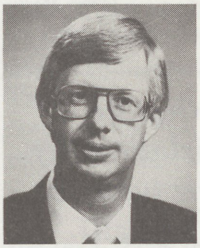

Michael Boehlje is Head of the Department of Agricultural and Applied Economics at the University of Minnesota, St. Paul, Minn. He conducts extension programs in finance for farmers and lenders and is a frequent speaker at lenders' conferences, schools and workshops. Boehlje is involved in research in agricultural finance and farm management and participated in a U.S.D.A. research program on tax and credit policy for farmers. He has authored or co-authored more than 250 articles and publications.

Prepare for successful ag lending in the 1990s

by Michael D. Boehlje

The farm and agribusiness sector in the United States is changing significantly and so is the banking environment. To be a successful agricultural lender in the 1990s will require strategic planning to transform nonperforming credits to performing ones or eliminate them from the portfolio, and to position the institution to be a viable competitor for new business in the new environment. This article will focus on positioning for new business. We will review the new agricultural lending environment, the new agricultural loan market, and the concepts of performance-based lending.

The new lending environment

The current agricultural lending environment might best be described by five characteristics: financial stress, shrinking market, increased competition, changing debtor-creditor rights and increased documentation. Let's examine each of these.

Financial stress

Significant financial stress abounds in agriculture, and the agricultural loan officer is not immune. The numbers and severity of problem loans continue to grow. Work loads expand as more detailed monitoring is required. Workouts become more complex and litigation, or the threat of it, is always a possibility. Personal relationships with borrowers are strained. The analysis tools and techniques of the past no longer seem adequate. Unfortunately, this stressful environment is expected to persist for the next 18 to 24 months.

Shrinking market

The debt load in agriculture is shrinking, and rightly so. Unless new volume is consciously added to the books, loan volume will decline. This will occur as nonperforming credits and problem loans are removed from the portfolio. As volume declines and problem loans are removed, fewer resources are needed to service the portfolio. A lender will either shrink with the market, or must adopt a more aggressive marketing and new business development program than was used in the 1970s to expand market share.

Increased competition

Increased competition will develop among existing institutions that wish to increase market share and maintain volume. "New players" may enter the market when the agricultural economy improves. Potential new players include a restructured Farm Credit System, banks outside the local community including regional money center and international banks, credit subsidiaries of input supply firms, savings and loan institutions and credit unions. Many lending institutions are pursuing aggressive product line and geographic diversification strategies, and the agricultural sector and rural communities could be a target for this diversification drive.

Changing debtor-creditor rights

Increased exemptions under state and federal bankruptcy law, the introduction of Chapter 12 bankruptcy rules, mandatory mediation in some states (specifically Minnesota and Iowa), double jeopardy legislation, and proposed changes in the Uniform Commercial Code are specific examples of changes in the legal rights of lenders and borrowers. With specific reference to agriculture, new and pending legislation has reduced the rights of the creditor and increased the rights of the debtor. These changes suggest more conservative lending practices for marginal customers and increased documentation of the credit-worthiness of the borrower so that legal remedies including foreclosure or repossession of collateral are less likely to be needed.

Increased documentation

The typical credit file of the past was dominated by security agreements, financing statements, assignments of equity and guarantees—all documents that support the backup position in case the borrower cannot repay. In the future, credit decisions will rely more heavily on financial performance than collateral and security. This will include income-generating capacity, repayment ability and efficiency. Some lenders argue that they never have put a "bad credit" on the books, but that statement might logically be questioned given the inadequate documentation for many agricultural credit decisions during the 1970s. This statement is not made to criticize the judgment of lenders, but to challenge and question the adequacy of the data base upon which these judgments were made during the 1970s.

The new ag loan market

Market segmentation and repositioning are critical for the agricultural lender to be successful in the future. The average farmer is disappearing from the scene.

We are clearly developing a bimodal distribution of farms with a limited number of large full-time commercial farms with sales of $250,000 to $500,000 or greater, and a much larger number of smaller part-time farms where off-farm income is a significant, if not major, source of cash flow and debt servicing capacity. The continuing trend to this bimodal distribution has important implications for the agricultural lending function and loan officers.

Commercial farmers need different products and services than part-time farmers. These products and services should be provided at a different cost and with different distribution strategies than those for part-time or even "average" farmers. For example, the full-time commercial farmer may want one-stop financial services. These services may include short, intermediate and long-term financing with the opportunities to use leasing products as well as access to insurance, financial counseling and market advisory services. The part-time farmer may only need operating credit and be unwilling to pay for counseling, marketing and other services. And costs of traditional credit services will be different for the large commercial operator compared to the small, part-time farmer. This suggests the need for different prices or interest rates for different farmers.

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Loan evaluation procedures may be different for different customers as well. A commercial farmer is not unlike any commerical loan customer in terms of credit analysis. His credit worthiness should be based on an evaluation of risk-bearing capacity, ability to generate returns, cash flow and repayment capacity and business performance and efficiency. Collateral should enter into the analysis as part of risk-bearing capacity, but should not be the dominant consideration. Evaluation techniques similar, if not identical, to those practiced by commercial loan officers are applicable and should be used.

In contrast, the source of debt servicing capacity for the part-time farmer is typically non-farm income. The analysis techniques used in this case are not unlike those used in consumer lending where the major source of debt servicing capacity is the salary or wage being generated. In essence then, the loan to the part-time farmer may be considered to be a consumer loan, and that to a full-time farmer to be a commercial loan.

The clear implication is that future agricultural loans may be made by consumer or commercial loan officers specializing in agriculture, not unlike the lending practices and procedures being used to service other industries and segments of our economy.

Cash-flow-based lending

The perils of collateral-based lending in agriculture are well understood, and lenders are now focusing attention on cash-flow-based lending procedures. Loan decisions based on cash flows and repayment capacity are an improvement over collateral-based lending decisions, but cash-flow-based lending analysis still frequently will be inadequate because *cash flow does not measure performance*.

The inadequacies of cash-flow analysis and lending procedures are numerous. First are the inherent problems in constructing a reasonable cash flow. Uncertainty about future prices and productivity makes it difficult to develop cash-flow budgets, and farmers have frequently used this uncertainty as an excuse not to do cash flows.

Farmers complete their cash-flow budgets fully aware that they must project positive debt-servicing capacity to justify the loan request. Farmers know that it is unreasonable to expect the lender to make the loan if the cash-flow budget clearly documents that it cannot be repaid. Consequently, there is a natural bias in the development of cash-flow projections to use optimistic expectations of prices and productivity and conservative estimates of costs including family living expenditures.

Second, cash-flow analysis does not adequately or fully measure performance. A farmer may be cash flowing and servicing the debt load but still be losing significant amounts of money. For some farm operations, debt servicing is occurring through the liquidation of assets, particularly inventory. Converting excess inventory into cash is a desirable management strategy, but systematic inventory liquidations to meet cash-flow pressures may give deceptive signals of financial performance. It is essential to regularly monitor inventories as well as cash flow throughout the year.

Also some farmers are cash flowing because they are using depreciation allowances to cover deficits that result from cash operating expenses exceeding cash income. In the short run, such a strategy is reasonable for firm survival. However, use of this procedure in the long run will result in systematic liquidation of the firm unless cash outflows for capital purchases and principal payments are equal to the depreciation allowance. This liquidation strategy may not be as dramatic or traumatic as the outright sale of capital assets, but the end result is the same. Once the current asset base is fully depreciated, funds are not available to replace it.

Performance-based lending

Cash-flow-based lending is better than collateral-based lending, but it is not adequate in today's economic and financial environment. What is needed is performance-based lending. The first element of a system to implement performance-based lending is that of ***risk and collateral assessment.*** The basic document necessary for such an evaluation is the balance sheet. The focus of such an assessment is the overall collateral offered as security for the loan and the liquidity reflected in the relationship between current assets and current liabilities. Documentation of collateral position and risk-bearing ability as reflected by balance sheet entries has been the standard fare in agricultural lending in the past, and thus will not be reviewed in detail here.

> ***"Credit decisions will rely more heavily on financial performance than collateral and security."***

The second element of performance-based lending is an assessment of the ***income-generating capacity*** of the business. The fundamental document here is the income statement and the essential measurement of bottom-line performance—*accrual net farm income*. Income statement analysis including proportions of total income and expense contributed by various enterprises and cost centers, along with detailed evaluation of business efficiency and performance (to be discussed later) are important dimensions of assessing income generation capacity.

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The third component of performance assessment is ***business efficiency and productivity analysis.*** Enterprise productivity can be effectively measured by yields per acre in crop production, and offspring per female, feed efficiency and rate of gain in livestock production. Business performance ratios for the entire farming operation include net production per dollar of assets (a basic measure of volume of business per dollar of investment or capital turnover ratio), net production per person (a measure of labor productivity), net income per dollar of sales (a measure of net margins on sales), net income per dollar of assets or equity (measurements of return on assets and equity, respectively), percent growth in income ratioed to percent growth in expense (a measure of current and future capacity to maintain positive margins), and fixed expense as a percent of total expense (a measure of the capacity in the short run to widen profit margins through expense control measures).

A fourth element is assessing ***repayment capacity.*** Seasonal repayment capacity can be measured best by accurately constructed seasonal (monthly or quarterly) cash-flow budgets. With respect to capital expenditure debt, annual repayment capacity measures are more useful. Such measurements include annual principal and interest payments related to net farm income before interest payments (a long-term measurement of capital expenditure debt servicing capacity), annual principal and interest payments ratioed to net cash flow before interest payments (a short-term measure of debt servicing capacity), interest as a percentage of total expenditures (a measure of the relative importance of the interest bill compared to other cost components), and interest as a percent of gross farm receipts (a measure of the proportion of total farm output that must be allocated to interest obligations).

Conclusions

The successful agricultural lender of the 1990s must adapt to a new agricultural environment of increased risk and tighter margins, and a new lending environment of increased competition, changing debtor/creditor rights and continued financial stress. Adapting to this new environment will require an aggressive marketing strategy that recognizes market segmentation and product differentiation, and the adoption of a performance-based lending system to analyze and control the risks in the agricultural loan portfolio.

It is important to resolve problem loans and "clean up the portfolio" if a lender is to survive in the short run. But those planning to be a part of the agricultural lending community in the long run must simultaneously emphasize new business development and performance-based lending.