Working With Your Ag Lender in Good Times and Bad

Steven L. Klose, Kurt M. Guidry, and Bryon J. Parman

Credit and financing problems in the agricultural industry have been on the rise for the past couple of years. Struggles have developed at varying pace and intensity by region and commodity, some beginning as early as 2011. But across the board, by the 2016 growing season, the high levels of liquidity previously built are diminishing as commodity prices have generally fallen and margins have become extremely tight. To make matters worse, the outlook for most crop and livestock commodities remains dim. While some indicators point to stability (interest rates remain low and total farm debt-to-asset ratios remain low), the problem at hand is one of liquidity.

For 3-4 years, debt repayment has declined, loan demand is up, and total outstanding debt has been on the rise in many regions. Much of the trend is due to an inability to repay operating loans, and the need to carry or convert those shortages to longer term debt. Currently stable asset and collateral values can, in many cases, support outstanding and extending debt levels. However, the 1980's crisis taught the dangers of too much reliance on asset based lending. If you dig very far into commodity prices and costs of production, it becomes clear that repayment capacity, and therefore financing is headed for difficult times. In the back of everyone's mind is the potential for a decline in land and other farm asset values and the significant solvency issues that would follow.

None of this discussion is to spread gloom and doom, but to highlight during this time the importance of the borrower / lender relationship in agriculture. Tighter producer margins will stress farmers and ranchers to cash flow and stay current on debt payments. Increased demand for loan funds, reduced repayment capacity, and reduced loan security will stress lending institutions and regulators. Tension is sure to arise between borrower and lender. There is no doubt some borrowers will lose access to credit.

Ag producers and lenders alike must recognize that their individual success is inextricably tied to the success of the other. An unproductive attitude of isolating your own business interests can destroy necessary working relationships, eventually limiting your own success. Whether times are difficult or the industry is soaring, the ones that continue to thrive and/or keep their head above water are the producers and their lenders that work together as partners.

Borrower / Lender Partnership

The borrower/lender relationship can be a confusing one. In one sense the borrower is a customer needing to purchase credit from the bank. In another sense, the bank can be the customer, pursuing borrowers that they might "invest" in their business in order to secure a return on the bank deposits. Given that it works both ways, the best relationship is one that both consider a partnership. If the partnership is positive and productive, a lender can assist a producer in taking advantage of opportunities to push ahead during good times as well as surviving those inevitable downturns in the market. A good borrower/ lender partnership consists of many of the same elements found in any good partnership. The following are some characteristics important to a borrower and lender working well together.

Honesty and Full Disclosure

Both parties need to be upfront and honest in their dealings. No one wants a partner that cannot be trusted. For the producer, full disclosure means sharing all the details of operating plans. Typical financial statement information is a given, but a producer also needs to disclose less obvious components such as outside partnerships, agreements, or contractual obligations. Any new business ventures, obtaining credit from other sources, significant capital purchases, or sales should also be discussed. A producer should allow and even encourage their lender to see their operation first hand.

A similar level of disclosure should be expected of the lender. While there may be situations that would legally prevent a bank from disclosing some information, a lender should openly help their borrowers understand the business and incentives that keep the bank profitable and a stable source of credit. Lenders should openly discuss issues of credit scoring, borrower ratings, timing of decisions and avoid making unrealistic commitments.

Communication

A solid borrower/lender partnership will include a continual communication. Too often producers see borrowing as a single event where if all goes as planned and you continue to make payments on time, you don't need to talk to the bank again. While that may be true of your car loan or home mortgage, any business loan is much more involved. Even when things are going according to plan, periodically checking in with your lender is time well spent. It reinforces the concept of a partnership, and it can't hurt to make sure things are going according to plan with the bank. Most importantly, the partnership is supported when you make sure to have positive conversations. You don't want the only time you talk to be when something went wrong or when a problem needs to be solved.

It's important to remember that effective communication is not simply an ongoing conversation. Both parties must be prepared to hear and account for the advice, knowledge, and expertise the other party brings to the table. During periods of financial stress or hardship, lenders may recommend "belt tightening" measures adjusting current production practices or living expenditures. If this sound advice is ignored, it can be detrimental both businesses. At the same time, the producer may explain that certain practices or costs of production cannot be adjusted without risking the entire operating plan. Likewise, if the farmer's sound production knowledge is ignored, it can be detrimental to both businesses. Effective communication requires the active compromise of ideas toward a solution. While these type of give and take conversations may be difficult, they are critical to staying away from significant losses that both borrower and lender hope to avoid.

Proactivity

A producer should develop management plans and particularly financing plans well in advance. The casual "just checking in" conversations can be used to bring up potential plans and things a producer is considering. The lender's opinion should be sought regarding strategic changes well before time to obtain financing. In fact, more than just opinions, it is often best if plans and strategies are developed through coordination with the lender, taking advantage of his expertise. These actions help the lender understand the manager is one that thinks things through, and when it does come time for financing, the lender will know that plans have been thoroughly evaluated. Contrast the proactive borrower with one that springs new ideas on the lender at the last minute and expects the bank to make quick turnaround decision on a loan. Which borrower is a more attractive partner to the lender?

Trustworthiness

A critical key to any partnership is two parties that have a trust in one another. While the capital purchase plans and operating plans upon which a loan is based are not necessarily full contractual obligations, there is an expectation that both will stick to the plans. A lender is not interested in working with a borrower that routinely makes drastic departures from his original cash flow budget that impact his repayment capacity. By the same token, a producer would not want to work with a lender that changed his access to an agreed operating line of credit halfway through the growing season.

Knowing and Communicating Your Business

In addition to the characteristics above, one of the things that makes an attractive borrower is the extent to which he knows his own business. It is an indication that a producer is and will be making sound financial decisions that in turn limit risk on the part of the lender. The beginning of that for most lenders is looking for a borrower that has a good understanding of his own financial statements. Too often, these documents either don't exist or they exist because the loan officer creates them. More appropriate is the borrower that can communicate the story of his operation through historical financial statements and *pro forma* estimates of future plans. A sound cash flow budget effectively communicates an operating plan, the timing associated with accessing an operating line of credit, and estimates of repayment capacity. A complete and accurate balance sheet illustrates your overall solvency position, other debt obligations, and current liquidity position. Several years of recent income statements will demonstrate a track record of performance for an operation. Each of these financial statements should be updated frequently as a standard management practice to monitor a business, but it is also important to share updates with the lender indicating progress or deviation from an original plan.

It is often the case in the current agricultural lending environment that while the lender may be financially or business savvy, he/she may not have an agricultural background, or be well versed in an agricultural producer's enterprise. This is especially true for less common commercial agricultural enterprises such as horticultural crops and niche livestock operations. Therefore, in addition to providing a financial understanding, it is incumbent on the borrower to educate the lender on enterprise specific production practices. It is essential that the lender comprehend technical elements of the operation beyond the simple dollar totals tied to loans and loan repayment.

In line with the earlier discussion of being proactive, a necessary part of having a solid grasp on a business is planning ahead for credit needs. Planning appropriately for credit needs means having a constant eye on the future and having realistic financial and operating expectations. Overly optimistic commodity prices, crop yields, or undervalued costs of production may look good on paper at the beginning of the season. However, poor credit planning will usually lead to a position of insufficient credit availability and a strained partnership with the lender. A producer that consistently makes credit plans that do not need to be adjusted is the customer the bank is most interested in keeping. Planning for credit needs also means simply keeping surprises to a minimum. Capital purchases or third party debt shouldn't be made without some discussion with the primary lender. When plans begin to fall apart, getting the lender involved as soon as possible will demonstrate that the borrower is on top of the situation, as well as allowing time for the lender to help plan a solution.

A major concern for agricultural producers and lenders alike are risk management strategies and tools available to producers. These tools have become even more critical since the passage of the 2014 Farm Bill and the elimination of direct payments. Previously, operating credit lines were made more secure with the certain revenue of fixed direct payments. Without direct payments, crop insurance and price risk management have become more critical from a lender's perspective. However, the many crop insurance and marketing choices available can be an area of contention between borrowers and lenders. For example, the level of crop insurance a farmer buys is determined by a balance between premium cost and risk tolerance. In some situations, an operating loan may be made contingent on the producer buying specific levels of coverage in order to ensure repayment capacity. From the farmer's perspective, higher premiums may cut too deeply into profits and he would prefer to take the risk the banker is not willing to take. Of course the lender would like to see coverage levels approaching a guarantee on at least the operating line of credit extended for the crop. The lender interest in crop insurance choice can vary from suggestion to requirement, depending on the financial condition of the borrower and relative strength of the borrower/lender partnership.

Marketing opportunities and price risk management can also be a source of friction between borrower and lender. Once again, managing the balance between producer and lender profit/risk motives requires a proactive plan that both parties understand and are willing to follow through. Bankers often express frustration with producers when they fail to take action to lock in an available price that would accomplish their operating cash flow plan. Conversely, some elaborate pricing tools can leave a lender wary, especially if they do not understand the tools. If a specific plan involves credit needs for upfront premium costs or potential margin calls, it is critical to have a lender that understands and is willing to commit to the financing necessary to carry out the plan under a variety of possible outcomes.

A bigger picture, long-term strategy is also critical for a successful credit partnership. Experience in agricultural production reminds us that everything comes in cycles. Short sighted optimism can be a problem for both borrower and lender. During market highs, some people will assume the industry has reached and will sustain a new plateau. Producers and lenders alike may be willing to over extend credit based on solid collateral values and repayment capacities. Similar conditions in the 1970's certainly contributed to the 1980's credit crisis. It is important to use the more profitable peaks of the cycle to first repair and strengthen one's financial condition in preparation for the next downturn. During times of depressed prices or challenging weather, operating shortfalls or unmet debt obligations may be extended into term debt to help a producer manage the cycle lows. Throughout the ups and downs of industry cycles, it is critical that borrower and lender work together toward a common long term strategy.

Understand the Bank Business

As with any partnership, it's important to put yourself in the other's shoes and understand their business incentives. A bank's profit motives, incentive structure, rules, and regulations will all impact the credit decisions critical to a farmer's continued success. Every detail of a bank's financial condition may not be necessary or even available, but a borrower should ask questions and be relatively familiar with the stability and strength of the bank. In addition to the condition of the bank, it may also be important to understand the bank's portfolio of deposits and lending business. For example, if a bank is well diversified, lending to a variety of industries and/or a variety of agricultural commodity production, it may be less likely to panic when one industry or commodity market is going through a downturn. At the same time, a producer would want his lender to have enough investment to demonstrate a commitment to his industry.

In addition to knowing the condition of the bank, a borrower should fully understand the process by which the bank makes lending decisions. Answers to the following questions will give the borrower an appropriate working knowledge of the loan process:

- Who are the key players in a loan decision?
- What is the role of the loan officer, credit analyst, and others?
- Is there a loan approval board? Who makes the final lending decision?
- How does the size or type of loan affect the approval process?
- How long will various types of loan decisions take?
- How are rates determined for different term, size, and types of loans?
- Under what circumstances might a loan be called?
- How do bankruptcy, homestead protection, and other borrower protection laws affect a loan?
- How do regulatory oversight and bank examination standards affect a loan?

A good lending partner should be as comfortable answering these types of questions as they are asking questions regarding the borrower's business.

When it comes to understanding your lender's business, another important factor to remember is that the bank's willingness to loan funds does not always mean it is a loan you should take. There may be times where the risk and terms of a loan make it a good business decision for the bank, but not the best business decision for the borrower. The final decision on whether to borrow or not rests within what the producer believes to be his/her best interests and it is the producer's responsibility to financially vet those decisions.

In the end, the strength of the borrower / lender relationship is critical to both parties. A good borrower must first be a good manager of his own business and then be able to effectively communicate his business plans to the lender. Likewise, a good lender must also first be a good manager of his own business. He then must be able to help the borrower navigate and understand the lending process while committing himself to understanding the industry and production practices of his borrower. Both must have open lines of communication. They must think proactively together as partners and be able to trust and depend on one another for the benefit of both businesses.