

Structuring Agricultural Loans

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Summary

Objectives

This module will discuss how to correctly structure various types of loans to benefit the borrower and lender. The learning objectives are to:

- Identify the key elements of loan structure.
- Recognize the different structuring tools and techniques.
- Explain different repayment terms and identify how repayment terms affect the risk of loan default.
- Understand the differences between structuring short-term, intermediate- and long-term credit.
- Discuss the elements of covenants and conditions
- Provide a brief introduction of how loan structuring can be used in troubleshooting for corrective action utilizing financial principles and concepts discussed in previous modules.

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Introduction

One of the most powerful tools at a loan officer's disposal is loan structuring. Loan structuring for new loan applications, whether it is for operating capital or refinancing, entails matching the terms of a loan package to the cash flow that will repay the debt and the purpose of the loan in a way that serves the interests of the borrower and the lending institution.

From the lender's standpoint, proper loan structuring may have several positive impacts on a particular loan:

- It may greatly improve the match between required payments and repayment ability and the long run or pro-forma liquidity of an operation.
- It may reduce the lender's risk exposure by improving the quality of a loan.
- It may provide a greater degree of control over the use of the loan proceeds and the client's borrowing practices
- It may improve the lender-client relationship by increasing the level of communication
- It may improve the long-term profitability of the loan package

The key determinants of loan structure are the loan purpose, the structure of the borrower's cash flow that will repay the debt, and loan security. The loan package should match the maturity of debt to the useful life of the asset (short-, intermediate-, and long-term). A lender must also meet collateral guidelines and other underwriting standards of the lending institution.

The two main tools for loan structuring are repayment plans and loan conditions or covenants. A loan officer should use these tools to construct a loan package that benefits the borrower and the lender.

Key Determinants of Loan Structure

When structuring an agricultural loan, the loan officer should consider loan purpose, loan security, repayment capacity and institutional regulation and policy. A loan officer should determine the most appropriate structure for a given loan. There are significant differences in the character of the repayment stream required for short-term credit and intermediate or long-term credit.

Loan Purpose

Loan purpose refers to the intended use of the loan proceeds. Borrowed funds may be used to pay operating expenses; to purchase operating supplies; to purchase breeding livestock, equipment or real estate; or to repay other debts. It is the loan officer's task to match the terms of the loan to the purpose of the loan. For example:

- Operating loans or lines of credit are structured as short-term debt.
- Machinery loans are typically structured as intermediate debt.
- Real estate and improvement loans are typically structured as long-term debt.

The loan term is usually at least partially determined by the loan purpose because it is the expected use of the loan that will normally generate the funds to repay the loan. If the

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asset purchased with the loan funds is used up before the loan is repaid, it cannot generate the funds to make the remaining payments. The producer is in the position of “paying for a dead cow.”

The loan officer should also be able to determine the actual manner in which the borrowed funds will be used. For example, a loan request may be for short-term operating needs, when in fact the loan proceeds are used to repay term debts, or as a down payment on capital asset expenditures. This situation is risky for the borrower and the lender. Careful analysis of the loan request and sound structuring practices will help to ensure the loan proceeds are used as intended. When evaluating loan purpose, it is useful to categorize the loan by considering whether the loan is for a claimable asset (asset-based), which could provide collateral, and whether the asset will generate sufficient cash flow to liquidate the loan (cash-generating).

While loan purpose is important to consider, it should not be the sole determinant in structuring a loan. There may be cases where loan purpose has very little impact on the structure of the loan. An example would be where carryover operating debt is rolled into a term loan. The initial purpose of the loan was operating supplies, but from a practical standpoint this is no longer relevant in structuring the new loan.

Loan Security

Loan security refers to collateral position. Collateralization is typically an overriding factor for most lenders. Guidelines for collateral are typically established by the loan policy or underwriting standards for the lending institution. Examiners and oversight people may also have collateral standards that may serve as guidelines for the loan officer. Collateral standards vary by institution, geographic location, economic conditions, and major enterprise. Thus, a loan officer must be aware of the institution’s internal policy, as well as regulator guidelines.

Assets that retain their values after purchase normally justify a higher percentage of loan to purchase price (loan-to-value) than assets that do not. For example, specialized structures, such as silos or livestock confinement facilities, are usually permanently attached to the land, have limited alternative use, and are not easily moved. As a result, these assets tend to have very low resale value. Thus, loans for specialized assets typically have lower loan-to-value ratios. In contrast, mobile assets, such as tractors, trucks, and combines, are easier to liquidate and may have multiple alternative uses; therefore, these assets tend to retain their value more than specialized assets. Loan-to-value ratios are typically higher for non-specialized assets. Land is the prime example of an asset that generally does not decline in value, and may actually increase in value over time. Thus, it frequently has a higher permissible loan to value ratio than other assets. An exception to these rules may occur in areas that have a high concentration of poultry or swine facilities and several strong integrators willing to place animals in these facilities. In this case, specialized facilities are the norm and may hold their value. The key is the uniqueness of the facility and whether changes or modifications would be needed before an integrator would place poultry or swine in the facility.

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The advance amount or down payment as a percentage of the acquisition price of capital assets needs to be carefully determined. Too little credit could prevent the borrower from making profitable investments in capital items. On the other hand, too much credit extended may increase the risk of higher debt payment load and can jeopardize the security of the loan if asset values decline. In some cases the borrower has been known to walk away from the agreement when liabilities are greater than assets.

Exhibit 1 lists typical loan-to-value ratios for different assets. Loan-to-value ratios are specified in the loan policy. It is important to note that loan-to-value ratios for current assets are somewhat dependent on the volatility in commodity price cycles. These percentages may be adjusted during extremes in the price cycle (peaks or troughs). If the loan officer is uncomfortable with the borrower's repayment ability, he or she may have the flexibility to use a lower loan-to-value ratio. This can protect the lender by reducing the amount of borrowed funds or by requiring a greater amount of collateral for a given loan request.

Exhibit 1:

Typical Loan-to-Value Ratio Ranges	
Type of Asset	Loan-to-Value Ratio
Farm Real Estate	65-80%
Machinery and Equipment	60-80%
Breeding Livestock	60-75%
Feeder Livestock	70-85%
Grain in Held for Sale	70-80%
Feed Inventory	50-70%
Growing Crop	Dependent on time of year or maturity of crop

Appendix A is an example of a typical borrowing base report focused on current assets for commercial or agribusiness accounts. A borrowing base report is used to determine the borrowing limit for the client by assessing the value of the borrower's assets. This particular report demonstrates an institution's philosophy regarding specific asset collateral valuations.

Loan maximums may be impacted by the nature of the asset that is taken as security and whether it is primary or secondary collateral. Condition, quality and geographic location of the assets may also impact maximum percentages. An example of how geographic location might impact loan maximums would be a loan for feeder cattle on grass in Montana versus a loan for feeder cattle on feed in Nebraska. Although both loans are for feeder cattle, the loan maximum might be higher for the Nebraska operation because it entails less risk than the Montana operation. The lender should also verify ownership of the assets. With more producers being incorporated, lenders must be careful to ensure the actual entity that owns the assets is a party to the loan. For example, in an integrated operation, the integrator may own the flock or herd; therefore, any funds loaned on inventory of the flock or herd must be made to the integrator, not the producer.

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Appendix B shows an example of a borrowing base report for current assets that may be used for production agriculture operations, such as feeder cattle operations. Note the loan-to-value percentages used for inventories as possible examples that can be utilized.

Repayment Capacity

It is always best to structure a loan in a way that it can be repaid. Thus, the expected repayment capacity of the business must be considered in determining the appropriate structure. A business with high leverage or modest repayment capacity will need longer than average terms. While some businesses need terms just a little shorter than they can handle in order to force “repayment discipline”, most will function best with terms they can meet. On the other hand a highly profitable business or one with little leverage may have lower interest costs and greater financial flexibility with a structure that involves rapid debt repayment.

Institutional Regulation and Policy

Each institution has charter or institutional regulations that establish limits on loan structuring. Within those limits institutions establish loan policies and guidelines that management believes are necessary to best meet the objectives of the firm. The character of the agriculture served, the source of funds, the character of the current portfolio, or the objectives of the firm may motivate these policies.

Main Tools of Loan Structuring

Just as a carpenter has “tools of the trade”, a loan officer has several loan structuring tools at his or her disposal. Sound use of these tools may greatly improve the quality of the loan by reducing the associated risk. The main loan structuring tools for an agricultural lender are repayment plans and special loan conditions and covenants.

Repayment Plans

The repayment plan is a powerful tool for the loan officer. Repayment plans may be tailored to individual loan requests to improve the quality of the loan. A repayment plan consists of:

- The term (maturity) of the loan
- The timing of payments
- The interest rate
- The method of repayment

Through wise application of these factors, the loan officer may positively impact the repayment ability of the borrower, as well as maintain a certain level of control over the loan. Furthermore, the terms of a repayment plan may be adjusted to improve the repayment performance of an existing problem loan.

Term (Maturity) of the Loan

The term of the loan depends on the purpose of the loan, as well as the borrower’s repayment ability. Operating loans or lines of credit typically have a term of one year or less. Loans for intermediate or long-term assets may range from one year to 50 years.

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Exhibit 2 lists average loan terms for intermediate and long-term assets, based upon research conducted at Cornell University, Virginia Tech and the University of Illinois.

Exhibit 2:

A Summary of Loan Repayment Terms and Maturities	
<u>Loan Purpose</u>	<u>Maximum Term</u>
Steers (Feeder)	1-1.5 years
Crops	1-1.5 years
Layer Hens	1-2 years
Dairy Cows	3-5 years
Beef Cows (Breeder)	3-5 years
Feeder Pigs, Veal Calves	6 months
Broilers	6 months
Sows and Boars	3-4 years
Equipment Affixed to Real Estate	10-15 years
Farm Equipment (new)	5-7 years
Farm Equipment (used)	3-5 years
Grain Storage Structures	7-15 years
Farm Real Estate and Buildings	15-50 years

A major problem in agriculture is scheduling repayment periods for relatively large loans. An example of this is an \$80,000 loan for machinery with a term of 3 years. Short payback periods reduce the overall interest cost to the borrower, but result in higher periodic payments. A borrower with strong repayment ability may be better suited for shorter payback terms. This allows the producer to build equity and provides a margin for adverse situations in the future should the situation go awry.

Longer payback periods increase the interest cost over the life of the loan, but the lower periodic payments reduce pressure on cash flow throughout the term of the loan. This may significantly improve the repayment ability (term debt and lease coverage ratio) of the borrower. However, if the term is too long the asset may be financed beyond its useful life. For example, with the rising cost of broiler houses, there is pressure to lengthen terms on poultry building loans; however, technological obsolescence makes longer-term loans much riskier.

Timing of Loan Payments

The timing of payments is a critical aspect of repayment plans. A loan officer should try to match the timing of the loan payments to the cash flow of the operation. For example, highly seasonal operations like cash grain operations and cow-calf operations may have only 1-2 periods of positive cash flow per year. Because the loan payments should coincide with the periods of positive cash flow, annual or semi-annual payments may be most appropriate for these operations. For operations with relatively constant cash flows, like dairies, feedlots, and greenhouses, quarterly or monthly loan payments may be more appropriate.

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If the timing of the loan payments does not coincide with the cash flows of the operation, the business is more likely to need larger operating loans. This may reduce the repayment ability (term debt and lease coverage ratio) and the profitability (net farm income) of the borrower. The bottom line is that loan payments should coincide with the cash flows of the operation.

Interest Rates

Interest rates are the third factor in repayment plans. The risk level of the loan, competition in the market and the current interest rate market determine the basic level of interest rate charged. The loan officer may have little flexibility in setting the rate or set of rates applicable to any particular business. However, in cases where the loan officer has some latitude, the interests of the producer and the lending institution must be considered.

The loan officer has a choice of fixed rate loans, variable rate loans or a combination of the two. Fixed rate loans transfer interest rate risk from the borrower to the lender by eliminating fluctuations in interest rates. The result is a reduction in the variability of the borrower's cash flow. The lending institution faces increased risk with the fixed rate loan because it is locked into a fixed interest rate for a given number of years. If the lender's cost of capital increases during this period, the profits from fixed rate loans will be reduced.

Variable rate loans leave all the interest rate risk with the borrower. As general interest rates move higher, the interest rate on variable rate loans adjusts upward. This limits the lender's risk exposure by allowing the lender to maintain a profitable spread. It also increases the risk to the borrower in the form of higher interest costs and/or higher periodic payments.

In most cases (when there is a normal upward sloping yield curve), fixed rates will be higher than variable rates. Depending upon money market conditions at the time the "premium" for a fixed rate may be large or small. The borrower and lender must decide whether the reduced risk is worth more than the premium that has to be paid.

Choice of fixed or variable interest rate loans depends on the repayment ability and sensitivity (5-5-3-analysis) of the borrower as well as current economic conditions. A borrower with marginal repayment ability or who is very sensitive to economic changes (revenues, expenses, or interest rates) may benefit more from a fixed rate loan than a variable rate loan. Another possibility for such a borrower is to use a hybrid loan – one that has a fixed rate in the first years of the loan and then switches to a variable or adjustable rate once the borrower is in a more favorable financial position. The Farm Service Agency and SBA along with Farmer MAC have programs that can be utilized to provide terms and rates that present more options to the borrower and institution.

Methods of Repayment by Loan Type

Operating (Seasonal) Loans

These are loans that finance the growing of crops and/or livestock (inventories). The cash from the loan is used to grow inventory. The inventory is eventually sold, creating one or

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more accounts receivable. The accounts receivable are collected and the seasonal loan is repaid.

Analysis: The primary focuses of the analysis are on the expansion and contraction of current assets and current liabilities. As current assets expand operating and/or trade credit may be used to fund the expansion. As non-cash current assets contract operating and/or trade creditors are repaid. The analysis of seasonal loans will often concentrate on the borrower's balance sheets, income statements and cash flows prepared on a monthly or quarterly basis. If balance sheets and income statement projections were not available at appropriate points throughout the year, a usable alternative would be to use a projection of current assets and current liabilities.

A line of credit or revolving line of credit can be used with the amount sufficient to meet peak needs. The maturity of the note should coincide with the low point in the current asset/current liability cycle (operating cycle), when it is anticipated the operating and trade creditors will be paid out. The cash flow statement covered in a previous module can be used as a tool to develop a strategy and plan.

Collateral: Normally seasonal loans are secured by a perfected security interest in accounts receivable, inventories (crops and/or livestock), and equipment. Real estate is often taken as secondary collateral as needed or required by institution policy. Annual lien searches are usually performed.

Servicing: Seasonal credits are usually easy to service. The lender should know when the loan will peak and when it will pay out. Periodic reporting from the borrower should concentrate on weekly, monthly or quarterly balance sheets, with detail on assets produced and/or held for sale, and cash flow variance reports. Visits to the borrower's place of business are usually appropriate.

The operating and/or trade creditors sometimes are not paid out at the end of the operating cycle. The following are some of the more common problems.

- Yields and/or prices are below projections and the borrower failed to take steps to reduce this business risk.
- The project cannot be sold due to obsolescence, spoilage, etc.
- Accounts receivable cannot be collected.
- Cash from the operating cycle is used for other purposes such as to retire other debt, pay dividends, purchase fixed assets, etc.

Even if the loan is paid as scheduled, the loan officer should keep track of these occurrences because they are often good indicators of business performance.

Facility, Long-term Capital and/or Working Capital Loans (Term Loans)

These loans are generally used to finance both depreciable and non-depreciable fixed assets. They can also be used to fund an expansion, ownership change, pay estate taxes, amortize a previous loss, etc. Term loans are repaid from the cash generated from earnings over one or more operating cycles.

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Analysis: While the analysis of seasonal credits concentrates on balance sheets and periodic cash flows, the analysis of capital credits is focused on the income statement. With adequate working capital a seasonal loan can be repaid despite an operating loss; however, a term loan is repaid from the earnings over the life of the loan and/or asset. The term loan analysis should concentrate on long-term cash generation and include a break-even and sensitivity analysis.

The term loan analysis should provide the loan officer and/or loan committee with a good understanding of the business's management, industry, and markets, as discussed in the Strategic Risk Management module. Key management issues are the ability to plan for the future and the flexibility to react to a changing environment. The lender should understand the industry well enough to know what could cause failure in the business. An understanding of the final uses of the company's products and what might cause a change in consumer demands is also relevant to the analysis.

The guiding principle in setting the payments and final maturity of a term loan is to obtain full repayment in as short a term as possible consistent with maintaining borrower liquidity, profitability and solvency. Many borrowers ask how long they can take to repay when they should be asking how quickly they could realistically repay the debt.

When financing fixed assets, the borrower and lender should ensure that the loan is repaid before the useful life of the asset financed has ended. The borrower must maintain financing flexibility. Nothing can be more constricting than being faced with the need to finance new assets while debt is still outstanding on obsolete assets. The borrower should be encouraged to work debts down as rapidly as possible so that they are always in a position to borrow again when conditions require or warrant. The useful life of an asset is often determined by technological obsolescence. For example, many stanchion or tie stall dairy barns financed over 20-25 years in the 1960's and 1970's were obsolete before the loans were repaid.

Term loan payments should be as frequent as possible with monthly or quarterly payments. The earlier a problem can be addressed the greater the probability it can be fixed; However when incomes are received once per year, an annual payment may be more appropriate, for example in grain, tobacco, fruit or cow-calf operations.

Collateral: The term loan is generally secured by a perfected lien on the borrower's real estate, facilities and/or equipment. The lender must estimate the useful life of the asset being financed and ensure that the loan is retired well before that asset becomes non-productive. The depreciable life of the asset is also important to loan structure. If the depreciable life is much shorter than the loan term, the borrower may not be able to service the debt because taxable income will increase when depreciation ceases. Collateral is generally taken to control cash flow and provide a secondary source of repayment should the loan repayment break down. As a secondary source of repayment a loan officer should consider valuing the collateral at its net realizable value after selling cost or fees in distressed conditions.

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In cases where a major change in the business is being financed, it may be best to consider a complete refinancing of the business. In that case, the life and value of the new assets is important only as they contribute to the total assets provided as collateral. It is important to assess the realizable value of the entire set of assets offered. Care must be exercised to be sure that any prior liens are repaid or accounted for. The appropriate term of the loan will depend upon the expected life and character of the assets. An “after acquired property clause” will often lengthen the maximum allowable loan terms for some asset classes, such as breeding livestock and machinery.

Servicing: In many cases, a term loan agreement is useful. The agreement spells out the terms, conditions, expectations, and responsibilities of both parties and sets forth the remedies available to the institution if the agreement is breached. The loan agreement defines the relationship between the borrower and the lender, and violations should not be taken lightly. Covenants should not be overly restrictive or so loose as to make them useless. They should also not be included unless the lender plans to follow through on the remedies indicated if the covenant is violated. The loan agreement is an excellent tool for maintaining communications with the borrower and controlling the risk in the loan. However, if the institution feels that a loan agreement is not necessary due to the financial condition and earnings of the borrower, the institution can forgo the loan agreement. Written agreements between the institution and the borrower can also be an effective communication tool.

The requirement of frequent, periodic payments provides some degree of servicing, as a delinquent payment is an obvious red flag. However, rather than waiting for a delinquency, the lender can scrutinize the loan through the loan agreement. Almost all loan agreements call for frequent, periodic financial reporting for covenant compliance purposes. These financial reports should be reviewed not only to measure compliance with the loan agreement, but analyzed for any adverse trends that may be developing.

In addition to periodic payments and financial reporting, an annual (at a minimum) visit to the borrower’s business should be required. This provides an opportunity to enhance communications with the borrower, initiate more business development, and allows the account officer to evaluate the facilities and observe how they are being maintained.

If these annual assessments find that earnings have become insufficient to cover debt servicing, or working capital has declined to the point where cash resources are inadequate to cover the debt servicing shortage, the cause(s) of the change should be investigated. Some alternatives to consider are listed below.

- Sales volumes may have dropped below the borrower’s break even level.
- Gross margins may have narrowed due to declining sales prices and/or increasing cost of goods sold.
- Fixed assets may have become obsolete or used up and the corresponding loans have not been liquidated.
- Overhead may have expanded more rapidly than sales.

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- Over-leveraging may cause interest expense and debt servicing to exceed income levels.
- Income may be used to expand into unprofitable areas or spent on non-earning assets like vacations, boats, etc.

Bridge Loans

These are loans, including construction loans, which bridge a gap until a specific event occurs that repays the loan. Bridge loans are paid from three different sources.

1. Refinancing the bridge debt with a committed term loan either from the originating lender or another lender. With construction financing this is a normal type of repayment.
2. Sales of non-current assets. This can sometimes be accomplished when the borrower is purchasing real estate and selling another parcel, for example, this may occur with a timber loan. The parcel being sold should be under contract when the bridge loan is closed.
3. In some cases, the bridge loan is repaid through the infusion of equity. In this case the equity can come from the addition of additional owners in a closely held business or the issuance of stock for a publicly traded company.

Analysis: The analysis should concentrate on two areas. The first is an analysis of the event that needs to occur for the bridge loan to be paid out. The lender should consider the probability that one of the three repayment sources listed above will happen and the loan will be liquidated as agreed. The second concentrates on the ability of the borrower to repay the loan on terms should the bridge loan not be liquidated as agreed. In other words, consider if the borrower can service a term loan the size of the bridge loan, within the useful life of the asset being purchased, and if the term loan would be within the institution's policies.

These loans are normally structured with the maturities that coincide with the repayment event. When the bridge loan comes due, the loan is to be paid in full. If the loan is not repaid, either the event has been delayed or a failure has occurred. Interest on bridge loans should be kept current, preferably monthly.

Collateral: When the repayment event is a refinance, the collateral for the loan is usually the asset being financed. This collateral not only gives the lender the assets being financed but helps control the proceeds of the new loan because the long term lender will need a release of the lien before, or at the time of, the long term loan closing.

If repayment is to come from the sale of another non-current asset both the asset being financed and the asset being sold should be taken as collateral. Where equity infusion is anticipated the lender should ensure, through a loan agreement or other mechanism, that the proceeds from the infusion are used to repay the loan. In this case the asset being financed should also be taken as collateral for the loan.

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Servicing: Servicing of bridge loans is dependent on the type of each loan (home construction, grove development, etc.) being extended. Each loan will normally have a servicing plan specific to the credit. In all cases, however, payment in full is expected on maturity of the note.

Potential problems generally result in the non-occurrence of the event anticipated to pay out the loan. Some examples include:

- Failure of the asset to sell
- Sale at less than the anticipated price.
- Prior liens on the asset or divergent claims, such as a divorce situation.
- Uninsured damage to the asset intended for sale.
- Lack of firm commitment to refinance.
- Inability to meet all contingencies of a financing commitment.
- Inability of the other lender to meet its commitment.
- Abrupt increases in the borrower's interest rate which makes it difficult for the borrower to service the debt.
- Inability to sell additional equity.

If the event expected to repay the loan does not occur, and the borrower does not have the ability to service the debt, the lender does not usually have a valid secondary source of repayment.

Committed Revolving Lines of Credit (RLOCs) (Inventory and/or Accounts Receivable Loans, Permanent Capital Loans, Asset Based Loans)

These loans are used to finance current assets and/or pay current liabilities in which the loan should always be secured by the liquidation value of the inventories and/or accounts receivable. The term "permanent capital loan" is used because the loan is really a substitute for owner's equity. When making these types of loans the lender should be cognizant of the following:

- Advances should increase current assets or decrease current liabilities. Any other uses should be handled through other types of loans.
- The loan should truly revolve based on the normal, seasonal fluctuations of the current assets.
- Constant scrutiny is required to ensure appropriate margins are maintained.

With a permanent capital loan, repayment is indefinite, so the lender's ability to withdraw from the loan is questionable at best. One means of repayment is the eventual conversion of the loan into a term loan, which assumes adequate underlying earnings ability to service the term debt.

One method of controlling repayment is to give the RLOC a term, such as five years, with repayment amortized over that term, and require annual renewal of the RLOC. The annual renewal can also be used as a time to adjust the maximum balance to fit the needs of the business. If the RLOC is not renewed, it automatically becomes a term loan (in our case, with a five year term).

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Another means of repayment is refinancing with another lender. This normally means the company is showing earnings and performing on its loans.

The final source of repayment, if the company is consistently unprofitable, is the liquidation of the company or at least the unprofitable enterprise.

Analysis: The analysis should concentrate on the following areas:

- Management – because the debt level is usually heavier than normal, management must be experienced and flexible. It must be willing to adapt quickly to rapidly changing environments.
- Long-term earnings – Once the business stabilizes, eventual repayment of the loan will come from the earnings. Without earnings, liquidation of the assets may be the only source of repayment.
- Internal controls – The lender relies on frequent borrower generated reports, therefore, accurate, timely reporting mechanisms are required.
- Periodic valuation of the assets being financed.

Loan Facilities: Permanent capital loans are generally secured RLOCs with the maximum amount of credit available based on an agreed to lending ratio between the assets used to secure the loan and the loan balance. The guiding principle of this type of credit is that advances are made only on proof of adequate secured assets. Cash receipts are generally applied to the loan and re-advanced as needed within established lending criteria. Interest is collected frequently with monthly payments preferred. The terms of the loan, the borrowing base, reporting requirements, and covenants are contained in a loan agreement that is a must with this type of lending.

The advance rate on inventories for this type of loan is a function of the type of assets being financed (cattle, machinery, finished goods, goods in process, raw materials, etc.), marketability of the inventories and/or perishability of the goods. Where accounts receivable are used in the borrowing base, the lender must consider the credit terms used, the aging of the accounts receivable, and how much concentration is allowed.

Collateral: Collateral for these types of loans will normally be a perfected lien on the assets financed. Additional collateral may be required.

Servicing: Once the valuation (eligibility) of the assets has been agreed on, the lender should develop a borrowing request form containing a certification of inventory and/or accounts receivable levels. Advances should not exceed the previously agreed to borrowing base. Inventory and accounts receivable reporting from the borrower should be required monthly and financial reporting at least quarterly. Periodic visits to the place of business should be made to confirm the inventories. Periodic audits of the accounts receivable should also be completed.

What can go wrong?

- Inventories become obsolete or damaged.
- Receivables cannot be collected.

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- The market value of the assets decline more rapidly than the periodic reports indicate.
- Loan proceeds are used for other than the intended purpose thereby exposing the borrower to additional debt servicing that the business may not be able to handle.
- The business may not be sufficiently profitable to service existing debts thereby eroding working capital.
- Fraudulent inventory and/or accounts receivable reporting.

Financing Integrated Livestock

These loans are primarily used to finance either the initial construction or purchase of poultry or swine facilities. These facilities are used to produce animals or eggs on a contract basis for large companies like Tyson Foods, Smithfield Foods, Perdue Farms and Pilgrim's Pride. In integrated operations the animals being grown, the breeding stock and/or products generated are owned by the integrators. The integrators supply the feed, veterinary care, and medicines. Some integrators pay a portion of operating expenses. The grower and owner of the facilities provide the facilities to grow the animals as well as electricity, gas and fuel for heating, labor for care of the animals and other operating expenses.

Analysis

While the analysis of the grower's financial condition is important, the analysis on facility loans should concentrate more on the income producing potential of the facilities being financed. A key component in facility financing is the strength and stability of the integrator as well as the capital investment of the integrator in the geographic area where the facilities are being financed. Since the integrator is the source of the repayment for the lender's loans, the integrator needs to be financially sound. The integrator should have enough invested in infrastructure such as feed mills, hatcheries, etc. to show that they have a commitment to stay in the area. Another important factor is the number of integrators in the area that could and would be willing to contract with a grower to use their facilities. The more integrators that are in an area, then the more options a grower has if the current integrator has financial problems or decides to leave the area. The terms offered on new facility loans normally range from 10 to 15 years. A major consideration on the term given on existing facilities being purchased or refinanced should be the remaining economic life of the facility, equipment, and fixtures.

The loan analysis should include an analysis of the integrator, the current state of the industry as well as the financial condition and repayment capacity of the borrower. Quite often loans are made for the full cost of construction or purchase price for the facilities and, while in most cases the facilities will have the income producing capacity to repay the debt for its construction or purchase, there is limited additional net cash flow available for servicing additional debt or living expense.

When financing integrated facility operations it is important for the borrower to have a long-term contract with the integrator, preferably with a term greater than the term of the loan being made. An assignment of payments from the integrator should normally be required in a sufficient amount to service the loans being made. Typically the integrator

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will send the check directly to the lender. To eliminate interest rate risk, fixed interest rates should be encouraged on loans with weaker repayment margins. If loans are made on a variable rate, assignments should be set at a level that will be high enough to cover a rate increase of 2 to 3 percent.

Many types of facility loans such as sow farms and breeder egg operations have a fairly constant cash flow and may be scheduled with monthly payments. Some poultry operations may be suited for quarterly payments as they produce 4 flocks per year but most need to be placed on annual payments because of placement cycles that do not correspond with either monthly or quarterly schedules. The key is to have a properly executed assignment in place to capture the cash flow and apply funds to the loan when cash flow is available.

As with any confinement facility for livestock, waste management and bio-security for integrated facilities is a concern. Normally integrators have rules and guidelines that must be followed to protect their animals. The integrators employ farm supervisors that will visit the operations periodically to provide expertise and guidance in production, animal health and farm management. The success of an operation is often dependent upon their willingness to comply with the recommendations of the integrator. While the integrators provide some expertise and monitoring in regards to waste management the growers are primarily responsible for waste disposal and environmental issues. Compliance with state and local regulations and rules is critical. When facility loans are made the borrower should have a current waste management plan and all applicable licenses and permits. Failure to comply with environmental laws and regulations can cause possible fines and penalties and if serious enough, closing of the facility.

Collateral

Loans for facility financing are normally secured by a lien on the real estate where the facilities are located along with the fixtures and equipment associated with those facilities. Collateral requirements should be based on the overall financial strength of the borrower and the term of the loan. Loans with weaknesses in equity (less than 35%) and a relatively high loan to value (higher than 85%) should normally be enhanced with an FSA guarantee. Access to these types of operations is critical and liens should be perfected on the physical right-of-way to the facilities. Because the need to provide feed to animals and removal of the animals for sale is a necessity the physical and legal access to the security need to be the same. In cases where adequate land to dispose of the waste generated by that facility is not on the farm where the swine facilities are located, liens should normally be perfected on the spray fields for swine facility loans where the waste is to be spread.

Special Loan Conditions or Covenants

While the choice of repayment plan may give the lender some control over a loan, loan conditions or covenants provide a broader degree of control. The required degree of control will vary depending upon credit risk factors, past history, and experience with the borrower.

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Effective covenants and conditions are usually designed to mitigate a weakness in the credit. Covenants and conditions should be in writing. They should be used as a two-way communication tool and not so comprehensive that they are too controlling on the borrower. Some recommend the limit of three to five covenants or conditions. The covenants and controls should discuss who, when, where, how, and what; any follow-up needed; and how they will be executed.

Covenants should be tailored to the specific business, not just thrown in as lender “boiler plate.” The “borrower burden” of reporting and similar covenants should be considered. For example, requiring weekly or monthly complete financial statements for a greenhouse operator could be burdensome and provide a lot of information the lender would not use. Requiring a detailed list of current assets and accounts receivable could be a good indicator of business performance and loan security. Covenants should also be included only if the lender is willing to follow through with the indicated penalty if the agreement is violated.

Frequently loan conditions and covenants are used to:

- Ensure that loan proceeds are used as agreed.
 - Example: Operating loans must be used only for supplies and operating expenses
- Restrict purchases or limit the dollar amount of purchases
 - Require prior consent of lender for large purchases (i.e. all machinery or real estate)
- Control borrowing from, and pledging of security to, other creditors
- Ensure revenues are used to repay current debt
 - Example: Accounts receivable may be assigned as part of security. Assignment of receivables or income from an integrator or marketing cooperative to the lender is common on dairy, swine and poultry operations.
- Ensure that excessive funds are not withdrawn from the business – either for family living, salaries and dividends or as equity withdrawal from the business
- Require information – monthly, or quarterly financial reports, or notification of changes in ownership, legal status, or financial condition
- Specify performance requirements – ensure that sound business practices are maintained (record keeping, business size) or that certain production or agricultural practices are followed.
- Define collateral requirements – maximum debt/asset ratios, inventory requirements, number of animals to be maintained, maintenance of collateral, fire/medical/disability insurance coverage
- Specify lender concerns about the business – negative trends, marginal collateral, poor management practices or performance, lack of partnership agreement
- Define payment and liquidity requirements
 - Timing of payments
 - Handling delinquency
 - Maintaining or reducing the level of open accounts
 - Maintaining a certain current ratio/working capital level or term debt and lease coverage ratio

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- List requirements for asset liquidation or sales – timing, use of proceeds, releases, sales efforts
- Indicate expectations and limitations on use of line of credit or advancement of funds
- Specify extension or deferment requirements and agreements
- Indicate what is required for continued financing

Troubleshooting

Despite your best efforts at structuring a loan, occasionally problems arise. At such times loan structuring may be one of the loan officer's most powerful corrective tools. With a challenged credit the main determinants of loan structuring are cash flow and loan security. The original purpose of the loan has little to do with the loan structuring for a marginal or problem loan.

In some cases the repayment problems are best addressed with a careful assessment of the profitability and management of the business. The basic issue may be a need to make significant changes in the operation of the business to make it more profitable. This will be the best long run solution. However, changes in loan structuring can often provide a short run solution to the current problems and give management time to make the necessary changes.

The following section describes how a loan officer might use loan structuring for marginal or problem loans to improve the situation. See Appendix C for a matrix of possible corrective actions for marginal or problem loans.

Poor Liquidity

Poor liquidity, as measured by the current ratio and working capital, may be improved through loan structuring. The two general causes of poor liquidity are relatively low current assets or relative high current liabilities. Loan structuring has a much greater impact on reducing current liabilities than it does in impacting the current assets. Possible strategies are:

- Extend the term (years) of the loan, thereby reducing the periodic loan principal payments
- Convert to a fixed rate loan, thereby reducing volatility in principal and interest payments.
- Utilize a graduated payment repayment plan, lowering the periodic payments until a more secure financial position is achieved
- Institute single-purpose financing for operating funds, as a means to control spending
- Use of covenants and loan conditions to control spending and borrowing, and maintain increased communication with the borrower
- Request sale of excess or unproductive intermediate or long-term assets, using the proceeds to pay down existing debts or maintain a cash reserve
- Roll operating debt into term debt, thereby lowering the current portion of principal due (note: this strategy must be carefully analyzed before implementation!)

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Be cautious when analyzing liquidity. A loan officer must determine whether a poor current ratio or insufficient working capital is due to loan structure, asset structure, or possibly due to the time of year when the balance sheet is constructed. For example, a grain producer may have a relatively poor current ratio just after spring planting due to a large operating loan balance and very low value of crops in the field. However, if crops are valued at the amount invested in the crop, there will be less impact on liquidity

Also, it is a deterioration of liquidity more than the specific level of liquidity that is of concern. Because the character of the business and the style of management can result in quite different levels of liquidity, any particular level of liquidity needs to be assessed with care. However, a sudden decline in liquidity from historical levels is usually a danger sign.

Poor Repayment Performance

Changes to the existing loan structure may dramatically improve the repayment performance of the borrower. Possible options are:

- Reduce periodic loan payments by:
 - Extending the term of the loan
 - Use of amortized or graduated payment repayment plans
 - Use of fixed rate loans instead of variable rate loans
- Use of covenants to monitor the borrower's cost control and non-farm expense
- Refinance split credit accommodations into a single loan with a lower payment than the combined payments of existing loans

Cash Flow Problems

Occasionally a borrower will have significant cash flow problems that are not evident from the main financial ratios. In such cases, detailed analysis of the borrower's cash flow statements is crucial. Loan structuring may be of help in correcting or easing these cash flow pressures. Possible corrective actions include:

- Matching the timing of loan payments to the periods of positive (surplus) cash flow
- Extending the term of the loan to reduce periodic payments
- Using amortized or graduated loan repayment plans to lower the periodic payments
- Use of covenants to monitor non-farm expenses and other spending or purchasing practices
- Approve an operating line of credit to cover all payment needs. This must be done with care to ensure that it does not just convert a cash flow problem to a longer run leverage problem.

Poor Sensitivity

Many operations are relatively sensitive to changes in revenues, expenses, and interest rates (5-5-3 Analysis). In these cases, loan structuring may be of great help in stabilizing cash flows and reducing overall variability. Loan structuring practices that may help a borrower who is sensitive to changes in economic factors include:

- Using fixed rate loans to reduce variability in interest expense and/or the amount of the periodic loan payment

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- Tailoring a repayment plan to the cash flow fluctuations of the business by increasing payments during good times and allowing lower, possibly interest only, during times of low inflows.
- Amortized or graduated repayment plans to stabilize the amount of the periodic payments
- Covenants to help monitor and control spending and purchasing practices
 - Require sale of inventory at current prices to reduce price speculation
- Require marketing plans or crop insurance to eliminate down-side risk

Poor Collateral Position

Loan structuring may have limited impact on cases where collateral position is a problem. However, certain strategies may help to improve the situation:

- Use of accelerated repayment plan to improve the solvency position more rapidly
- Use of covenants to monitor and control sale of assets and additional borrowing
- Use of FSA and SBA guarantees to lock in the value of collateral over a longer period of time

Poor Profitability and/or Financial Efficiency

Poor profitability and financial efficiency is difficult to improve through loan structuring. Possible strategies to improve the financial condition typically include methods of reducing annual interest expense. Possible actions include:

- Use of level principal payment plan to reduce interest expense over the life of the loan
- Fixed rate loans to reduce variability of interest expense

Poor Credit Management

Some problem loans may be avoided by thoroughly investigating the borrower's credit history. However, history does not always provide a clear picture of the future. In cases where loan problems arise due to poor credit management, or recent credit problems, loan structuring may have a positive impact, mainly through the use of conditions and covenants.

- Covenants to monitor and control spending and borrowing practices
- Covenants to increase lender-borrower communication
- Refinance the build-up of credit card debt

Summary

Agricultural lending is a two-way street. That is, it requires teamwork between the borrower and lender to ensure loans and other financial obligations are planned and executed successfully. This requires loan proceeds be utilized for intended purposes and financial obligations be structured with conditions and covenants that optimize both the lender's and borrower's ability to conduct business in a sustainable manner in a globally competitive environment.

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Appendix A:

Borrowing Base Report

For Commercial or Agribusiness Operations

Name: _____

Accounts Receivable

Date: _____

(70%) 0/30-day Accts. Rec.	_____	x .70	=	_____
(70%) 31/60-day Accts. Rec.	_____	x .70	=	_____
(50%) 61/90-day Accts. Rec.	_____	x .50	=	_____

TOTAL LOAN VALUE OF OUTSTANDING ACCTS. REC. (A) _____

Inventory

Fertilizer Inventory	_____
Chemical Inventory	_____
Feed Inventory	_____
Seed Inventory	_____
Misc. Inventory	_____
Plus Prepaid Inventories	_____

TOTAL INVENTORY VALUE (70%)	_____
(Less Payables)	- _____
NET INVENTORY VALUE (70%)	_____

(B) _____

Combined Borrowing Value:

Total A/R Loan Value	(A) _____
Total Inventory Value	(B) _____

TOTAL _____

Amount of Loan Outstanding	- _____
Borrowing Base Margin	_____
Borrowing Limit	_____

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Appendix B:

Borrowing Base Report For Production Agriculture Operations

Name: _____

Accounts Receivable

Date: _____

(80%) 0/30-day Accts. Rec.	_____	x .80	=	_____
(70%) 31/60-day Accts. Rec.	_____	x .70	=	_____
(50%) 61/90-day Accts. Rec.	_____	x .50	=	_____

TOTAL LOAN VALUE OF OUTSTANDING ACCTS. REC. (A) _____

Inventory

(80%) Livestock Held for Sale	_____	x .80	=	_____
(90%) Grain Inventory	_____	x .90	=	_____
(75%) Feed Inventory	_____	x .75	=	_____
(80%) Seed Inventory	_____	x .80	=	_____
(50%) Roughage Inventory	_____	x .50	=	_____
(60%) Misc. Inventory	_____	x .60	=	_____
(70%) Plus Prepaid Inventories	_____	x .70	=	_____

TOTAL INVENTORY VALUE (70%) _____
(Less Payables) - _____

NET INVENTORY VALUE (70%) (B) _____

Combined Borrowing Value:

Total A/R Loan Value (A) _____

Total Inventory Value (B) _____

TOTAL _____

Amount of Loan Outstanding - _____

Borrowing Base Margin _____

Borrowing Limit _____

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Appendix C

Possible Corrective Actions for Challenged Credits								
Financial Problem	Lengthen Term	Lower Interest Rate	Conditions/ Covenants	Combine Split Lines of Credit	Added Collateral	FSA Loan Guarantee	Reschedule Periodic Payments to Match Cash Flow	Fixed Rate
Poor Repayment Ability								
Low Farm Revenue	X	X	X	X	X	X	X	X
High Farm Expenses	X	X	X	X	X	X	X	X
High Non-Farm Expenses			X	X				
High P&I Payments	X	X	X	X	X	X		
Poor Sensitivity								
Revenues	X	X	X	X	X	X	X	
Expenses	X	X	X	X	X	X	X	X
Interest Rates		X	X	X	X	X		X
Poor Liquidity								
Low Current Assets			X	X	X		X	
High Current Liabilities	X	X	X	X	X		X	X
Poor Collateral Position								
Poor Collateral Position			X	X	X	X		
Poor Profitability								
Low Revenue	X	X	X	X	X	X	X	X
High Expenses	X	X	X	X	X	X	X	X
Unproductive Assets			X	X	X			
Poor Financial Efficiency								
High Expenses			X	X		X		
Low Revenues			X	X	X	X		
Poor Credit History								
Multiple Credits			X	X	X			X
Poor Repayment			X	X	X		X	X
Excessive Consumer Debt			X	X	X		X	X

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CA07 War Stories (Interspersed throughout Flash module)

1. Can a lender have too many covenants and conditions on a loan?

Yes. Historically I have observed some loan agreements with up to 20 different covenants and conditions, particularly on marginal credits. Three to five conditions and covenants that are focused on the weaknesses of the credit are preferable. This reduces the complexity and increases communication and focus by both the borrower and lender. The borrower knows what is important and does not feel the lender is “including everything but the kitchen sink.”

2. What are the biggest mistakes made when developing covenants and conditions?

Again, requiring too many conditions and covenants is one of the major mistakes. By far the biggest mistake is requiring a covenant and not following through by enforcing it. In the farm crisis, lack of follow up by the lender frequently led to communication problems, which in turn sometimes ended up with the courts favoring the terms of the borrower. Timely follow up and communication are the keys.

3. If you restructure, refinance or consolidate lines of credit, what potential problems must you avoid?

If not properly monitored the producer frequently reverts back to utilizing accounts payable and credit card financing, which is usually a result of poor profits as a result of marginal management or just poor credit management. I have seen cases where a lender consolidated and restructured debt and then in three years, the same challenge raised its ugly head. Timely financial statements and close attention is needed.

4. Can a lender finance a capital asset for too long of a period?

Yes, with increased capital expenditure cost and tighter margins, longer terms of financing are requested to make the repayment plan work. In some cases such as with poultry, hog or dairy facilities and equipment, the facility will become technically obsolete before the loan matures, frequently resulting in lower production efficiency. In some cases integrators have resorted to dropping the contracts leaving the producer with an obsolete facility and no access to markets or lack of competitiveness, which drives them out of business.

5. How does the analysis of seasonal credits differ from the analysis of capital credits?

Seasonal credits focus on balance sheets, particularly in the current asset side and periodic cash flow generated from the sales of these assets. Capital expenditures and loans on the other hand have emphasis on the income statement or profits generated. Reoccurring net income is critical over the life of the loan for capital loans. While even

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though a farm could show an operating loss, it could make a seasonal loan payment if it has working capital.

6. Are there situations when interest-only loans are a necessary tool in debt structuring?

Yes, in a startup business, with a young and beginning producer or during the transition or expansion, interest-only loans can be utilized. In some cases, lenders will resort to this method of debt structuring in problem loans if other credit criteria are being met. The interest-only minimizes debt servicing to provide flexibility so that borrowers can take advantage of opportunities to generate revenue or reduce cost.

7. In loan structuring and servicing, lenders sometimes require insurances. What are your thoughts?

Make sure you have a logical strategy for requiring certain insurance coverage to get the borrower's buy-in. "Key person" insurance is often logical for individual proprietorships where the success of the business is highly dependent upon one personality or management style. Frequently a spouse is more receptive to insurance because he or she has the most to lose. You need to consider disability insurance. A person is more likely to be disabled on a farm or ranch than to die.

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