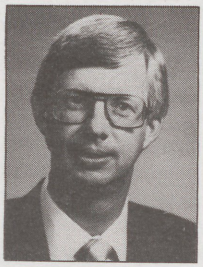
Lending to Integrated Agricultural Production Firms: Part II

by Michael Boehlje and David Lins

This is the second in a two-part series on issues associated with lending to integrated agricultural producers. The first article, in the February issue, provided a background on changes occurring in production agriculture and showed that financial standards and norms applied to traditional independent producers are of limited value in evaluating the financial position of integrated producers. This article will focus on a broader set of issues in lending to integrated vs. independent producers.



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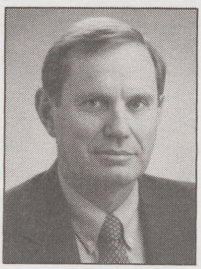

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The assessment of the financial soundness and credit worthiness of credit requests from integrated production units typically involves a broader set of dimensions and different analysis than those for traditional production agriculture.

In many cases, integrated credits involve larger capital outlays and might be described as major new ventures in contrast to the incremental expansions that are more common in traditional production agriculture.

For example, the credit request from an integrated unit may include a one to two million dollar facility loan and a similar amount for operating funds to start a new hog or dairy venture in contrast to the traditional request for a $100,000 capital expenditure loan and a modest increase in operating funds to add a new nursery or expand the dairy herd by 50 cows.

Because of the size of the loan and because there is less opportunity for current operations to "subsidize" delays in construction or a bad decision, the first task of the lender with integrated/industrialized credits is to assess whether the project is in fact profitable. Is it a good investment? Is the customer's analysis of the profitability of the investment solid? And what is the impact on profitability of different prices, costs and efficiencies? This is a critical and essential question that should be analyzed prior to detailed analysis of the credit-worthiness of the customer and the project.

Not surprisingly, the credit analysis for integrated credits is more comprehensive than that for traditional loan requests. Figure 1 summarizes the nine areas where documentation is required to make a sound decision for integrated credits. We will discuss each of these areas in turn.

Business Integrity

Little need be said about the importance of documenting business and personal integrity for any credit decision. But for industrialized credits, the questions go beyond fulfilling financial commitments as reflected by credit checks and past repayment performance. Integrated credits generally involve numerous contractual

Figure 1

Factors To Consider In Evaluating Integrated Credits

I. Business and Personal Integrity

II. Managerial Capacity
- A. Strategic
- B. General or production manager

III. Business Plan
- A. Strategy
- B. Resources
- C. Projections
- D. Management (team & back-up)

IV. Credit-Worthy
- A. Risk (financial statement)
- B. Return (income statement)
- C. Repayment (cash flows, debt service ratios)

V. Collateral/Security

VI. Risk Management
- A. Market
- B. Technological
- C. Construction/start-up
- D. Operating
- E. Regulatory

VII. Appraisal
- A. Cost
- B. Comparables
- C. Income

VIII. Environmental Management
- A. Audit
- B. Waste management plan
- C. Indemnification

IX. Contracting Parties
- A. Financial strength
- B. Longevity
- C. Contract provisions

and maybe informal arrangements with suppliers such as genetics companies, feed dealers, pharmaceutical companies, equipment manufacturers, etc. as well as other producers in a joint venture, a packer, or a marketing agency. The past history as well as expected willingness to fulfill these contractual or informal agreements also is part of business and personal integrity. Violating a contractual arrangement with an input supplier or a marketing agency may lead to serious debt servicing problems, and an individual who does not understand or have the commitment to honor these legal and informal agreements is a higher credit risk.

Managerial Capacity

A second element of the analysis for integrated credits is that of the managerial capacity of the borrower. Adequate managerial capacity is essential for any credit, but industrialized credits require additional managerial skills and capacities compared to traditional credits. The size of the credit request and the business venture will frequently require a different managerial style from the traditional hands-on manager. A producer who manages by being in the building and/or in the field and observing operations directly may find it difficult to adjust to the managerial style of a general manager.

A general manager manages primarily people, money, and relationships with suppliers and purchasers, and relies on employees to be the eyes and ears in the barns or the field. The manager must think more strategically about the longer term direction of the operation and allow employees to take more responsibility for tactics and operations. The manager must understand negotiation and be effective in working with suppliers and buyers. He/she must know how to motivate and manage people including recognizing them for their important contributions. This transition from a production/operations manager to a general manager is critical for the success of large-scale, new venture operations. It is essential that the lender assess the understanding, willingness and ability of the borrower to make this transition.

Business Plan

Because the integrated credit request is frequently larger and more complex than that for an incremental expansion, it is critical that the borrower have a business plan that identifies the longer term direction for the venture and how he/she anticipates accomplishing the longer term goals and objectives that have been specified.

This business plan should include identification of the strategy that the borrower is attempting to follow and where that strategy leads over the next five to seven years. It should include identification of the resources needed (financial, physical and human) and how those resources will

be acquired to implement the strategy.

Will additional buildings and facilities be needed in two years and what additional funds might be necessary to carry out the strategy? Is this really phase one of a major expansion plan that will include phase two and three further down the road? If so, are these phases compatible and properly sequenced? What managerial and operations personnel are needed to implement the strategy and are they in place or anticipated? What happens if critical partners such as a packer or feed supplier change direction and want to alter the contractual relationship? These and numerous other questions that anticipate the future and delineate a strategy and the ability to implement that strategy are critical to the credit decision.

This business plan should also include projections of financial performance based on realistic physical production efficiencies during not just the first year but also a three to five year time frame. A one year annual cash flow is absolutely not adequate for larger scale integrated/industrialized credits. And part of this business plan (in many cases the fatal flaw for some business plans) is the recognition of the importance of a managerial team and backup management.

What would happen if the borrower had an accident and was not available to manage the business? Who will step in and take over? What if critical operations people leave? Is personnel succession and advancement part of the strategic plan? Who will take over if the borrower is mentally or physically disabled (a life insurance program does not solve this problem!)? It is essential for both the borrower and the lender to have plans in place for not only a management team, but backup personnel for key areas of responsibility.

Credit Worthiness

The credit worthiness analysis focusing on risk, returns and repayment is fundamentally different for integrated, new venture projects than traditional agricultural credits. That issue was discussed in detail in the previous article.

Collateral

The collateral and security for integrated credits may be different than that for traditional loans for two fundamental reasons. First, the size of the investment may be very large as a proportion of the total capital investment in the business, and thus there is little additional collateral or security available for the loan. In essence, the opportunity for cross-collateralization or shoring up the security position from other sources is often not available for the integrated credit request.

Furthermore, the fixed facilities to be financed are frequently very specialized in nature with limited market potential for other uses. These specialized assets may be discounted in the appraisal process, as we will note later, and may be difficult to remarket if the borrower defaults and the lender repossess them. Consequently, the collateral/security issues for integrated credits are not only different, but may be very difficult to manage for a lender who has limited knowledge of these specialized asset markets.

Risk Management

The risk involved in integrated production agriculture are different than those in traditional agricultural lending. If the product produced is a specialized or differentiated product rather than a commodity, the risk of market access may increase. Differentiated product markets can disappear and/or be flooded by alternative suppliers; the borrower must have a thorough understanding of the market as well as well-developed marketing and distribution skills to be successful in differentiated product markets.

Many of the integrated, new venture projects also involve specialized assets as noted earlier. The technology embodied in these specialized assets may be critical to the physical performance and debt servicing capacity of the venture. The wrong technology will be disastrous, both in terms of operating performance and marketability of assets if default occurs. Although the technological risk for integrated, new venture projects may not be all that different than for traditional loans,

the size of the loan and thus the exposure to a bad technological choice is generally larger.

New venture projects generally have long lag times during the construction and start-up phase which must be recognized in developing financial projections. It is not unusual for delays in construction of hog buildings and other livestock facilities, resulting in little revenue during the first year and an expanded need for operating funds to cover cash flow deficits during the longer than expected start-up period. It is not uncommon to have the operation running only at 75% to 90% of efficiency and/or capacity during the second year of operation, so cash flow and debt servicing is impeded further.

The seriousness of start-up problems cannot be overstated.

It may not be until the third year after construction has been initiated and funds committed for the operation to be performing according to expectations and the cash flow to be as budgeted. If this likely lag is not anticipated in setting up the financial plans, both borrower and lender are likely to be highly disappointed and the loan may at least technically be in default before the facility is in full operation at full efficiency. The seriousness of start up problems cannot be overstated, and contingency plans to account for them must be included in the initial financial projections.

Once the project is in full operation, the typical risks of disease, weather, low prices, high input cost, changes in government regulations, etc. will be encountered just like with any traditional loan request. Again, the size of the financial obligation compared to other sources of liquidity and solvency may result in more serious financial risk and debt servicing problems for new venture, integrated credits when these circumstances occur compared to traditional credits.

And in part, as a function of the larger scale of operations, integrated, new venture projects may more frequently encounter regulatory compliance risk. Particularly in integrated livestock production, larger scale units may be held to higher standards concerning environmental rules and regulations and labor and worker safety rules. Recent violations of environmental regulations, both in the Midwest and Southeast, have resulted not only in significant increased monitoring of compliance, but have made the approval and permitting process in some states more formidable. Thus regulatory concerns may not only increase the delays in current and future construction which will impact cash flows, but they also may increase monitoring and compliance cost as well as the potential risk of shutdown because of non-compliance which also will impact debt servicing capacity.

Appraisal

Particularly in the case of livestock facilities, the appraisal becomes a key component of the credit documentation. Livestock facilities can be appraised at cost, at market value as a function of sales of comparable facilities in the area, or based on income generating capacity. Most appraisers rely heavily on comparable sales as a key determinant of the value they will place on new facilities and equipment.

This can result in relatively low appraised values in cases where facilities and equipment are sufficiently specialized as to have limited resale potential. This may particularly be the case if the technology is sufficiently specialized that few buyers can acquire and efficiently use the facilities, or if they are in a geographic region of limited market potential.

For example, it is not uncommon for contract finishing facilities in the southeastern United States to be appraised at 100% of cost because of the wide acceptance of contracting and numerous potential purchasers of such facilities if default

should occur. In contrast, similar facilities may be appraised at only 80% of cost in the Midwest where contract production is not as well accepted or developed and fewer potential buyers of such facilities are in the market.

Since most new venture project financing requires equity investments in proportion to the appraised cost of the facility, an appraisal less than cost will automatically require a larger equity investment. So the appraisal may have a dramatic impact on the overall financial structure of the business venture.

Environmental Management

As has been noted earlier, environmental compliance may be a significant source of risk for integrated, new venture livestock operations. Consequently, the lender must make sure the facility is in compliance with all environmental rules and regulations and has obtained the proper environmental permits.

An environmental audit that includes a review of the public records as well as a detailed site inspection (not a windshield survey) is critical to manage and/or reduce the environmental risk. Detailed plans concerning animal waste storage and land application including the proper management and monitoring of lagoons or other storage facilities and agreements with landowners if waste is to be disposed offsite are critical components of the waste management plan. In some cases, it may be desirable to include indemnification clauses or other language that would reduce the lenders exposure to liability or compliance and cleanup cost if an environmental spill were to occur.

Environmental risk may be one of the most serious problems in many integrated, new venture livestock operations. It is not the liability risk for a borrowers potential environmental spill that is the most serious concern for the lender; it is the fact that violations of environmental law may result in fines, increased compliance cost and/or even facility shutdown which could severely impact the cash flow and debt servicing capacity of the operation and result in loan default.

Contracting Parties

A final risk that must be carefully assessed in loans to integrated producers is that of the partners in the integrated arrangement. What is the financial strength of the feed company, the genetics company, or the packer who is a key supplier or buyer for the contract producer. What is the commitment of these partners to the arrangement; is it a one-year contract with few incentives for renewal, or a longer term commitment? Are the contracting parties philosophically committed to the concept of integrated production, or is this simply an experiment to see if it works? Do the contract provisions provide protections for all parties and an equitable sharing of the risk and the returns from the joint venture?

The terms of the contract and the sharing of risk and returns between the various parties will be critical to sound credit decisions. Although the contract arrangement may reduce price or other market risk for integrated producers, it may introduce a new risk in the form of the stability and/or uncertainty of the relationship between the various parties in the contract or joint venture.

Thus the loan officer must not only evaluate the internal creditworthiness of the customer, but also the terms and conditions of the contract or alliance to make sure that the overall arrangement is financially sound. A contract grower may be a solid customer, but if the success of the venture is dependent upon the performance of a partner, the financial strength, the market position and the overall capacity of that partner to perform will be important considerations in the overall credit decision.

Finally, explicit documentation is required of each of the nine factors noted in Figure 1. And each of these factors should be considered in the periodic loan review to make sure the borrower is not only in compliance with financial requirements, but continues to meet standards with respect to other dimensions of firm performance as well. ▲