
Understanding Credit and Preparing for Credit Applications

March 21, 2013

John Phillips
First Americans Land-grant Consortium (FALCON)
Announcements

• Supported by the Christensen Fund: Strengthening the capacity of Native producers on the Colorado Plateau.

• Next Webinar:
  – Farm-to-School Best Practices – April 25

• Post-webinar evaluation
Food Sovereignty Summit: collaboration for Sustainability

- Sharing best food systems and Native communities
- **When**: April 15-18, 2013
- **Where**: Green Bay, WI
- **Training Tracks**:
  - **Track 1**: Sustainable Agricultural Practices
  - **Track 2**: Community Outreach and Development
  - **Track 3**: Business Management, Finance and Marketing
- [www.firstnations.org/summit](http://www.firstnations.org/summit)
“A bank is a place that will lend you money if you can prove that you don't need it.”

Bob Hope
Actor & comedian (1903 - 2003)
Learning Outcomes

1. Understand credit as a wise business management tool.
2. Understand the use of short-, intermediate-, and long-term business credit.
3. Understand how to prepare for a credit application.
Who Are We?

• Which of the following best describes your professional role/organization?

  a) The principal owner/operator of an agricultural business.
  b) A non-profit technical assistance or service provider.
  c) An educational institution that supports agricultural business development.
  d) A local community-based group or organization.
  e) Some other role/organization.
Who Are We?

• About how long have you been in your current professional role/organization?
  a) Less than two years.
  b) Between two and five years.
  c) Between five and ten years.
  d) More than ten years.
Who Are We?

- Which of the following best describes your primary agricultural focus?
  a) Farming of row and/or field crops.
  b) Ranching and/or hay production.
  c) Community and/or household gardening.
  d) Forestry and timber production.
  e) Fisheries and/or aquaculture.
  f) Some other agricultural focus.
  g) Multiple focus; no primary focus.
Who Are We?

• Which of the following best describes your geographic region?
  a) Pacific Northwest.
  b) Southwest.
  c) Plains/Midwest.
  d) Southeast.
  e) Great Lakes/Woodlands.
  f) Northeast.
  g) Alaska
Who Are We?

• Which of the following best describes your experience with agricultural and business credit?

  a) Have applied for ag. credit in the past.
  b) Have **NOT** applied for ag. credit **BUT** plan to in the future.
  c) Have applied for non-ag. business credit in the past.
  d) Have **NOT** applied for non-ag. credit **BUT** plan to in the future.
I. Understanding Credit as a Wise Business Tool

• Business credit *used wisely* has many advantages. It can...
  – provide you with capital at important phases in the business.
  – allow you to own large capital assets (land, buildings) that are too costly to buy outright.
  – increase your purchasing power.
  – provide cash for emergences or unexpected expenses.
  – build your credit rating, which can lead to future credit with more favorable terms.
  – have tax benefits.
Business Credit can have Disadvantages too…

- Loan repayments can lower cash flows; create thin operating margins.
- Unexpected revenue loss may result in late payments, default, damaged credit rating.
- High or variable interest rates may make repayment difficult and costly.
- Collateral may be at risk if business defaults on loan.
- Debt load may reduce financial flexibility for future opportunities.
- High debt loads may lower credit rating/worthiness.
Steps to Making the Decision to use Credit…

1. Clearly identify its purpose.
2. Develop a specific plan on its use.
3. Directly relate it to your business plan and goals.
4. Decide on the type of credit needed:
   • Short-, intermediate-, or long-term.
5. Develop a specific repayment plan: how and when?
6. Use financial statements and analysis to support your decision.
Next Step: Working with a Lender

• Find a lender that’s familiar with your type of agricultural business.
  ➢ Agricultural banks, local banks, Farm Credit Services institutions.
  ➢ CDFIs.
  ➢ USDA Farm Service Agency (FSA).
• Understand your lender; understand their risk.
• Carefully study the loan products offered.
  ➢ Terms & conditions, total borrowing costs, etc.
• Shop around.
• Work with lender to prepare application.
• Be honest. Don’t try to hide bad news.
Quiz

• Which of the following are important considerations for using business credit?

a) Understanding the advantages and disadvantages of business credit.
b) Relating the use of credit directly to your business plan and goals.
c) Carefully studying the loan products offered.
d) a, b, and c are all important.
Quiz

• Which of the following are lenders to consider for agricultural credit?
  a) USDA Farm Service Agency (FSA).
  b) Local and/or agricultural banks.
  c) Federal Agricultural Mortgage Corporation (Farmer Mac).
  d) Farm Credit Services institutions.
  e) a, b, and d are lenders to consider.
  f) All of the above are lenders to consider.
II. Understanding short-, intermediate-, and long-term business credit.

1. Short-term operating credit.
   - Terms less than a year; typically follow the production cycle.
   - Used to maintain cash flows, meet short-term obligations or unexpected expenses.

2. Intermediate-term operating credit.
   - Terms more than one year, less than ten years.
   - Used to finance equipment purchases, breeding livestock, building improvements, etc.

3. Long-term mortgages and contracts.
   - Terms more than ten years.
   - Used to buy land and/or construct buildings.
Short-term operating credit.

- Used to buy farm inputs; repaid from crop revenue.
- Allows you to take advantage of cash discounts, prepays, and tax savings.
- Lender secures loan with crop lien or other asset.
- Payment types:
  - Interest-only payments; full principal due at end of term.
  - Regular (principal + interest) fixed amount.
Short-term operating credit

- Interest: fixed or variable.
- Interest: simple or discount.
  - Simple interest used for single payment loans.
    - Interest calculated on loan amount; due at end of term.
  - Discount interest subtracted from loan amount up front.
    - Results in higher effective interest rate.
- Don’t forget any fees and service charges.
Short-term operating credit, cont.

• Some alternatives:
  - Cash reserves.
  - Borrowing from owner’s equity (borrowing from yourself).
  - Borrowing from family & friends.

• Lines of credit are also useful.
  - Secured in advance, not used immediately.
  - Revolving (like credit card), or non-revolving (used & repaid once).

• Beware of payday loans and other predatory lending.
Intermediate-term operating credit

• More complex than short-term credit. Requires more analysis, forecasting & decisions.

• Lenders more careful of risks.
  ➢ Beware of accepting less credit than needed.
  ➢ Beware of accepting higher payments or shorter terms.
  ➢ Beware of “demand clauses.”

• Payment types:
  ➢ **Fixed, equal payments:** Principal + interest amortizations occur at set times. Interest is bulk of early payments.
  ➢ **Fixed principal payments:** Principal amortization fixed & equal. Interest calculated on declining principal.
  ➢ **Balloon payment:** Short-term loan w/payments based on longer term. Full payment due by shorter term.
Exercise: Calculating total borrowing costs

• Joe and Frank are both corn farmers on neighboring land in Clinton County. Joe and Frank have both estimated that they will need $100,000 for the purchase of a new field tractor.

• Joe meets with his local agricultural lender and agrees to a 5-year loan at 10% interest, with fixed, equal payments, 1 payment per year.

• Frank meets with his local agricultural lender and agrees to a 5-year loan at 10% interest, with fixed, principal payments, 1 payment per year.

• Using the table on the next page, calculate the total borrowing costs for Joe and Frank.
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<th>(Joe) Fixed Equal Payment Method</th>
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Table adapted from Ellinger, Paul N. and Peter J. Barry. nd. A Farmer’s Guide to Agricultural Credit. The Center for Farm and Rural Business Finance, University of Illinois at Urbana-Champaign.

- What is the total cost of borrowing for Joe and Frank?
- What are the benefits and challenges to cash flow with the two payment methods?
- Assume that corn prices were high and yields good in Years 1 & 2. Who made the better decision?
- Assume that corn prices were low and yields poor in Years 1 & 2. Who made the better decision?
Intermediate-term operating credit: Leasing vs. Ownership?

- Advantages to leasing:
  - Allows you to use equipment if you can’t buy it or access credit.
  - Lease payments might be lower than loan payments.
  - Doesn’t negatively impact debt ratios of business.
  - Shifts depreciation to owner.
  - Payments may be considered tax deductible expense.

- Advantages to Ownership:
  - Have full right to equipment. Can sell or modify it.
  - Can use depreciation as business expense.
  - Loan interest may be considered tax deductible expense.
Long-term mortgages and contracts

- Mortgages are loans secured by real estate through a lender.

- Advantages to Mortgages:
  - Buyer owns the land at time of purchase. Can use it as needed.
  - Buyer builds equity through payments.
  - Seller is paid in full at time of purchase. Relinquishes ownership rights & responsibilities.
  - Good way to build solid credit rating.
  - Widely available at competitive terms.

- Disadvantages:
  - Typically require larger down payments, have higher interest rates, & more closing costs and servicing fees.
Long-term mortgages and contracts

• Contracts are loan agreements directly between a seller and a buyer.

• Advantages to Contracts:
  ➢ Can involve smaller down payments, better interest rates, fewer closing closing costs & service fees.
  ➢ Seller may be more flexible than traditional lender. Good news for beginning or limited-resource producers.
  ➢ Seller may sell land and generate cash more quickly.

➢ Disadvantages:
  ➢ Buyer has no ownership rights until contract is fulfilled.
  ➢ Buyer risks loss of land and/or payments if seller backs out.
  ➢ Seller risks default by buyer, and costly recourse.
Long-term mortgages and contracts

- Payment options and terms similar to intermediate-term credit.

- Long-term interest rates:
  - **Fixed**: guaranteed rate, but higher than variable rate loans.
  - **Variable**: lower rates, but carry risk of higher rates and costs.
  - Can re-finance, if your credit is still good and financial marketplace is solid.

- Lenders more willing to offer flexible loan products when credit secured with land or real estate.
Exercise: Using an Amortization Table

- What would be the total borrowing costs (principal + interest) for a $100,000 loan at a 10% interest rate over 30 years?
- What would be the total borrowing costs if that same $100,000 loan at 10% interest were repaid in 20 years?
- What would be the total borrowing costs if that same $100,000 loan was at 7% interest over 20 years?
- What are the implications of shorter/longer loan terms, and lower/higher interest rates with regard to total borrowing costs and cash flows?
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Table reproduced from Langemeier, Michael R. 2009. Interpretation and Use of the Amortization Table. Farm Management Guide MF-489. Department of Agricultural Economics, Kansas State University.
Quiz

• What are some characteristics of short-term credit?

a) Terms more than one year but less than ten years.
b) Used to pay for farm inputs such as seed, fertilizer and fuel.
c) Used for large purchases such as farm equipment and building improvements.
d) Usually secured by real estate or land.
e) None of these are characteristics of short-term credit.
Quiz

- What are some characteristics of intermediate-term credit?
  
a) Terms more than ten years.
b) Requires more analysis, forecasting & decisions than short-term credit.
c) Usually involves contracts and mortgages.
d) Used to maintain cash flows, meet short-term obligations or unexpected expenses.
e) None of these are characteristics of intermediate-term credit.
Quiz

• What are some characteristics of long-term credit?

a) Terms more than ten years.
b) Can involve fixed or variable interest rates.
c) Usually involves contracts and mortgages.
d) Used to buy land and/or construct buildings.
e) All of these are characteristics of long-term credit.
III. Preparing for a credit application

- It’s like taking a test: It pays to prepare!
  - Begin preparing early—at least 6 months before applying.
  - Know your credit history & score.
  - Have good financial records, including:
    - At least 3 years of financial statements & tax filings,
    - At least 3 years of farm/ranch production records,
    - Current bank account, deposit, & investment statements,
    - Mortgage statements,
    - Loan & lease agreements, and
    - Proof of collateral assets.
Preparing for a credit application

• Don’t take on any new sizeable debt (including credit cards) or purchases at least 6 months before applying.
• Evaluate your debt ratios to make sure you’re not too highly indebted.
• Establish a reserve fund that can sustain you for at least 6 months in case something bad happens.
• Update your business plan and be ready to present it.
• Be able to explain exactly how the credit will be used, how it will help the business, and how it will be repaid.
Preparing for a credit application

• Research exactly how much credit you need. Don’t ask for too little or too much.
• Study the types of loan products and services and choose the right one for you.
• Make sure your personal and household finances are in good order. They will affect your business finances.
• But, keep personal and business finances clearly separated.
• Remember that a lender is successful only when YOU are successful. Help them make a good decision for you.
USDA Farm Service Agency (FSA) Loans

- FSA provides loans only when traditional lenders have denied credit to you first.
- FSA offers direct and guaranteed farm ownership and operating loans.
- Direct loans are made directly by FSA with government funds.
- Guaranteed loans provide lenders with a guarantee of up to 95% of loss of principal/interest, so that they lend to producers who do not meet their normal lending criteria.
- Farm Ownership loans are used to buy farmland, construct/repair buildings, etc.
- Operating loans are used to buy livestock, farm equipment, feed, seed, fuel, insurance, etc.
USDA Farm Service Agency (FSA) Loans

- FSA provides set-aside loans to “beginning farmers & ranchers.”
- FSA provides set-aside loans to “socially disadvantaged farmers & ranchers.”
- Microloans available (up to 1 yr., $35,000) as streamlined operating loans.
- Local FSA representatives are the best people to work with on your application.
  - They will know your agricultural area and any special application requirements.
  - They will provide you with a loan application package with many forms.
  - The information required is basically the same as what traditional lenders require.
Quiz !!

• Which of the following are true of FSA loans products?

a) Operating loans provide credit for farm inputs such as seed, feed, and fuel.

b) Direct loans are loans made directly by FSA with government funds.

c) Farm Ownership loans are used to buy land and construct buildings.

d) There are set-asides for “socially disadvantaged” and “beginning” farmers and ranchers.

e) All of these statements are true.
Where to go for more information…

• Local banks and financial institutions.
• U.S. Department of Agriculture (USDA)
  – Local Service Centers (Farm Service Agency, Rural Development, Natural Resource Conservation Service)
  – Nationwide agencies (e.g., National Institute of Food & Ag., Risk Management Service, Ag. Marketing Service, etc.)
• State and Tribal entities
• Other partners, such as…
  – First Nations Development Institute
  – Indian Nations Conservation Alliance
  – Inter-Tribal Agriculture Council
  – Your local tribal college or university
  – First Americans Land-grant Consortium
Thank You!

Questions?

Don't forget to submit your evaluation!
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<th>Event</th>
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<td>Farm-to-School Best Practices</td>
<td>April 25</td>
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<tr>
<td>Co-operative Models</td>
<td>May 23</td>
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<td>Senior Citizen Hunger</td>
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