

The Farmer's Guide to Agricultural Credit



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CONTENTS

Foreword	3
How To Use This Guide	5
<i>Farmer Scenario: Starting a New On-farm Nursery Business</i>	6
Ag Lending 101	7
Credit Basics	13
<i>Farmer Scenario: Transition from Grain-fed to Grass-fed Dairy</i>	17
Business Performance Measures	18
<i>Farmer Scenario: From 'Chicken Houses' to Pastured Poultry</i>	22
Business Planning	23
<i>Farmer Story: Direct Marketing Pasture-raised Poultry</i>	25
Communicating Your Idea to a Lender	26
<i>Two Scenarios: How do interest rates and terms affect my bottom line?</i>	30
Acknowledgements	32

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FOREWORD

RAFI initiated the Agricultural Reinvestment Fund in 1997 to assist transitioning farmers and rural communities to find new ways to replace lost tobacco income. Thanks to a grant from the NC Tobacco Trust Fund Commission, the Fund continues to provide a limited number of cost-share awards and technical assistance to farmers in tobacco-dependent North Carolina counties for pilot tests of innovative farm enterprises.

RAFI started the program hoping that farmers whose new projects succeeded would find additional capital to grow their new business. We hoped farmers could take their experiences with the Fund to the bank—literally. This happened in some cases: some growers did secure financing to expand successful enterprises. However, in too many cases, successful farmers went to their lenders and were denied financing. What went wrong? Why were they turned down?

The reasons have to do with both farmers and lenders. Many farmers have years of success getting annual operating loans to grow commodity crops. Yet when these same farmers apply for loans for new production ideas, they may be turned down. The same thing applies from the lender's side: many lenders are skilled in assessing the risks and rewards of a traditional operating loan. But when presented with plans for new agricultural enterprises, lenders may find themselves lacking the means to do an effective evaluation.

Farmers who are accustomed to annual operating loans for production of commodity crops may not be ready for the burden of research and documentation that a lender expects for a non-traditional farm product. It's also true that lenders who are familiar with the production and profitability of farm commodities do not always have the expertise necessary to evaluate the risk of agricultural

enterprises that he or she has never seen before.

Many of the financing issues discussed apply to innovators in other kinds of businesses. The same is true of recommendations — many apply to non-farm enterprises. However, farmers are the chief intended users of the guide. Farm financing has unique complexities and resources for agricultural entrepreneurs are needed.

Accessing capital is one of the many challenges facing farmers. Agricultural financing is crucial for maintaining production, expanding operations, or trying different enterprises. To maximize profits, more farmers and farm entrepreneurs are turning away from simple commodity crops in favor of more complicated or diversified enterprises. These new business models may be unfamiliar to lenders and the farmer may need to take some extra steps in preparing and presenting his or her business plans. This guide is a tool to help transitioning farmers and farm entrepreneurs take those steps.

This guide is aimed at helping farmers get ready to ask a lender for the financing needed in new and innovative ventures. When used as part of an overall enterprise development strategy, it can help farmers and lenders achieve mutually beneficial results when they sit down to do business.

HOW TO USE THIS GUIDE

All good lenders want to see you succeed and build equity; their profession is to invest in your success. But your challenge in seeking financing is to find the right lender for you. This guide can help you seek experienced agricultural lenders to help you solve problems--and avoid them in the first place! You want to find a lender who is knowledgeable and open to learning about new, profitable crops, innovations in farm production, and new ways to market farm goods.

This guide was written to:

- Improve your understanding of agricultural finance
- Help you get ready to apply for financing for your agricultural or farm-related venture
- Give you tools to increase your opportunities for accessing capital
- Connect you with other resources where you can learn more

By using this guide, you'll learn how to:

- Assess and potentially improve your credit score
- Initiate the business planning process for your farm enterprise
- Approach a lender with a well-written business plan and loan application materials

Farmer Scenario: Starting a New On-farm Nursery Business

Natalie and her family farmed soybeans, corn, and wheat for most of her life. They had borrowed from the same bank for the past 12 years. The process was simple and it worked. They always made the payments on time and the lender didn't ask a lot of questions. Every year, Natalie went to the lender for the money needed to get through the season. Every year she received the loan based on a short conversation and a few short forms. It felt like a real personal relationship. One year Natalie decided she wanted to expand her landscaping nursery, a sideline wholesale business she had been working on for a few years. Profits on her family's row crops were declining, and she and her family felt that they would have more control over their income by focusing on the nursery. Learning of this for the first time, their lender seemed skeptical. She asked Natalie many questions and seemed to doubt that she could sell that many shrubs. She finished by saying that she would need to better understand her marketing plan and then see at least a three-year cash flow projection. After such a long relationship, Natalie was somewhat surprised at her lender's response.

Natalie first decided to discuss the matter with her family and ask her parents and brother to pitch in on developing their business plan. Her brother suggested that they find help for the new business by searching for resources and information online. They came across a few resources: a state-based agricultural nonprofit that worked with small and mid-scale farms, Cooperative Extension, and an agricultural business planning and marketing course offered through a community college about an hour from their home. Natalie decided to enroll in the course and use it to develop the needed plan and projections. They also began researching other landscaping nurseries in the region and identifying potential markets within a three-hour drive of their farm. Their next steps would be deciding how to leverage their current operation and resources to initiate the business and convince the lender of their potential for success.

AG LENDING 101

Lenders gain confidence in your capabilities by looking at your:

- Prior production history
- Personal and business credit history
- Your financial records (including balance sheets, inventories, income statements or tax returns)
- Farm plan or business and marketing plan

Lenders need to see your path to repayment of the loan, shown in your:

- Production or management plan
- Marketing plan
- Projected cash flows
- Collateral, equity, or other off-farm income streams

By learning how lenders look at loan applications, you can avoid wasting time during the application process. The more questions you anticipate, the more time you can save. There are common issues that all our lenders agreed were important in dealing with loan applicants. There are common issues that lenders agree were important in dealing with loan applicants. The “Five C’s” are one way of understanding these issues.

The Five C’s:

- 1. Cash Flow** (Capacity to repay the loan)
- 2. Capital** (Equity investment in the enterprise)
- 3. Collateral** (Security for the loan)
- 4. Conditions** (Considering the ‘big picture’)
- 5. Character** (Capacity to manage a successful enterprise)

1. Cash Flow: Capacity to Repay the Loan

Cash Flow tells you how much of the cash you generate remains after expenses and repayment of debt. A Cash Flow Projection shows your income and expenses looking forward into the future. Cash Flow is looked at as a measure of your capacity to repay a loan. While you can look at cash flow for a period as short as a month, a quarter, or a year, most lenders want to see cash flows projected three to five years into the future.

Cash flow is used to determine whether a business is able to meet monthly loan payments. Lenders use your cash-flow statement to derive a ratio often called a minimum-debt-service-coverage (DSC) ratio requirement. A lender will want to see that you have more cash coming in each month from income than you have going out from expenses and loan repayment. Lenders use different ways of figuring DSC ratios, but a good rule of thumb is to shoot for a DSC ratio of 1.2 to 1.25. That means that for every \$1,000 of debt repayment you have to make each month, you should have \$1,200 to \$1,250 of cash after expenses. By having more income than you need to pay expenses, you create a buffer that protects you (and your lender) from the unexpected, such as rising costs or falling prices.

Cash flow is sometimes measured by earnings before interest, depreciation and amortization (EBIDA). Some businesses call it a pro forma projection.

2. Capital: Equity Investment in the Enterprise

Capital is the money you have personally invested in the business and is an indication of how much you have at risk should the business fail. Lenders and investors will need to know what you have put “on the line” before asking them to commit any funding. They will expect you to have undertaken personal financial risk to establish the business. You could say that capital is the measure of your equity investment in the project.

What percent of the total cost of your project will be covered by your own equity? Some community lenders may agree to some amount of “sweat equity” investment in the business. However, most lenders want to see some capital investment as well. Lenders typically look for a significant investment by the individual applying for the loan, seeing this as a measure of your commitment to your business plan.

Capital can go beyond the question of the money you plan to invest. What other equity sources are invested? Are you getting friends and family (or others) to invest in shares of the business? A Consumer Supported Agriculture (CSA) model is an alternative way of raising short-term capital by selling shares of your production in advance of harvest directly to your customers.

3. Collateral: Security for the Loan

Lenders have to consider all possibilities, and must plan for the worst-case scenario. In the case of a loan, what can the lender turn to in the event the business fails? If the borrower is unable to repay the loan, how does the lender get back his money? Collateral is land, equipment, houses, cars, and other things of value that a lender can hold as security for a loan, and repossess if the loan is not repaid.

The value of the property being held as security is an important factor: Lenders will likely require their own appraisal of the property or other assets. Often, assets are not valued according to market-value, but at what a lender can get for the item if they have to foreclose or liquidate. That often means the lowest commodity price for crops and livestock and a severe discount on equipment. Remember lenders are not in the business of operating the farm business and/or buying and selling farm products, so the lender may not get the best price on live animals, crops in the field, perishable, or repossessed goods.

Most lenders have policies regarding loan to value ratios. For example, lenders might only loan 80% of the value of a parcel of property, or 25% to 50% of the value of a particular piece of equipment. Other lenders require 150% collateral because of the costs and losses incurred in a liquidation of the collateral.

The kind of collateral is important, too: Lenders may ask that you secure the loan with your house. While some say this is based on the theory that you will be less likely to default if your home is at risk, there is another reason. In comparison to land or equipment, houses make good collateral because their value is relatively constant. Land values go up and down based on weather, crops, Federal programs, and development; equipment values are determined by the relatively small number of potential buyers;

but the potential market for a house is broader, so the values are more constant.

Why Is Collateral Discounted?

Why is it that lenders discount collateral so much? While a lender is investing in the potential for your success, he or she must also prepare for your failure. If you run into trouble with your loan, and the lender is unable to help you get back on track with loan payments, the lender must recover the money lent through your collateral. In these cases, lenders often cannot sell the property, equipment, etc. at market for the same value it might bring under different circumstances. Sometimes the collateral must be sold for pennies on the dollar. This is why so many lenders require 150% or more collateral to loan value.

4. Conditions: Considering the Big Picture

What are the current economic conditions, and where do your farm and business plans fit in? The lender looks at the intended purpose of the loan. Will the money be used for seasonal production costs, livestock, or equipment? The lender thinks about the impact of the local and national economy on your plans. Lenders may also look at larger trends relevant to your business, and in related industries, and generally consider how the ‘big picture’ could impact your plans.

5. Character: Capacity to manage a successful enterprise

Character is about your personal, professional capacity to execute your plan successfully. Different people, including lenders, evaluate character differently. Most will want to see a steady employment history and a good credit record. Your credit history is a record of your past borrowing performance. Lenders look at past performance carefully and evaluate the borrower on his or her potential for future bankruptcy.

CREDIT BASICS

Credit History

Depending on your business plan and the loan you request, the lender may look at the credit history of the business the individual borrower, and any co-signers, guarantors, or investors.

Essentially, consumer reporting agencies, usually referred to as ‘credit bureaus’ track, classify, and rank all of us according to secret, proprietary formulas. (Though it may sound a little like a conspiracy theory, it’s really true!) There are three major credit rating institutions operating in the US — Equifax, Experian, and TransUnion. These institutions are “global corporate conglomerates,” one of which is actually based outside the US.

All lenders use one or more of these institutions when examining your credit history. It is important that you know what is on your credit record prior to applying for a loan. A negative entry on your credit record does not necessarily keep you from getting a loan. However, it is important that you have taken steps to address any negative entries on your credit record and that you can explain to your lender why you received them.

By law you are entitled to one free copy of your credit reports from each of the institutions once a year. Take advantage of this to keep up with your credit record. Each of the three bureaus keep separate records. Call **1-877-322-8228** or use this simple website to request all three reports at once: www.annualcreditreport.com. On the site, you can also learn how to dispute errors on your credit record.

Before you apply for a loan, get a copy of your credit reports from each of the three credit rating institutions.

Management Experience

Your personal agricultural management experience is very important to agricultural lenders. If you are venturing into something brand new to you, you are not likely to get financing to start new enterprise. Instead, consider a business plan that allows you at least three years of self-financed operations, to build experience and prove your capabilities.

Your lender looks at your vision for the business and whether or not you have the leadership capacity or experience to execute your plan. Your production history, or your success or failure with past enterprises is key. With a new venture, the lender will need to see any experience you or your partners have to indicate chances of success with this new venture. With more complex business proposals, such as value-added enterprises, lenders typically analyze the experience and leadership of any consultants hired to help with the development process (for example, architects, contractors, lawyers, marketing agents). If you have such partners, you may need to write these people into your business plan.

*A quality business plan will build
your lender's confidence in your character.*

In some ways, communicating your character to your lender is like applying for a job. Your proposal to your lender should list all of your relevant educational and work experience. When you meet your lender face-to-face, you should be prepared to explain the details of your business plan so that the lender gains confidence in your knowledge of the proposal.

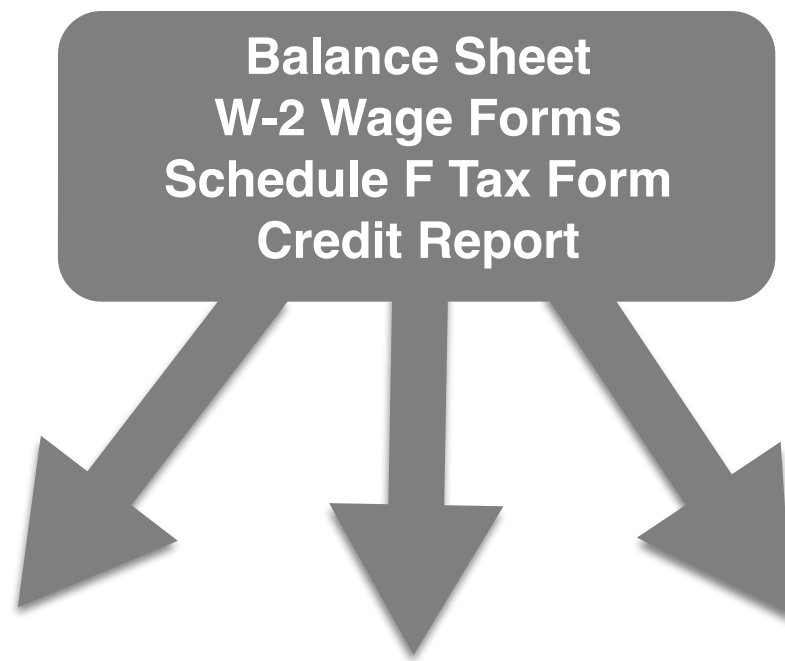
Working With Your Lender

- Arrange credit in advance. Do not make major financial decisions without informing your lender. Letting them know after the fact will damage your credibility and your lender's trust in you.

- Give your lender plenty of time to review your plans. By explaining your goals and plans, you build trust and confidence, and you strengthen your relationship with your lender. It also allows your lender the time to offer sound advice to you. Because they are in the business of evaluating business ideas, your lender's suggestions or comments could be very valuable. They may help you avoid mistakes others have made.
 - Let your lender know about problems and changes. Many businesses encounter financial problems, and by letting your lender know, adjustments can be made and solutions can be found. Communication is key, not just with the first loan request, but throughout the whole credit process.
 - Maintain a high level of integrity. You expect your lender to be honest and straightforward with you, and your lender is entitled to the same. That means letting your lender know if and when problems occur, so that you can work together to come up with a solution.
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How Lenders Analyze Smaller Ag Loans

Lenders typically evaluate small loan applications by using a Balance Sheet, W-2 Wage Forms, Schedule F Tax Form, and a credit report.



REPAYMENT ABILITY

Debt Payment Ratio
(Debt ÷ Income)
< 25% = Low Risk
25% - 50% = Mod. Risk
> 50% = High Risk

TRACK RECORD

Credit History
Credit Card Balances
Courthouse Files
Supplier References

LEVERAGE & COLLATERAL

Debt to Asset Ratio
< 50% = Low Risk
50% - 75% = Mod. Risk
> 75% = High Risk

Collateral Coverage Ratio
(Pledged Collateral ÷
Amount of Loan)
> 2.00 = Low Risk
Close to 1.00 = High Risk

Farmer Scenario: Transition from Grain-fed to Grass-fed Dairy

Richard and his wife Charlene had run a 400-cow dairy for many years. Their son Kenneth wanted to come back to the farm with his young family and take over the business. Richard was grateful that they could begin to retire, because the dairy business was getting tougher and tougher. Kenneth knew the old ways of dairying wouldn't pay the bills, so he wanted to convert the operation to grass-fed organic production. He did a lot of research, visited with experienced grass-fed dairymen, found a buyer for the milk, and wrote a business plan. None of the other dairymen in the county had ever considered grass-fed dairying, and the one lender he spoke to was not familiar with grass-fed dairy production.

Richard and Charlene knew their son could manage the operation, but they both worried about financing the three-year organic transition period. Should they harvest the timber? Should they sell the back acreage? Could they finance this major change and still ensure enough money for their retirement?

As a first step, they contacted both a local agricultural nonprofit and their county's Cooperative Extension office for resources and information. The nonprofit referred them to a family in a neighboring county who had made a similar transition and joined a dairy cooperative just a few years before. When they called, the farmer said she and her husband would be more than happy to come out to their dairy and talk about their experiences. An Extension agent connected them with farm enterprise development resources helpful for preparing a new business plan. Lastly, they contacted a local financial counselor to discuss managing their personal plans for retirement.

BUSINESS PERFORMANCE MEASURES:

The “Sweet Sixteen” Ratios & Calculations

The “Five C’s” are important, but they don’t cover all cases. Farmers with more complicated business plans might find the “Sweet Sixteen” to be more helpful. The “Sweet Sixteen” are ratios and calculations used by bankers and lenders to measure business performance. These 16 ratios and calculations define Liquidity, Solvency, Profitability, Repayment Capacity, and Financial Efficiency. These business performance measures were developed by the Farm Financial Standards Council (FFSC).

Ratio	Explanation
Liquidity	
Current Ratio: Calculated as (total current farm assets) ÷ (total current farm liabilities)	This measure of liquidity reflects the extent to which current farm assets, if sold tomorrow, could pay off current farm liabilities.
Working Capital: Calculated as (total current farm assets) – (total current farm liabilities)	This measure represents the short-term operating capital available from within the business.
Solvency	
Debt-to-Asset Ratio: Calculated as (total farm liabilities) ÷ (total farm assets)	This represents the bank’s share of your business. A higher ratio is an indicator of greater financial risk and lower borrowing capacity.
Equity-to-Asset Ratio: Calculated as (farm net worth) ÷ (total farm assets)	This measure of solvency compares farm equity to total farm assets.
Debt-to-Equity Ratio: Calculated as (total farm liabilities) ÷ (farm net worth)	This measure compares the bank’s ownership to your ownership of the business.

Ratio	Explanation
Profitability	
Rate of Return on Assets: Calculated as [(net farm income) + (farm interest) – (value of operator labor and management)] ÷ (average value of farm assets)	This measure represents the average “interest” rate being earned on all investments in the business (your investment and that of your creditors).
Rate of Return on Equity: Calculated as [(net farm income) – (value of operator labor and management)] ÷ (average farm net worth)	This measure represents the “interest” rate being earned by your investment in the farm. This return can be compared to the return on your investments if equity were invested somewhere else, outside the business.
Operating Profit Margin: Calculated as (return on farm assets) ÷ (value of farm production), where return on farm assets equals (net farm income from operation) + (farm interest expense) – (opportunity return to labor and management)	This measure of profitability shows the operating efficiency of the business. Low expenses relative to the value of farm production result in a healthy operating profit margin.
Net Farm Income: Calculated as (gross cash farm revenue) – (total cash farm expense) + (inventory changes) + (depreciation and other capital adjustments, including gains ÷ losses from the sale of capital assets)	This measure represents profitability or the farm’s return to labor, management, and equity.

Ratio	Explanation
Repayment Capacity	
Term Debt Coverage Ratio: Calculated as [(net farm operating income) + (net nonfarm income) + (depreciation) + (scheduled interest on term debt and capital leases) – (family living and taxes paid)] ÷ (scheduled principal and interest payments on term debt and capital leases)	This measure of repayment capacity tells whether the business produced enough cash to cover all intermediate and long-term debt payments.
Funds Flow Coverage Ratio: Sum of net profit, depreciation, amortization + interest — all dividends, withdrawals and non-cash income ÷ sum of all current maturities of long term debt, capital lease obligations, and interest.]	[Note: Some commercial lenders use a variation on the ratio above called the "Funds Flow Coverage Ratio."
Capital Replacement Margin: Calculated as the value of (net farm income) + (net nonfarm income) + depreciation – (family living expenses, taxes paid, scheduled payments on term debt)	This measure describes the amount of money left over after all operating expenses, taxes, family living costs, and scheduled debt payments have been made.
Financial Efficiency	
Asset Turnover Rate: Calculated as the (gross farm revenue) ÷ (average farm assets)	This measures the efficiency of using capital. A high level of production in proportion to the level of capital investment yields a high (or efficient) asset turnover rate.

Ratio	Explanation
Financial Efficiency	
Operating Expense Ratio: Calculated as the value of [(total farm operating expenses)– (depreciation) – (farm interest)] ÷ (gross farm revenue)	This measure reflects the proportion of farm revenues used to pay operating expenses, not including principal or interest.
Interest Expense Ratio: Calculated as (farm interest) ÷ (gross farm revenue)	This measure of financial efficiency shows how much of gross farm revenue is used to pay for borrowed capital.
Depreciation Expense Ratio: Calculated as (depreciation and other capital adjustments) ÷ (gross farm revenue)	This measure indicates what proportion of farm revenue is needed to maintain the capital used by your business.
Net Farm Income from Operations Ratio: Calculated as (net farm income) ÷ (gross farm revenue)	This measure indicates the percent of gross farm income remaining after all expenses for living, tax needs, capital purchases, investment, retirement, or debt payments. Note: A ratio of 15% or more is optimal; less than 5% unsatisfactory.

Farmer Scenario: From ‘Chicken Houses’ to Pastured Poultry

Samuel, a former tobacco farmer, raised broilers under contract until he turned 47 in 2010. He hadn't made as much money with broilers as he had hoped. Instead of building new poultry houses as the company had asked, he quit raising contract broilers as soon as his houses were paid off. After he took a tobacco buyout payment years before and quit growing tobacco, he really didn't want to give up farming, nor did he want to sell the land. He was interested in trying to grow birds on his own, thinking he could potentially sell to restaurants like the one his daughter worked for in Durham. He knew of a processing plant where he could have his birds processed. But he would have a lot to learn about marketing, packaging, delivery, and billing. He also knew that there would be risk in growing birds without antibiotics and hormones, as the customers preferred. Who could help him think through all the details? Could he live on credit cards until he worked out his plan? What kind of insurance was available? He knew that it would be a profitable business, but he wasn't sure which questions to ask, let alone who to ask.

Samuel decided to first get online and search for business development resources for farmers in his state. He came across two nonprofits that worked with small and mid-scale farmers. Some of the farmers he read about online seemed to at least partly match his own circumstances. After emailing and calling both organizations, he received a referral to a nonprofit with a marketing and labeling program that had worked with former contract poultry growers. They sent a field representative out to meet with him at his farm and provide information about the program. The field rep gave him a better sense of how to move forward on his plan and also gave him contact information for several other former contract growers in the state to call and talk to about how they started their new pastured poultry businesses. He decided that he would first contact other farmers, do more research, and then start drafting a business plan.

BUSINESS PLANNING

Business Plan Outline

As you may imagine from looking over the business plan outline below, it will take some time to collect all the information necessary to complete a good business plan. You should allow at least a few months to complete the process. While business plans take many different forms, all good plans should contain the following elements:

Executive Summary

A one page summary of the plan: purpose, who prepared it, brief description of the business, its products and owners, form of organization. If you are seeking a loan, include the amount requested, over what period you wish to repay it, the use of the loan proceeds, collateral you are prepared to offer, and your equity investment.

Product or Service

- Detailed description of the product or service (include an example or photo if possible).

Marketing

- Target market/customer profile specifying age, gender, income, preferences, location, etc.
- Industry analysis. (What are the trends in your industry?)
- Market analysis. (Total market size and the share you will capture, seasonality, unique aspects.)
- Describe the “Five P’s of Marketing” for your business:
 - Product: How will you design and package your product? Where does your product fit in the marketplace?
 - Price: How will you price your product or service?

- Placement: Where will customers learn about your product? In the grocery store, by mail-order, or through a broker?
- Promotion: What media and marketing methods will you use to generate awareness and interest about your product/service? Include examples of your promotional materials.
- People: Who will be responsible for marketing your product/service?
- Competition: List your competitors by name, location, and their strengths and weaknesses; explain how you will succeed against them; how will they react to your entry into the market?

Operations

- Legal structure and why you chose it; include legal/governing documents (articles of incorporation, by-laws, etc.)
- Management and personnel: Who the key managers/owners/employees/consultants are and what relevant experience and background they bring to the business.
- Customer Service: Procedures and policies regarding your work.
- Location and operations.
 - Describe your production practices. Production schedule, major suppliers, production methods, equipment, etc.
 - Operations Plan. How will you deliver your product/service to the customer, from start to finish (Who does what? How long does it take?)

Financials

- Cash flow projections for three to five years.
 - Loan amortization schedule.
 - Detailed description of the assumptions you made in constructing the cash flow.
- Breakeven analysis.
- Risk management. Identify the major risks and how you plan to overcome them.

Farmer Story: Direct Marketing Pasture-raised Poultry

After years of success with lamb production and conventional contract broiler production, Genell Pridgen of Rainbow Meadow Farms began raising broilers on pasture. After some success, and seeing great demand from her customers for this premium product, she developed a plan to expand her production and her market.

After some research, she recruited the assistance of business school students at East Carolina University. Under the guidance of their professor, they developed a detailed marketing plan for the business. The professor tapped the knowledge and expertise of a volunteer from SCORE, the Service Corps of Retired Executives. Genell still had to do lots of research herself, but by doing her homework, and finding the right people to help her, she and her support team produced an excellent plan.

COMMUNICATING YOUR IDEA TO A LENDER

Suppose you know what you are going to grow, what equipment to use, and so on. You know what you need to do to make your new idea succeed. The next step is to communicate your idea to someone whose job is to loan money and manage risk—your lender. Presenting your idea in a format that a lender can understand is the key to successfully convincing a lender to loan you money.

It is also helpful to bear in mind what you are asking for when you ask for a loan. Lending is a complex deal where the lender takes on a lot of risk. When you receive a loan, the lender fulfills its end of the deal the moment the loan is advanced. You fulfill your end of the deal with every payment you make. Your lender is relying upon you to keep up that end of the bargain—in some cases far into the future. This is why lenders need to see an excellent plan, financial strength, and a strong sense of commitment in order to develop confidence in your idea.

Checklist of what you need before approaching a lender:

- **Balance Sheet**
- **Income Statement**
- **Production Records**
- **Cash Flow Projections**
- **A Business Plan**

Balance Sheet

A balance sheet lists all business assets and liabilities, showing what is owned and what is owed. A completed balance sheet will help you and your lender to determine your net worth and equity. A balance sheet is only a snapshot of your financial situation at a specific date

and time. It does not indicate whether you or your business are making or losing money.

There are different ways to construct a balance sheet, and your financial institution may have a preference as to the method they want you to use. The simplest way to construct a balance sheet is to list all your farm and non-farm assets and their values in one column and all your farm and non-farm liabilities in another column. Total the columns. Then subtract liabilities from assets. This result (positive or negative) will give you your net worth and is an indication of how much equity and capital you might have available to put towards your project.

Income Statement

While a balance sheet is a snapshot of your business at a given instant in time, an income statement tells how much money you have earned over a period of time—usually a year, sometimes longer or shorter. Often, lenders will want to use tax records as a record of income. (For many farmers this is Schedule F.) You should note that there are different types of Income Statements. Make sure to get help in creating your own. Turn to an accountant, a good software program, or someone with experience in providing assistance to farmers in financial planning and record-keeping.

Production Records

Production history is a critical component of how a lender evaluates a lending proposal. Past performance is an indicator of future success. Preferably, lenders will want to see documented evidence of your success for the enterprise for which you are seeking capital. If the enterprise is new to you, you may not have production records. In that case, a lender will want to see documentation of success with other enterprises and crops. The key point is that keeping records is important. You must keep the

records in the first place in order to use them as part of a loan application package.

Cash-Flow Projections

A major part of planning a new enterprise is looking to the future, and testing how your ideas will fair in realistic scenarios. Cash flow projections allow you to analyze the future viability of an enterprise by determining the timing of expenses and income and whether you will have enough cash on hand when it is needed. Cash flow management is a critical component of operating a successful business. Many profitable businesses have failed because they did not cash flow.

As a farm-business manager, you can use cash flow analysis to ensure that you will have enough cash to pay expenses, loans, and to get a sense of your future profits.

While cash flow projections should be included as part of a written business plan (which we will describe in greater detail later), cash flow is important enough to discuss separately here.

There are almost as many different forms and methods for evaluating cash flow as there are entrepreneurs. What is most important in constructing a cash flow projection is that you develop a method that makes sense to you. In order for a cash flow projection to be useful, the information in it must be as realistic as possible. Do not cut corners when constructing a cash flow document. Even a small error early on can make a big difference when projected out over a period of years.

It is worth noting the difference between a cash flow projection and an income statement: The cash flow projection measures the actual cash coming in and going out of the enterprise, whereas an income statement

does not always account for timing of revenues or expenses, such as accounts receivable or accounts payable.

Cash flow projections look at sources and uses of cash or incoming cash and outgoing cash. When you create yours, you will take into consideration your current cash position, receivables or sales, other cash sources, and you will compare them against all uses of cash, such as the cost of seed and other inputs, operating expenses, income taxes, and other cash uses. Finally, a cash flow projection ends with “net change in cash position,” a figure derived by subtracting the estimated cash uses from the estimated cash sources. By adding the net change figure to the starting cash figure, you learn how much cash you will have for the next month, quarter or year.

You can use cash flow projections to test your plan under the worst-case scenarios simply by changing some of the numbers around. Use them to see how your business will weather hard times. Always clearly state your assumptions, then project how these assumptions effect your cash flow in the future. This exercise will help you determine in advance what actions you may need to take to avoid problems. Many farmers have a gut-level understanding of this, but a cash flow projection helps your lender quickly understand this aspect of your business.

SCENARIO: How do interest rates and terms affect my bottom line?

There are a lot of different products available for financing a new venture: credit cards, home mortgages, commercial loans, etc. When you make decisions about how to raise capital for your business, it is important to consider the total costs of the money.

Equipment Purchase: Credit Card or Bank Loan?

	Credit Card	Equipment Loan
Amount Borrowed:	\$10,000.00	\$10,000.00
Interest:	18%	8%
Term:	32 months	32 months
Payment Frequency:	Monthly	Monthly
Payment Amount:	\$395.77	\$348.05
Total interest paid:	\$2,664.64	\$1,137.60
TOTAL COST:	\$12,664.64	\$11,137.60

How much does it cost to defer a loan?

	Immediate	18 Month Deferral
Amount Borrowed:	\$100,000.00	\$100,000.00
Interest:	8.25%	8.25%
Term:	15 years	15 years
Number of Payments:	180, monthly	162, monthly, after 18 interest payments
Payment Amount:	\$970.40	\$987.00
Total interest paid:	\$74,670.81	\$84,142.86
TOTAL COST:	\$174,670.81	\$184,142.86

Amortization is the division of a debt into periodic payments over a certain period of time. Amortization calculators can help you to calculate the effects of changing interest rates, terms, principal, balloon payments, and other factors on the total cost of a loan. A good amortization calculator is located online at: <http://bretwhissel.net/amortization/>

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