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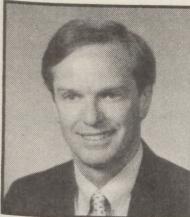
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He holds a degree in marketing from the College of St. Thomas and an MBA from the University of Minnesota.

# Lending to an Agricultural Equipment Dealer

by Patrick E. Mack

In the ever changing agricultural financing environment, lending to agricultural equipment dealers is often overlooked. Under the right circumstances, this can often be an excellent lending opportunity. According to the National Farm and Power Equipment Dealer's Association, agricultural equipment dealer numbers have dropped nearly 30% in the last decade. While this decline is significant, it can also be misleading. This reduction is a result not only of business failures, but due to dealership consolidations. For the remaining dealers, this trend toward fewer dealerships represents potential for both increased volume and profit.

Overall, since 1987 agricultural equipment dealers have benefited from an improved farm economy and have experienced positive operating results.

Sales have increased in most major categories, and operating margins have also strengthened. As a result, profitability has increased dramatically, and many equipment dealers are enjoying return on equity levels not achieved since the late

1970s. It should also be noted that equity positions for most dealers during this same time period have also improved.

The equipment dealer functions in a volatile industry. Understanding the dealer's operations, needs, and unique business characteristics, however, can enable a lender to tap into a very desirable lending relationship. There are opportunities for short-term financing to satisfy the dealer's operational needs, as well as fixed asset financing, which is typically long-term.

Although a needs analysis may appear to be the first step in financing a dealership, even more crucial is an accurate determination of the credit risk/worthiness of the borrowing dealer. Assessing an agricultural equipment dealer as a potential loan recipient involves a financial analysis and consideration of non-financial factors.

## Financial Analysis

Measuring the financial position and performance of an agricultural equipment dealership involves reviewing the financial data from three standpoints:

1. Financing--The security of various short-term claims against the dealership.

2. Investment--The effectiveness with which capital is used.
3. Operations--The efficiency and profitability of operations.

Different ratios are used to measure performance in these three areas. Generally three groups of ratios are used:

1. Liquidity ratios (financing)
2. Leverage ratios (investment)
3. Operating ratios (operations)

### Liquidity Ratios

Liquidity measures the equipment dealership's ability to convert current assets into cash to meet current operations. Table 1 identifies the dealership's liquidity ratios.

Liquidity ratios are interrelated and should be reviewed together to avoid a ratio being taken out of context. For example, having a relatively high current ratio does not necessarily mean that the equipment dealership has a favorable liquidity position. For it to be favorable, a high percentage of receivables should be current. The days' sales outstanding should be within the dealership's net credit terms.

Table 1  
Liquidity Ratios

Liquidity ratios	Agricultural equipment dealer guidelines
Quick ratio	0.25 to 1 or more
Current ratio	1.5 to 1 or more
Accounts receivable aging	Net credit terms
Day's sales outstanding	2-3 times
Average inventory turnover	120-180 days
Day's sales in inventory	

In addition, the inventory should be turning over at a reasonably high rate.

## Leverage Ratios

Leverage is the use of borrowed capital to increase the dealership's return on equity. Leverage ratios compare the owner's investment in the dealership to that of creditors. In addition, these ratios measure the dealership's performance in generating the income required to pay debts. The degree of leverage required by the dealership depends on the dealership's financial strength. A dealership should be leveraged only to the extent that its profitability is able to service its total debt. The ratios in Table 2 are used to measure leverage.

When reviewing the leverage ratios, it is important to consider return on equity. From either the dealer's or the creditor's point of view, it is imperative that the use of borrowed capital generates an adequate return on equity.

## Operations Ratios

Measuring the operating performance of a dealership includes a review of the balance sheet and income statement. In addition, various ratios provide an in-depth look at operations. Operating ratios measure the operating performance from two

perspectives:

1. The efficiency and profitability of operations.
2. The effectiveness with which capital is used.

The operating ratios in Table 3 are used to measure the operating performance of an equipment dealership.

Profitability is the most basic measure of operating performance. However, it is not enough just to be profitable. The dealership should efficiently use available resources by taking advantage of three major areas:

1. The available working capital
2. The work force
3. The trade area

Whereas the success or failure of a dealership depends on profitability; the growth, maturity, and longevity of the dealership are greatly influenced by efficient operations.

There are pitfalls and limitations in analyzing a dealership operation by using financial statements and ratios. Many statements reflect tax strategies, unique situations, and capital structures. Beyond an initial, basic financial analysis, situation-specific questions need to be raised:

Table 2  
Leverage Ratios

Leverage ratios	Agricultural equipment dealer guidelines
Owner's equity ratio	23% or more
Accounts payable to assets ratio	55% or less
Long term debt to assets ratio	15% or less
Debt service ratio	3 times or more

Table 3  
Operating Ratios

Operating ratios	Agricultural equipment dealer guidelines
Return on sales	4% or more
Return on assets	8% or more
Return on equity	24% or more
Asset turnover	2 times
Working capital turnover	5-7 times
Total net sales per employee	80% or less
Total expense efficiency	
Break-even sales point	

- \* Are the customer receivables being factored in? What is the quality of the accounts receivables? Have the accounts receivables been written down? How old are they? Is interest being charged? Is the interest being collected?
- \* Are the inventories stated correctly or are they tax adjusted? Are they true market value? Are they current?
- \* Are the buildings and land owned or leased by the business? What is the level of depreciation? What is the true market value?
- \* What portion of the payables are interest bearing? When will they become interest bearing?
- \* Is a large portion of dealership profits being reflected in owner's salaries or bonuses?
- \* Is there a shareholder loan? Is it considered debt or equity? Are there any shareholder agreements? What parties have security interest in the assets

of the business? Has the dealer provided personal guarantees?

- \* Is the business a Sub-chapter S Corporation? What is the impact on the financial statements?

### *Non-financial Analysis*

Even more critical than a financial analysis is a more subjective, qualitative review of a dealership. The managerial styles and capabilities of the key personnel in the dealership weigh heavily in the potential for success. Although managerial skills are difficult to identify, the successful agricultural equipment dealer of the future will need to be aggressive, intelligent, innovative, flexible, progressive, and honest. The dealer will not only possess these traits, but will demand them in employees.

### *Other Considerations*

Dealership analysis to determine strength, viability, and the future of the business should also include market share and market potential, which play an inte-

gral role in determining future sales growth. The sales mix between complete goods, parts, and services will determine future profitability due to the different margins generated from each department.

The dealership competitors must be evaluated at the local and national level.

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Any competition between major manufacturers that will directly effect an equipment dealer's day to day operations should be analyzed. The strength of the manufacturers represented in the dealership is crucial in determining the longevity of an agricultural equipment dealership. Recent changes, failures, and consolidations among major manufacturers within the agricultural industry have emphasized this point. It is imperative that the relationship between the manufacturer and equipment dealer is solid, with plans for continued growth.

The dealer's market, farmer-customers, their numbers, quality, level of profitability, buying trends, and products will all affect the equipment dealer. The reputation of the equipment dealership within the agricultural industry is also key. More importantly, how the business is perceived from the eyes of the customer is vital to the equipment dealership's success. All of these influences must be factored into the analysis.

Equipment dealers are inherently more highly leveraged than many businesses. Liabilities relative to total assets are higher for equipment dealers than for most businesses due to the level of interest-free liabilities. This "effective equity" is the

result of equipment shipped to dealers bearing no interest for a certain period.

Agricultural dealers also have unique cash needs that require a strong relationship with an informed, understanding lender. Cash flow for most agricultural equipment dealers is cyclical and fluctuates widely throughout the year. At times, a dealer may need large infusions of cash to pay for items due, for parts purchased, or for special purchasing opportunities.

Conversely, most dealers also experience "cash-rich" periods that can more than offset the borrowing needs. Many dealers receive a "volume-discount" check from their manufacturer during certain periods of the year, which can be a significant source of funds.

### *What to Require from the Dealer*

A strong and ongoing relationship between an agricultural equipment dealer and a lender should revolve around a complete dealership business plan. This plan should include historical financial statements: balance statements, income statements, and cash flow statements.

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Audited statements are preferable. The financial plans, goals, and objectives are integral to the business plan. The financial plans include a pro forma income statement, projected balance sheet, and a cash budget. There are many microcomputer

software packages that generate these reports.

Accompanying the financial plan should be a detailed marketing and operational plan outlining how the financial results will be achieved. Specific action plans, with assigned tasks and due dates will help ensure success. This dealership business plan should be developed in concert with the dealer principal, the key per-

sonnel, the accountant, and tax advisor. This plan needs to be reviewed periodically with the lender, and adjusted where appropriate to reflect the current strategy and dealership condition. Developing these materials can be a first step to a close working relationship. By building an understanding of the special needs of equipment dealers, lenders can assist effective dealers to thrive and grow in a uncertain world.

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