Module 3
Borrower-Lender Relationships:
Side-by-Side

Module Outline

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Learning Objectives

The learning objectives for this module are to:

- Know the important attributes to look for in a lending decision.
- Explore the loan process using examples.
- Introduce the documentation required for a loan request.
- Understand the basic attributes that lenders consider in determining the viability of your loan or capital request.
- Enhance the side-by-side relationship between borrower and lender.

Introduction

Whether you plan to begin a business or operate one in generational transition, produce for a cooperative or for a value-added market, it is important to develop a plan and process in writing, to consider both the challenges and opportunities for the business.

In the past, producers have gone to their lender with questions like, "How much can I borrow?" or "Can you give me a loan for this?" While these are important questions, today's economic environment requires something more than a simple, verbal request. Moving forward it will be important to go to your lender with a plan when requesting financing.

In the past, there were times when one could receive a loan based on family reputation, farm name, or collateral on your balance sheet. Those approaches are elements of the past. This is due, in part, to the high-stakes reality of agriculture which includes economic volatility, shifting global market pressures and, in general, a surprise around every corner. Couple this with increased expectations from financial regulators responsible for a safe and secure financial system, and seeking capital and financial services today looks very different than it has in the past.

Regardless of size or complexity of the business, those in the agricultural industry should prepare financial plans and documentation.   These plans will be scrutinized intensely by potential lenders or investors in your business. However, these documents hold the most value for you as an owner or operator.   Written plans such as a balance sheet and cash flow projection will help determine your financial management strategies. In fact, financial documents should be used to plan, strategize, execute and monitor your business performance. While growing livestock and crops and developing value added services are all important factors, a complete and accurate set of financial statements is not just an option, but a requirement for 21st Century agriculture.

PODCAST #1: How important is having a plan when seeking financing?

> Lets' draw upon how Henry got started. He developed a business plan with input from his college professors. He worked and proved himself as a good manager for a high profile successful producer while building some equity. He discussed his plan with the lending institution's board members and loan officers individually. When they all met, he was approved with 5 percent equity and 95 percent debt! Before his sudden passing a number of years later, he was the "millionaire next door" by executing the business plan!

Financial Documentation

What types of financial documentation are needed? A good place to start is a complete historical or projected cash flow statement. The components of this document can include up to 80 percent of a business plan. How? As you are thinking through the cash flow, you must make assumptions on factors such as production, price, number of services and timing of revenue. In addition, you must estimate timing of costs including feed, labor, repairs and crop inputs. The cash flow document allows one to think through, on paper, the marketing, operational and financial plans before committing.

Later modules will outline the importance of accurate assumptions. Utilize your lender, extension agent, or crop or livestock consultant to confirm the validity of your assumptions as well as suggest possible "what if" scenarios. What if there is a drought or a streak of hot weather that suppresses production or quality of output? What about overruns on an expansion or startup? Each of these scenarios can be developed and tested on a computer spreadsheet.

Updated balance sheets and income statements can improve credibility with a lender. In addition, these documents help build confidence in business decision-making as one monitors business progress. Be transparent and document all assets and liabilities. Lenders do not look favorably on financial surprises as it can reflect the character and honesty of the individual requesting credit. Evaluate the value assigned to each asset. Forgotten or underestimated liabilities can be problematic for both lender and the borrower in making sound business decisions. Next, allow time for the lender to conduct due diligence by checking credit reports, visiting your business, checking with other creditors and completing reference checks.

How the Loan Process Works

Depending on the financial institution, the loan process can vary. Most often, a borrower's first point of contact is the loan officer. You meet with your loan officer and he or she collects pertinent financial and management data. In some cases, after conducting analysis, the loan officer will inform you on the status of your request. This often depends on the size of the loan, tenure and experience of the loan officer, lender policy and limits on loan authority. In other cases, these point people will collect information, and then a credit analyst will analyze and review the loan request, sometimes analyzing 3 to 5 year financial trends for an existing business or projections for a startup. In other situations, your information will be packaged and sent to a loan committee to either approve or deny the loan request. In order to move through the loan process as efficiently and successfully as possible, it is important to know the different steps. If approved, your loan will be officially processed, recorded, and monitored by an internal review team as well as external regulators.

Lender and Regulator Views

One of the first elements lenders and regulators examine is the quality of your financial records. Specifically, they will look for updated balance sheets, tax records, and possible cash flow statements. Do not be surprised when lenders and regulators want serial numbers on equipment, livestock identification and other accountability measures on grain and crop inventories. The paperwork and requests for information will only increase as regulators attempt to protect the safety and soundness of the financial system.

Regulators will also review loan agreements and covenants. Moving forward, regulators will expect loan officers to increase their level of supervision and enforcement on accounts especially in an agricultural downturn. In addition, if you are a larger agriculture producer, audited financial statements and accrual adjusted financials will most likely be required by your lender.

In general, larger businesses need to prepare for tighter scrutiny and additional oversight. Quality records increase your level of protection as well as the resources available for your business. When seeking financing, the better prepared you are, the faster and more successful the loan process will be.

Your spouse or business partner may play an integral part in obtaining credit. He or she may be required to be a co-signer or guarantor on loan documents. Expect the lender to verify financial status or earnings, if he or she is contributing to cash flow. This includes checking his or her credit history as well as sources of income. Nearly 70 percent of U.S. farms and the majority of small operations are supplemented with off-farm income either by the individual, spouse or partners. Most lenders will require proof of income for an existing business and documentation of non-farm earnings. To reduce fraud, they will often ask for original copies of these documents as they conduct due diligence.

Often, supplemental information is required on the updated balance sheet detailing status and amounts of all assets and liabilities. Do not be surprised if your lender asks about the status of life, disability, health, liability, fire and key-person insurance. This is all part of a risk management assessment. Be prepared to document proof of the status of each of these insurances. Finally, expect your lender to ask about your vision for your business and how this balances with your family and personal ambitions.

PODCAST #2: Are credit scores really that important?

Yes, not only for credit, but also for insurance and employment. I know a man who had once passed all the mental, physical, and background tests for employment by the state police, but was denied employment because of a low credit score. His cousin with a similar name and Social Security number had a low credit score. The cousin's score was accidentally placed on his record. A year later, the mistake was corrected. Now, the man is a successful state highway patrolman, and he and his wife are successful part-time farmers.

Credit History and Credit Scores

A strong credit score individually as well as with your spouse and partners is very critical when applying for credit as well as insurance and employment. It is very important to check your credit score and examine your credit history and report annually. Additionally, check the credit report and history of each person connected with your financial standing each year. Each individual is entitled to one free credit history report annually from each of the three credit agencies or bureaus. The best way to access free credit reports is through www.annualcreditreport.com. This site is maintained in partnership with U.S. government and is completely free.

Your credit history is important. A history of delinquent payments, repossessions, or bankruptcies will increase your degree of difficulty in obtaining credit. You may be charged higher interest rates because of increased risk. Also, check your credit report for incorrect information or identity theft. A history of current, timely payments can improve your credit score. Lenders prefer credit scores in the 700 to 800 plus range. In the case of a business partner or spouse with a low score, lenders will often analyze the lowest score or at best, average the scores. Thus, maintaining a strong credit score and a stellar credit report are important steps in improving your chances of receiving credit.

Improving Your Credit Score

How can one improve their credit score? First, make sure your payments are made on time as this accounts for approximately 35 percent of your score. If you have credit cards, allow three but no more than nine cards. Simply limiting the number of cards, you have will often improve or maintain your score. Remember, a credit card is an unsecured line of credit that can be used at your discretion. Be careful not to exceed 10 to 15 percent of the credit limit on each card, if possible. The top reasons for a low score are bankruptcy and medical collection issues. If possible, resolve any of these types of issues as quickly as possible. Do not cancel old cards even if you are not using them. This can result in your score being lowered by up to 25 points because length of credit history is a major factor. Remember, checking your credit score personally will not lower your score. However, several creditor and vendor credit checks, particularly over a short period of time, can be detrimental to your score. Lastly, be cautious in authorizing someone else to use your credit card because you could be responsible for any charges.

When checking your score, report any errors to the credit reporting agency immediately. The credit reporting agency must respond within 30 days. A customer can correct errors and enter a statement explaining the blemish on the credit report. Maintaining a good credit score and a clean report not only improves your ability to obtain credit but it also impacts insurance and sometimes even employment.

Business Entities

Frequently, producers ask, "What type of business entity is the best?" Well, although it may sound like an attorney's answer, it depends. The type of organization refers to how the business is legally organized; examples include sole proprietorship, partnership, corporation, or Limited Liability Company (LLC). Below is a quick overview of advantages and disadvantages of each organizational type. However, please consult with an attorney to obtain legal advice on the business organization type.

1. Sole Proprietorship

   A sole proprietorship is a business owned and managed by one individual. The advantages of this structure are that it is simply created, with a low-cost to maintain, offers maximum control, is easily dissolved and has a profit incentive of single taxation. The disadvantages include unlimited liability, limited capital and lack of continuity.

2. Partnership

   This entity involves two or more people who co-own the business. The general partners share ownership and management of the business. Partners have unlimited personal liability, an active role in management of the business, and there must be at least one general partner.

   Limited partners often are financial partners that do not participate in the day-to-day activities or management of the business. The financial liability is limited to the amount of the limited partner's investment.

   The advantages of a partnership include easy establishment, division of profits, pooling of resources (capital, abilities, etc.) and single taxation. Disadvantages are unlimited liability, difficulty to dissolve, potential conflicts between partners, and lack of continuity.

3. Corporation

A corporation is a separate entity apart from its owners that may engage in business and legal action, enter into contracts, and pay taxes. Advantages include limited liability of stockholders, ability to raise and borrow capital, ease of transfer, and indefinite continuity. Disadvantages are the cost of creation, required procedures, double taxation, legal requirements, and potential loss of control by founders. A C Corporation is a regular corporate structure and an S Corporation is a closely held family corporation.

4. Limited Liability Company or LLC

A LLC is a hybrid of the partnership and corporation, and can be similar to an S corporation. The advantage is limited liability, but not complete liability elimination as is often thought. This structure allows maximum flexibility and eliminates double taxation. The disadvantages can include the cost of creation and maintenance. Again, liability is only limited, not eliminated.

The following is a checklist that can be useful in preparing for your lender or for documenting your business.

Lender and Documentation Preparation and Planning Checklist

Item	Yes	No	In Progress	Expected Date of Completion
1. Business vision and core values				
2. Short and long-term goals: business, family and personal				
3. Up to date credit scores & reports				
4. Documentation of wills and insurance (life, health, disability, liability and compliance)				
5. Accurate disclosure of key business & personal information, i.e., pending lawsuits, divorce, etc.				
6. Business licenses and documentation of legal entities, deeds, partnership and corporate agreements, cattle registrations and crop records				
7. Current accurate balance sheet				
8. Current accurate income statement with tax records verified				
9. Projected cash flow with assumptions & estimates documented in writing				
10. Scenario testing with key assumptions (production, price, cost)				

PODCAST #3: Secure Documents: Security breaches are rampant. How important is it to secure your critical documents?

Make sure all electronic documents are well secured and backed up. If on paper, keep a backup file in a safe, convenient place known to all partners, spouses and stakeholders in the business.

A recent case brings relevancy to this factor. A young farmer lost his barn in a fire. In the fire, all livestock records, machinery maintenance logs and crop production records were a casualty as a result of not having a backup system. Regardless of how your records are kept, whether by a low tech or high tech method, backup and duplication is critical to keeping your records secure.

Selecting a Lender

In the side-by-side relationship, lenders and borrowers have distinct roles. A lender's role is multi-dimensional. As a lending organization, they tend to be **conservative** in the good times, **courageous** in the tough times, but **consistent** all the time. Drilling down to the qualities of a good lender, some other criteria are needed. They must be able to **calculate** the numbers, **critically think** about the results, and then **communicate** the outcomes internally and externally to borrowers. These 6 "C" criteria evolve into three main roles of a lender.

The first role of a lender is teacher. Cyclical volatility can provide teachable moments on finances, marketing, risk management, and overall strategic operations. A lender cannot assume all risk in the lending relationship which is why typically there is a down payment requirement. The business owner or operator must be willing to assume and shoulder the first line of risk. The lender must have up to date knowledge of the agricultural industry and trends, as well as develop an understanding of your operation.

The second lender role is that of a coach. As alternatives are identified, the coach will help provide the culture and environment needed, as well as encouragement when accomplishments are met or exceeded. The coaching role adds a valuable dimension, particularly in a downturn or as one watches the business over time. However, lenders can only provide options, not advice because that is potential lender liability.

The third lender role is a facilitator. In the past, some of the best lending outcomes were the result of working with other lenders such as Farm Service Agency (FSA) or even competitors to maintain a sustainable growth path. In this role, the lender can facilitate resources such as consultants and experienced professionals accustomed to working on the front lines and presenting alternative solutions.

Attributes of an Agricultural Lender

The following are some attributes that are important in selecting a lender for your ag lending needs.

Knowledge of Your Industry

Agriculture is a diverse industry, with each segment having its own unique needs. For a lender to make sound recommendations to you the borrower and also develop the best financial package for your business there must be common ground between the two of you upon which to start.

Choose a lender that has a stake in your industry! Their success should depend on ***your*** success. You should ask these questions: Can the lender quickly identify an unprecedented change occurring in the industry? Are they caught in a time warp, thinking only of yesteryear's agriculture? Do they have an open mind to new ventures in entrepreneurial agriculture? Have you seen them at industry trade shows? Do they sponsor events? In what ways are they active in the agricultural industry? The lender should understand your industry and your business, the risks involved with each, the production processes, and the cyclical nature of the business.

Capacity

A lending institution should have the capacity to meet your loan requests for current as well as future borrowing needs. Ask a prospective lender about borrowing limitations in relation to individual businesses, as well as how much they can lend in certain industries. Some lenders have specific loan limits established by policy or regulators. Some lenders might be able to get your business started, but will they be able to grow along with you?

Competitive Products and Services

Does your lender offer products that can be seen as a *cookie cutter* approach to lending – that is, the same for every borrower? Or, can their products be customized? Seek out a lender that provides loan products with competitive rates, and most importantly, flexible terms.

For example, repayment schedules should mirror the timing of cash flows for your operation. A good lender will customize loans to fit your needs and price loans recognizing the efficiencies of having multiple loans to a single customer. Consider a lender that offers quality services in addition to loan products. Services may include cash management tools, insurance products, investment products, retirement planning, and others. These additional products and services complement loan products and can save time and money, and also reduce risk to you as a borrower by creating a *total financial package* for your business.

Active in Special Lending Programs

There are several lending programs designed to assist young, beginning, small and minority farmers by offering special interest rates or favorable terms. Many of these programs are tied to government programs such as USDA Farm Service Agency (FSA) or state-specific ag development boards. Is the lender knowledgeable of these programs and an active participant in these programs? Is the lender a FSA Preferred Lender or Certified Lender?

PODCAST #4: Young Beginning Producer Education

Some Farm Credit associations and to some extent banks and other agricultural organizations offer educational and financial incentive program as incentive packages. For example, the class you are enrolled in is an example of what some investment progressive organizations are making into the future of the industry. These programs can provide the competitive edge if proactive engagement results.

Team Approach

In a time of mergers, acquisitions, staff retirements, and employee turnover, it is important to select a lender that can offer stability in a changing environment. Look for an institution that takes a ***team approach*** to servicing your account. This assures that more than one person at the institution is familiar with ***you*** and ***your operation***. There should always be someone on the staff acting as a backup in case the primary credit officer is unavailable or leaves the institution. Does the institution provide the culture to attract and retain a qualified staff that can meet your needs?

Interest Rates, Terms and Conditions

Be aware of hidden fees and prepayment penalties, the “Oh, by the way!” factors. There should be few surprises in the relationship. While having the lowest interest rate may give you *coffee shop bragging rights*, being able to obtain the lowest interest rate is only the tip of an iceberg. You need to ask other questions that help you compare “apples to apples” and tell you the rest of the story. Is your loan being sold to the secondary market or maybe to another lender? Is the lender only concerned with maximizing next quarter’s results or are they in business with you for the long term?

Honesty and Ethics

Throughout the whole loan process, open and transparent communication is imperative. Inform your lender upfront on issues and changes that may impact your ability to repay your obligations on time. Lenders do not like surprises, nor do business people. Liabilities that are not identified on the balance sheet, or assets sold out of compliance can create major problems. Often, borrowers will wait too long before taking corrective action to solve issues. Disclose information such as pending lawsuits, divorce proceedings, major medical bills/issues, and other life events such as births or deaths.

Strong character is imperative to young and beginning businesses as an offset for financial deficiencies such as limited equity or when embarking on a major expense or facing financial challenges. Relationship building and teachable moments can benefit both the borrower and lender as they work side-by-side.

PODCAST #5: Common Mistakes in Borrower/Lender Relationships

1) Purchasing new set of equipment with zero percent financing without telling your lender only to seek refinancing of the equipment.
2) Need money yesterday!! You purchased the livestock, equipment or land at auction without informing your lender and need the loan next week!
3) Failure to identify all liabilities such as account payables, credit cards, capital leases or loans from relatives.
4) Split lines of credit. More than 7 sources of credit is often an issue. Often one is robbing Peter to pay Paul.
5) Lender sponsored programs with a special invitation and you are a "no show" or you attend the meeting but you are distracted with your technology or personal agenda.

Lender Wish List

Mentors of individuals who have successfully completed the Ag Biz Planner were given a special challenge. What would be on a wish list that would assist in better understanding of an individual's business? The following is a compiled list from the exercise to provide food for thought. Lenders wanted:

1. A clear idea, preferably in writing, of the individual's vision, values, and short and long term goals.
2. Credit scores and reports for all individuals involved in the loan process.
3. Accurate business and personal balance sheets with documentation of pertinent supplementary data such as insurance coverage, business licenses and personal status.
4. A cash flow projection would make any lenders day, with possible scenario testing of prices, cost, interest rates and production levels.
5. If it is an existing business, then three years of records would be needed.
6. If non-farm income is utilized, then W-2, Schedule K or other schedules that would document investment income is needed.

As one journeys through the remaining modules, you will be exposed to more in depth learning about many of these items on the wish list. The key is to be able to use these items in better analyzing your business. These are all critical to working more efficiently side by side with your lender.