

Borrowing Money

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Ag Business Management

*Informing farm families and ag
businesses about management issues.*

It takes capital to own and operate your farm business. Most often, some of the capital is yours (investment capital), and some of the capital is provided by creditors (borrowed capital).

Borrowing money is not entirely different than renting land. If you own enough land to provide all that you need for your farming operation, you do not have to rent additional. If you do rent land from others, it allows you to control more assets, with the goal of progressing financially with the larger land base. The land continues to belong to others, but you pay rent on an annual basis, for the use of the land. Similarly, if you have sufficient capital to fully fund your farming operation, you do not have to borrow (rent) capital from others. If you do borrow capital from others, it allows you to control more assets, with the goal of progressing financially with the larger base. You pay rent (interest) on an annual basis. You borrow the principal, but you need to return it to the owner (principal payment).

There are a lot of good reasons to borrow. You may be buying land, equipment, livestock facilities, or vehicles. You may be borrowing to buy feeder livestock, or buy crop inputs or pay operating expenses. You may even be borrowing from one lender to make the payments on a loan to another lender. When you borrow capital, you are sharing ownership in your assets (by giving a security interest to the lender). In doing so, you are giving up a bit of financial freedom. Sometimes this is a minute amount of freedom. Sometimes the freedom relinquished is significant, as lenders put demands and expectations on you, to protect their investment in your operation. The more highly leveraged you are (relying on a greater amount of borrowed capital), the more financial freedom you relinquish.

Lenders are in business to make loans. Among their many reasons for wanting to lend money, is to make a profit for their shareholders, and to develop relationships with their customers that will result in offering/selling more services. In addition, good bankers are truly interested in seeing their customers and communities prosper. It is in the best interest of the bank and the customers alike, to develop good business relationships.

These days of mergers and acquisitions are affecting lenders, also. You may have done business at the same bank for 25 years, and now feel like you are dealing with strangers. In the past your loan decision may have been made by the loan officer, where now it needs approval by a loan committee, or even by the board of directors, before it can be made. Don't be offended by the process.

When you are applying for a loan, you are asking the lender to become a financial partner in your business. They want to see your financial statements for many of the same reasons that you want to see your financial statements. Your Balance Sheet shows them your financial condition as of that time. Your accrual Income Statement measures your profit. Even though a Tax Return is not a great way to measure profit, many lenders will want to see several years of Tax Returns. A Cash Flow Projection / Projected Income Statement will show the lender and you, whether your dollars will be there when they are needed, and whether you are likely to be profitable. The lender will want to see if the repayment ability exists to service present and proposed loans. Trend Sheets that show Balance Sheet, Income Statement and Ratio Analysis show what progress your business has made, and your past ability to service debt.

If your loan request is approved, the lender will likely want to "secure" the loan with "collateral". If you are borrowing for a specific item (exp. vehicle, one piece of equipment, etc.), the "collateral" may be that specific item being financed. If you have several loans with the same lender, or your loan is relatively large, the lender may require that you pledge many items under a "blanket security agreement". Often these "blanket" security documents cover such things as "all equipment, all farm products (including crops, livestock, etc.) now owned or hereafter acquired, proceeds, contract rights, accounts, etc." They can be very broad and all encompassing. Other loans may require that real estate be pledged as collateral.

The documents that secure the loan will vary, based on the type of collateral. If the collateral is personal property (about everything that is not real estate), a “Security Agreement” will be used. This will name that property being pledged, and identify it as collateral either for a specific loan, or for existing and future loans. This Security Agreement is a document between the borrower and the lender. To notify the rest of the world that a security interest has been pledged, a signed Financing Statement / UCC-1 (not to be confused with a “financial statement”) is recorded with the Central Filing System of the Secretary of State. If the lender wants proceeds of crops, livestock, etc. to be paid to themselves as well as the producer, a UCC/EFS will be sent to the County Recorder. If the collateral is real estate, then a Real Estate Mortgage is recorded with the County Recorder in the county that the real estate is located in.

The lender is lending you someone else’s money. In the case of a bank, the money really belongs to the depositors. The depositors will want their money back, so the bank wants to feel comfortable that the loan will be repaid. In the eyes of the bank, there are a number of ways that your loan could be repaid. First, and by far the most pleasant and satisfying for everyone, is that the loan be repaid as agreed, from the profits of the business. Less desirable is that the loan be repaid as agreed, but from another source, if the profits of the business were not sufficient. Even less desirable, is if the dollars of loan repayment had to come from the borrower selling assets to repay the loan, because business profits did not exist. Another repayment source is if the borrower will re-finance the loan with another lender, and use the proceeds of the new loan to repay the first loan. A long way down the list of desirable methods of repayment (but certainly within the scope of reality), is that the lender take possession of the property that was pledged as collateral (either by the borrower voluntarily relinquishing it, or through legal foreclosure), and sell the property to generate the funds needed to repay the loan. Least desirable of all, is if the loan does not get repaid. Remember that it was the depositors’ money that was loaned out, and that they do indeed want their money back. If the loan is a “loss”, the lender must dip into its “reserve for loan losses” (a portion of its capital/net worth) to repay the depositors. In order to replenish the “reserve”, it will increase profits by charging more on loans and/or by paying less on deposits. This impacts the other customers of the bank, and jeopardizes the bank’s ability to compete for deposits and loans.

If you were the lender, your actions would be very similar to the bank’s. You would want to know that you are dealing with someone of good character, who has made financial progress over the years. You would want to see a history of good repayment of other loans, and good repayment potential of the proposed loan. You would not want to put up all of the capital, thereby taking all the financial risk. Rather, you would require that the borrower put up a portion of the capital (adequate down payment), or pledge sufficient collateral so that the collateral value to loan amount would be sufficient to repay the loan under the least desirable method of repayment (foreclosure). You would want the borrower to insure the collateral against hazards, and name you as loss payee on the policy in force. You would monitor the financial progress of the borrower by reviewing periodic financial statements while the loan exists.

Lenders are in the business of making loans, but not all loan requests are granted. Some common reasons for loan denial include: Bad character of the borrower; Poor credit history; Under capitalized (expect the lender to put up all or too much of the money); Inadequate collateral; Unrealistic expectations and projections; Poor history of profitability, growth and repayment ability; or Poor financial preparation on the part of the borrower.

Not every lender makes loans in every industry. Sometimes agricultural loans are denied because the lender does not know your industry. If that is the case, go to a lender that does know agriculture. However, just because someone is willing to make you a loan, does not mean that it is good for you. Getting the loan may be the easy part. Repaying it may be much more difficult. It is your financial life. Know your financial statements, ratios and trends. Be realistic in your projections and goals.