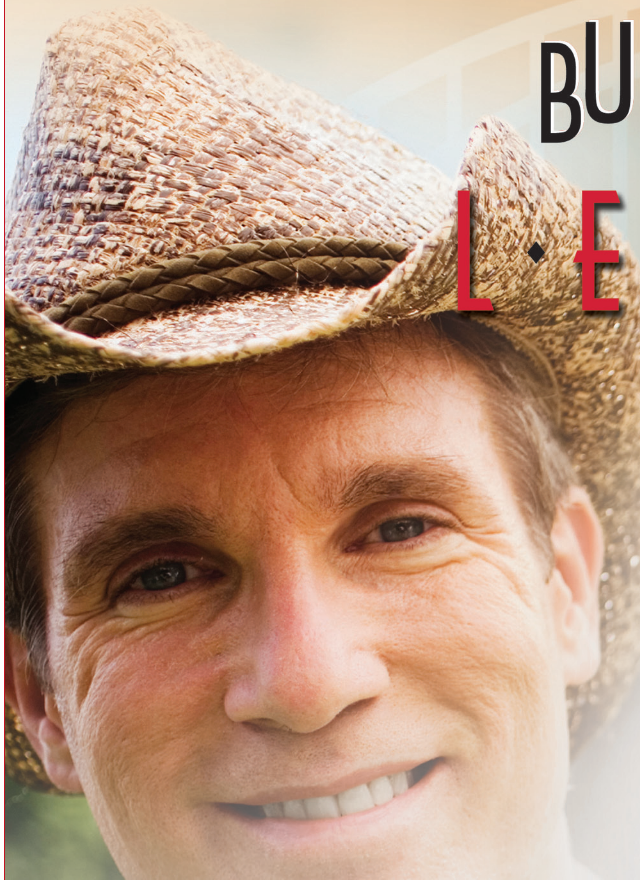
BUILDING BRIDGES with LENDERS





BUILDING BRIDGES with L·E·N·D·E·R·S

There was a time when most lenders knew the financial needs of operating a farm or agribusiness. Agriculture is capital-intensive, with special cash-flow needs. Unlike production lines in a factory that can be shut down, crops will keep growing. Animals will still need fed. Agriculture is different, and there was a time when that was well understood.

That was also a time when agriculture was the business for many Pennsylvanians. But with less than two percent of the state's population involved in agriculture production today, those in agriculture often compete against lower-risk businesses for the services of lenders. Once-common knowledge needs to be given to lenders – that agriculture has unique strengths and opportunities that often outweigh the financial risks. Whether as agricultural producers, processors, direct farmers markets or other businesses, you need to be an educator and an advocate for yourself if you want to obtain the capitalization – the funding that drives your business – that you need.

This guide gives you the tools to figure out what your operation needs and how to approach the lender to seal the deal. You can establish that line of trust and build that bridge.

At the Pennsylvania Department of Agriculture, we recognize the special considerations you need for your agribusiness. That's why we've brought together all our department's economic resources under the Keep PA Growing initiative to serve agribusinesses and the lending institutions who serve you. If you're looking for sources of funding for your operation, whether through grants, loans or other sources, PAgrows can help you navigate the lending puzzle. If you're looking to transition between generations or just getting into farming, the Center for Farm Transitions can help answer the questions that will pop up or pair up farmers who are ready to take the next step for their operations. If you need expert advice to help you find the best ways to protect your operation from risk, check out the department's crop insurance and risk management resources.

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1 *Know what you need*

Don't expect a lender to tell you what you need, because no one knows your business better than you. Come prepared. When you look to secure a loan, remember to finance "like" with "like." Use a long-term asset like real estate to purchase additional real estate, refinance, make improvements to land and buildings, or construct a new building, instead of using that equity to purchase equipment or finance short-term debt. Avoid using long-term debt to finance short-term assets. The lower payments might be easier to budget, but in the long run you'll end up paying more.

Also, don't use your farm to finance unpaid operating expenses unless you're recovering from a non-reoccurring event like a flood or drought.

Remember, your lender may not understand your agricultural business or market as well as you.

Knowing what you need and communicating that to the lender is key.

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2 *Organize before you meet*

There are plenty of pieces to pull together before you sit down with a lender.

- If you plan to purchase machinery or equipment (new or used), provide a complete list of the pieces you want to buy, the cost of each one, its expected service life, the names of the suppliers, and the costs of installations, shipping, and any other necessary expenses in making the equipment or machinery ready for use.

- If you plan to purchase land, provide a legal description of the property and buildings, including a copy of the deed or survey or a recent appraisal as well as the land's location and general condition, any known liens, the assessed value and amount of yearly taxes, the number of tillable acres, and the land's intended use. Also note if the land is listed in one of Pennsylvania's Agriculture Security Areas or enrolled in the state's nation-leading farmland preservation program, or if it has conservation or nutrient management plans.

- If you plan to build a new building or structure, provide some preliminary information about the cost of and possible financial benefits from the project, the building's dimensions, its use, structural plans, and site plans, if available.

- If you have a secondary income source, provide pay stubs (at least the prior three months), a W-2 form, or a 1099 form.

- Provide your business plan, including a marketing plan and capitalization plan – the plan for using your assets to fund your business.

- Provide your tax returns from at least the most recent three years.

- Provide financial statements that include a Balance Sheet, Income Statement, Cash Flow Statement, and Profit/Loss Statement for the last three years (with the most recent less than 60 days old).

- Think about how you'll pay off the loan before you get it – provide a proposed repayment plan. The plan's details will be worked out with the lender, but you'll be prepared.

- Provide any additional information that will help your lender positively evaluate your credit request.

Ask your lender about PA First Industries Fund loan guarantees and the USDA's Guaranteed Loan Program and how they may benefit your situation. If your lender does not know about these programs, have him or her contact PAgrows or the USDA Farm Service Agency.

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3 *Know what lenders look for in appraising capitalization requests*

A – Conditions:
industry trends, market conditions, farm operations and the transaction's purpose and related details.

B – The Person:
your management ability, integrity, efficiency, and marketing ability

C – Capital:
your net worth and financial ability to "weather a storm"

D – Cash Flow:
your ability to meet all obligations on an ongoing basis

E – Collateral:
your available equity, security agreement, and non-current assets

4 *Be open and honest in your communication*

Talk often with your lender – educate him or her about the issues and trends of agricultural production, and about yourself. You'll build a personal and professional relationship.

Talk to your lender before you have a need. Share how things are going and your vision for the future of your operation and family.

Have your lender visit your operation and experience it firsthand. These visits are opportunities to educate and advocate for yourself, rather than an obligatory time to "pass inspection."

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5 *Understand the lender's key concepts through ratios and benchmarks*

Financial ratios and margins to assess, benchmark, and monitor farm performance are common tools for lenders. Use the formulas in this section to learn the likelihood that your loan request will be approved.

This model uses the analogy of traffic signals – a red light indicates little to no chance of qualifying for a loan, while a green light means you'll likely qualify. Like all traffic lights, there are levels between "no chance" and the "sure thing" of being approved for a loan.

Profitability: Ability to Generate Profit

Value of Production (VOP) = Farm Cash Receipts (+) Change in Value of Product Inventory (+) Change in Value of Accounts Receivable (–) Livestock Purchases
represents the accrued value of commodities during the fiscal or calendar year

Net Farm Income (NFI) = VOP (–) Direct Costs (–) Capital Costs
represents the bottom line

Gross Margin = NFI (–) Depreciation
represents funds available to cover unallocated fixed costs, returns to unpaid operator and family labor, and returns to owner's equity

Return on Assets (ROA) = Net Income (+) Interest Expense (–) Unpaid Operator and Family Labor (÷) Total Assets
should fall in the range of 1.5 to 2.5

Return on Equity (ROE) = Net Farm Income (–) Unpaid Operator and Family Labor (÷) Total Equity
should fall in the range of 7% to 8%

Operating Profit Margin Ratio = Net Farm Income (+) Interest Expense (–) Unpaid Operator and Family Labor (÷) Value of Production
represents the portion of each dollar that reaches profit

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Leverage or Solvency: Long – Run Levels of Equity and Debt

Debt to Asset Ratio =
Total Debt (÷) Total Assets
represents level of debt and financial risk
Rule of Thumb:
Above 75% – "Red light"
50% to 75% – "Orange light"
33% to 50% – "Yellow light"
Less than 33% –"Green Light"

Equity to Asset Ratio =
Total Equity (÷) Total Assets
represents level of equity
Rule of Thumb:
Less than 30% – "Red Light"
30% to 55% – "Yellow Light"
Above 55% – "Green Light"

Debt to Equity Ratio =
Total Liabilities (÷) Total Equity
represents level of debt
Rule of Thumb:
Above 122% – "Red Light"
42% to 122% – "Yellow Light"
Less than 42% – "Green Light"

Debt Payout =
Total Liabilities (÷) Net Farm Income
represents the number of years it would take to reduce the debt to zero if all income of the farm could be directed towards principle reduction. It relates the level of debt to the ability of the farm to generate income to repay the debt.

Liquidity: Ability to Pay Obligations

Current Ratio = Total Current Assets (÷) Total Current Liabilities
represents the ability to meet cash obligations coming due in the next year

Rule of Thumb:
Less than 1.00 – "Red Light"
1.00 to 1.50 – "Yellow Light"
Above 1.50 – "Green Light"

Working Capital =
Current Assets (–) Current Liabilities
represents the ability to meet cash obligations
Rule of Thumb:
A positive number is desired, but too high of a value may mean too many assets are not providing a return.

California Working Capital Rule (6) =
Working Capital (÷) Total Farm assets
represents adequacy of working capital relative to business expense

Financial Efficiency: Ability to Generate Revenues and Control Costs

Capital (Asset) Turnover Ratio =
VOP (÷) Total Assets
represents capital intensity. Low value is positive with a capital intensive operation with a higher profit margin. If a lower value is combined with a low profit margin it represents an inefficient operation.

Operating Expense Ratio =
Operating Expense (excluding interest and depreciation) (÷) VOP
represents the percentage of operating expense that will consume every $1 of revenue
Rule of Thumb:
Above .80 – "Red Light"
.65 to .80 – "Yellow Light"
Less than .65 – "Green Light"

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Interest Expense Ratio =
Interest Expense (÷) VOP
represents interest expense to the farms ability to generate income. A trend upward will lead to eventual financial stress.

Rule of Thumb:

Above .20 – "Red Light"
.12 to .20 – "Yellow Light"
Less than .12 – "Green Light"

Financial Debt Coverage Measures: Ability to Generate Funds to Meet Debt Obligations

Cash Flow = Net Residual Income (÷) Total Annual Principle (+) Total Interest Payments

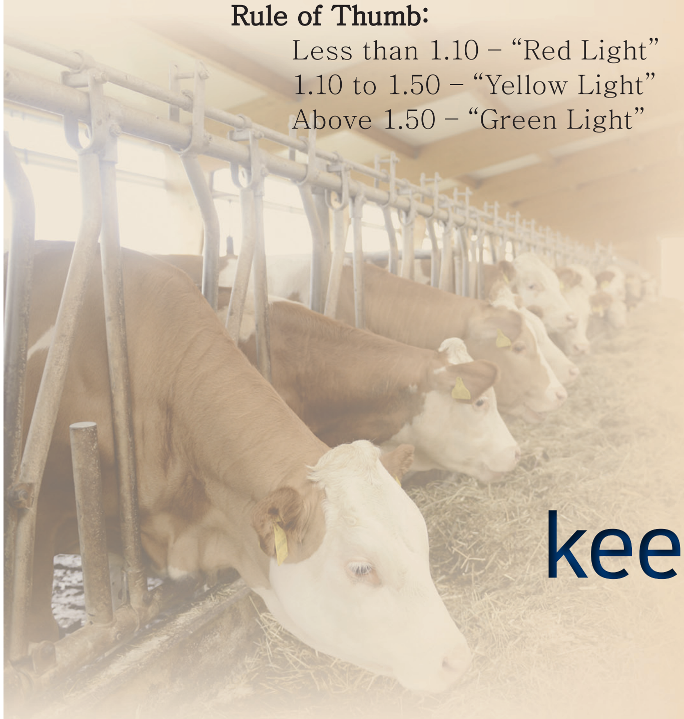
Rule of Thumb:

Less than .20 – "Red Light"
.20 to .50 – "Yellow Light"
Above .5 – "Green Light"

Term Debt Coverage Ratio = Net Income (+) Depreciation (+) Interest Expense (–) Family Expense (÷) Principle and Interest on Term Debt (+) Operating Loan Interest

Rule of Thumb:

Less than 1.10 – "Red Light"
1.10 to 1.50 – "Yellow Light"
Above 1.50 – "Green Light"



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