Lemonade

We welcome your contributions to Lemonade—an article where ag lenders share challenging experiences and their suggestions for how you might avoid a "sour" situation.

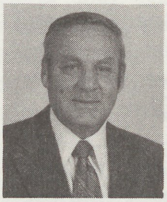
Bigger is not always better

by Robert H. Matthews

Most of us involved in agricultural lending are capable of measuring the risk on the typical agricultural production loan. If a bank wants to lend to agriculture, certain uncontrollable risks must be assumed, such as adverse weather, overproduction, low prices, damage to crops by disease and pests and other unknown events.

During the past 35 years, it has been my experience that the uncontrollable risks are not the ones that cause us the most difficulty. Although it would be naive to say that we have not had problems or won't have problems due to bad weather and other factors, my message in this article will focus on other risks created by people. These are the risks caused by such human weaknesses as greed, ego, overconfidence and poor judgment. It is convenient that these weaknesses can apply to either farm customers or bankers.

Although the names and location in this story have been changed, this article is based on an actual banking situation.



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The operation

The four Roulette brothers owned and operated a large farming operation in a western Colorado irrigation project. The cropping program was well diversified and included about 3,000 acres of irrigated crops such as sugar beets, potatoes, onions, beans, wheat, tomatoes and rotation crops. The farmland, both owned and leased, was of high quality and capable of top production. While many of the crops were grown under contract, potatoes and onions were packed fresh through two produce sheds owned by the brothers.

Business structure

The business structure included two separate corporations and a general partnership. Roulette Bros. was a general partnership between Joe, Ted, John and Charles Roulette. Roulette Produce Co. was a separate corporation owned by all four brothers and managed by

Ted. Roulette Pacific was a separate corporation owned by all four brothers and managed by Joe. John and Charles acted as general supervisors for all the operations. The farming partnership was the linch-pin that held the entire operation together.

Characteristics of the borrower

Roulette Bros. was highly regarded by the bank, suppliers, employees, other farmers and the produce industry. Following are some strengths and weaknesses that were recognized by the bank. However, the weaknesses that would ultimately destroy the operation were misleading.

Strengths

1. Excellent farmers—top producers
2. Good character and integrity
3. Well regarded in the community
4. Performed on financial obligations with suppliers and their bank

Weaknesses

1. The brothers exhibited excessive pride and egos that had to be nurtured by being the best and biggest.
2. A competitive battle existed between Joe and Ted as to who would end up as "Top Gun." This tended to divide the operation into two distinct camps with Joe running his operation, Ted running his, and John and Charles floating in between. This was not of great concern because the family was very close, and each operation was doing quite well.
3. The brothers had a burning desire to have a fully integrated operation. They wanted to control production, processing and marketing for all of their crops and not be dependent on other processors to get the job done.
4. They had tendencies to take excessive risk in expansionary moves, unrelated business ventures and the growing of crops.
5. They were reluctant to spend very much time on financial management, planning or setting financial goals. They also lacked understanding of proper debt levels and working capital.
6. They had bad habits of overdrawing their bank accounts, pushing the bank too much for credit decisions and leaning on their suppliers excessively. These bad habits were negated by prompt payment of payables to suppliers, and a successful operation that was able to perform on bank loans.

Banking relationship

The size of the Roulette operation and the high-cost crops grown required a large annual production loan and extensive term loans to finance equipment. The operation also required various other interim loans to acquire, level and develop land and to build buildings. The boys had a strong appetite for new farm equipment, fancy pickups and big cars. They were the largest loan in this rural bank. They were able to clean up their bank debt each year, maintain adequate working capital and service all intermediate and long-term debt. The account was difficult to handle. Also, the bank was constantly being pushed to do more for what had been an expansion-minded, aggressive customer with an excellent track record.

Deterioration and collapse

It is always easy to critique the events of the past. It is not so easy to under-stand what is happening to us when it is happening. This was the case with Roulette Bros. over a three year span.

Year one

The farming operation was functioning properly. A large production loan was in place at the bank, and the prior year had been highly profitable due to a "hot" onion market. After many years of good performance with the bank, a few trouble spots were starting to show in the bank relationship.

1. Production of crops gradually fell off.
2. Overdrafts at the bank became larger and more frequent.
3. The bank had less communication with the customers and experienced delays in obtaining pertinent information.
4. It became difficult to track crop proceeds, and the partnership tended to finance the produce companies.
5. There was a higher than normal level of capital expenditures, along with a rather substantial increase in acres farmed, and a decrease in the margin (although still positive) of estimated income over expense.

During year one, Joe Roulette announced to the bank that he had hired an experienced tomato processing expert and asked that the bank entertain his request for a term loan to build a tomato paste plant. He also asked for a revolving line of credit to carry inventory and receivables. The amounts were uncomfortably substantial, but the purpose (vertical integration to process crops) made some sense.

Lots of veiled threats and pressure were used against the bank to induce it to grant the loans. The loan requests were turned down based on the premise that the new credit needed, plus the normal farm operating loans, were more than Roulette Bros.' financial resources could support. At this point, the boys agreed to hold the line on the project, and the bank agreed to reconsider the following year. It was fairly obvious that the relationship had become somewhat strained over the denial of the new credit request.

Year two

The four brothers came to the bank early in the year to discuss their credit requirements for the coming season.

"As the year wore on, trouble began to develop."

They stated that they had located long-term money to build the tomato plant, and that they only needed their normal (but larger) farm operating loan and a revolving credit for their processing plant. They had obtained a commitment from a long-term lender to increase the real estate loan on their farmland, and the proceeds would be used to provide equity for the processing plant—a separate corporation.

In looking at the entire picture, the bank concluded that if everything "clicked," the requested loans would work out, but the risk level on the credit was rising very rapidly. The loans were approved. The brothers proceeded to put their crops in the ground and started construction of the new plant.

As the year wore on, trouble began to develop. Crop production and quality were dropping off. It became apparent that management was devoting its time to getting the plant up and running, and the farming operation was suffering.

In the fall of that year, the plant started to operate, and there were myriad technical and production problems typical of a new processing plant. Tomatoes being processed belonged to Roulette Bros., and the new product was difficult to sell because prices were low.

The boys came in to borrow under the revolving credit, but there was not sufficient collateral to justify the loan request and the company had no working capital. It appeared that the processing plant would have to shutdown. The boys were able to locate four new investors who made a substantial capital contribution and provided limited guaranties for the revolving credit. The picture for the processing operation looked a little brighter.

Year two ended very uncomfortably for both the borrower and the bank.

Year three

Roulette Bros. again came into the bank to discuss their credit requirements for the coming year. The financial statements for the partnership, the two produce companies and the processing plant all showed substantial deterioration. The credit requirements for the farm were up due to a carryover of the prior year production loan.

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The processing plant and two produce companies were struggling, and they were unable to pay Roulette Bros. for potatoes and tomatoes delivered. There was ample evidence of financial stress. Larger suppliers were requiring personal guaranties and the boys were not getting along.

After a great deal of deliberation, the bank decided to continue the production loan for one more year and continue with the revolving credit on a formula basis month-to-month. To secure the farm operating loan, the bank insisted on a mortgage, which was reluctantly provided, on all farmland.

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Around the middle of year three, the processing company requested substantial advances to pay for packaging materials, taxes, tomatoes delivered by growers and other expenses. There was no collateral available to support additional loans, and the farm production loan was too "tight" to stand any advances other than to grow and harvest crops. The outside investors in the processing plant refused to put in more funds and would not increase their limited guaranty. It was very obvious that operating losses had decimated all equity and working capital, and the tomato plant was insolvent.

After loans to the processing plant were turned down, it was apparent that the entire Roulette Bros. operation was in danger of collapse. The processing plant was forced into involuntary bankruptcy, and the farming operation and two produce sheds were liquidated during the following two years.

In retrospect

There are some lessons to be learned from this unfortunate situation.

1. It is very difficult to try to divide a family operation by creating various corporations and partnerships. In the event of trouble, one entity can pull the entire operation down.
2. Ego, which was a definite factor in this case, can override good judgment.
3. Farming and manufacturing are two different businesses, even though they were related in this case. The processing operation failed because it was not properly capitalized, a market had not been found for the finished product and the borrowers did not have the background and expertise to run the new business.
4. A bank should not allow itself to be pushed into a decision that it knows or suspects is wrong.
5. Neither the customer nor the bank wanted to face up to the fact that the proposed project was out of line with the financial resources available to support the project and the fact that the partners did not have the management expertise to "pull it off."
6. The bank allowed the customer to deplete real estate equity and net worth that ended up in the defunct processing operation and had a serious impact on the good part of the credit—the farming operation.

To be successful agricultural bankers, we must evaluate *all* the risks involved in making a loan. This requires us to take an objective look at the human weaknesses of greed, ego, overconfidence and poor judgment. Taking this step can save us from the Roulette brothers—and others like them.

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