## A GUIDE TO BORROWING

The agribusiness industry employs many managers who have proven themselves to be highly successful in their profession. They can be found in farm supply firms, food processing plants, marketing associations and every other sector of the industry. During my travels, I have had the pleasure of meeting several of these successful agribusiness managers. It is extremely difficult to describe this select group of people. While each manager has an individualistic approach to his job, as a group, they do share a few basic similarities. This paper will discuss one of those similarities.

One of the well-accepted criteria for success is the ability to show a profit-and do so consistently. Successful managers, therefore, do exhibit the ability to operate a profitable business most of the time. However, I have observed that *besides showing an excellent ability to make money, the successful manager is usually equally adept at borrowing it.* This relationship between making and borrowing money is a strong one. Are you a successful borrower? How much time and talent do you devote to your borrowing activities? How can an agribusiness manager improve his performance as a borrower? This paper's objective is to provide an answer to the final question. More specifically, the discussion shall deal with: a) a manager's credit attitude, b) an understanding of credit worthiness, c) the amount of money to be borrowed, d) collateral, and e) loan restrictions.

### Do You Think Credit?

Has your application for a loan (personal or business) ever been refused? Like many others, I have experienced this rather unsettling event. My reaction to this refusal could only be described as a combination of personal embarrassment (How do I explain this to my wife!) and total bewilderment (Does this mean I'm unreliable?). The confusion and disappointment soon turned to anger, and for several weeks following the incident I proceeded to tell all my colleagues and friends about what a skunk my banker had turned out to be. Several months passed before I realized that the loan refusal was justified and my banker had done me a favor.

Probably as a result of the refusal, my attitude toward borrowing has changed substantially. At the time of my loan application, I was little concerned about the fine points of credit ratings, repayment capacity, and loan restrictions. I assumed that the use of commercial bank credit would be no more difficult than the use of my gasoline credit card. Knowledge of the financial facts of borrowing could have saved me considerable consternation. A successful borrower maintains a proper attitude about his request for and use of borrowed money. He thinks credit and appreciates what it can do for him or to him.



WASHINGTON STATE UNIVERSITY & U.S. DEPARTMENT OF AGRICULTURE COOPERATING

**Credit Worthiness**

The ability to obtain money when needed is one of the most cherished attributes of any business. This ability is not automatically acquired, nor, is it easily retained. Before any lending agency will loan money to a business, the loan officer will require satisfactory answers to six basic questions. Successful borrowers are familiar with these questions and recognize that they are used to establish a firm's credit worthiness. More specifically, the credit worthiness of your business is based on the following factors.

***Character:*** What is your attitude towards borrowing and how capable are you as a manager? In many cases, a loan will rest heavily on the strength of the manager's character and his ability to control the firm's activities.

***Use:*** What is the intended use of the money to be borrowed? The answer to this question will not only help determine whether or not the loan is warranted, but also assist in selecting the proper type of loan (short, intermediate, or long term) and a suitable repayment schedule.

***Repayment:*** When and how does the firm expect to repay the loan? Too many would-be borrowers assume that these terms are dictated by the lending agency. This is rarely the case and the successful borrower negotiates these conditions to his best advantage. Moreover, he is prepared to substantiate his request for a particular schedule.

***Amount:*** The amount of money to be borrowed will be discussed in more detail later in this paper. Basically, however, the successful borrower makes an allowance for unexpected developments by adding a "cushion" to the amount of money immediately required. The concept of a cushion is generally understood by commercial lenders and, like the repayment terms, is subject to negotiation.

***Outlook:*** What is the economic outlook for business, in general, and for the borrower's firm, in particular? This question cannot go unanswered because the future will have a direct impact on the security of the loan and the manager's ability to use the money efficiently.

***Financial Statements:*** Lenders prefer to make loans to businesses, which are: 1) solvent, 2) profitable, and 3) growing. Successful borrowers devote considerable effort proving that their firm meets all three requirements. The balance sheet and profit-and-loss statement are two basic financial statements, which are critically important. After all, the balance sheet is a major measurement of the firm's solvency. The P and L statement is a direct indication of the firm's profitability. And finally, a continuous series of these two financial statements over several recent years provides a relatively accurate measure of the firm's financial stability and growth potential.

In most cases, the lender will express an interest in some general information about the firm. For example, he may inquire about the nature and extent of the firm's record-keeping activities. He may ask about the condition of accounts receivable, i.e., turnover, size of reserve for losses, customer credit policies, etc. Inventories may also be of interest to the lender. He may ask that they be checked or confirmed. Fixed assets may be evaluated for type, age, and operating condition. Depreciation schedules may be checked and existing mortgages may be called for observation. Regardless, the successful borrower does not consider these inquiries to be an unjustified invasion of privileged information. In fact, the

intelligent manager anticipates the lender's questions and has the answers readily available. As a result, the lender will be able to make an efficient appraisal of your firm's credit worthiness, thereby saving considerable time and effort for all parties concerned.

**How Much Money?**

The amount of money you need to borrow depends on its purpose or intended use. Calculating the amount of money required to build a new warehouse or modernize a retail display area is not extremely difficult. Architects, builders and equipment salesman will readily supply you with cost estimates. A determination of the amount of working capital needed is considerably more difficult, however. Your needs will probably depend on the type of business your firm is engaged in. Rule-of-thumb estimates are sometimes used, but they are a poor substitute for a detailed projection of sources and uses of funds over some future period of time (generally no less than 12 months).

Such a projection can be prepared by the agribusiness manager through the combined use of a budget and cash flow forecast. The budget will usually be based on the firm's recent operating experience and the manager's best estimate of firm performance during the loan period. The cash flow forecast is simply the manager's estimate of cash receipts and expenditures during the budget period. In this manner, the budget and the cash flow forecast, together, provide the successful borrower and his lender generally realistic estimates of the firm's total future capital requirements. As such, it also provides the basis of a mutual understanding between participating parties regarding the privileges and responsibilities of each.

**What is Collateral?**

On a rare occasion, the manager's signature may be the only form of security requested by the lender. More commonly, the lender will require additional assurance that the loan will be repaid. The nature and extent of this security depends on the lender's and the borrower's particular circumstances.

Suppose for a moment that a firm's financial statements, alone, do not justify approval of the loan request. Does this mean that the agribusiness firm must go elsewhere in search of funds or do without? Not necessarily. Collateral (or loan security) may take many forms. For example, the agribusiness manager, in an attempt to secure the loan, may use as collateral such financial instruments as: endorsers, co-makers, and guarantors; assignment of leases; trust receipts; chattel mortgages; stocks and bonds; etc.

A lender may request that outside parties sign a note in order to bolster the security of the borrowing firm. The outside party may play the role of an *endorser,* i.e., upon failure of the borrower to repay the loan; the endorser is contingently liable to make the note good. Similarly, a *co-maker is* one who creates an obligation jointly with the borrower. In this case, however, the lender can collect directly from either the borrower or the co-maker without waiting on the borrower's failure to repay. A *guarantor is* one who guarantees the payment of a note by signing a commitment. This device is sometimes used by equipment manufacturers who, in order to facilitate a sale, act as guarantor for one of their agribusiness customers.

Another form of collateral is called an *assignment of lease* and is somewhat similar to the guarantee. Suppose your firm purchases some rental property using

borrowed funds. As collateral, the lender asks that to guarantee regular payment, all or a portion of the monthly fees from the leasing of this property be assigned directly to him.
When dealing with the agribusiness industry, lenders may take agricultural commodities as security through the acceptance of a *warehouse receipt.* This receipt is usually delivered directly to the lender and shows that the merchandise used as collateral either has been placed in a public warehouse or left on the borrower's premises under the control of the bonded employee. The typical warehouse receipt loan, however, will generally amount to less than 100 percent of the estimated market value of the goods being held. Furthermore, the successful borrower knows that this document is hard to negotiate when dealing with an agricultural product with a widely fluctuating market or one, which is susceptible to quality deterioration while in storage.

If your agribusiness firm is engaged in retail farm supply activities, you are no doubt aware that merchandise often must be displayed in order to sell it. A firm may require a loan to construct a special display or conduct a merchandising campaign. In such cases, the lender may ask for a *trust receipt.* The trust receipt is the legal document for so-called floor planning (where displayed merchandise is serial-numbered). With this form of collateral, the borrower: 1) acknowledges the existence of the merchandise, 2) agrees to keep it in trust to the lender, and 3) promises to repay the lender as the goods are sold.

*Chattel mortgages* (a lien on equipment purchased), *real estate, accounts receivable, savings accounts, stock, and bonds* are other items which may be accepted by the lender as collateral. Regardless of what form of security is used, the successful borrower asks for and receives a complete description of the loan documents before they are signed.

**Loan Restrictions**

Lending institutions are not just interested in loan repayments. They are also sincerely interested in assisting their clients to become healthy profit-making operations. Whether or not collateral is required for a loan, the lender is likely to establish additional loan limitations or restrictions. These are used to provide the lender with additional protection and reduce the chance that the borrowing firm may become a victim of a poor management practice.

Some agribusiness managers, to be sure, consider these limitations to be unnecessary, if not an outright burden. Others believe that the limitations provide an opportunity for them to improve their managerial techniques.

The kinds of restrictions and limitations placed on your loan will depend on numerous factors. As a general rule, however, one may expect the number and extent of these limitations to increase in direct proportion to: 1) the size of the loan, 2) the risks involved, and 3) the duration of the loan. Let's consider briefly the various types of restrictions with which you, as a borrower, may some day be confronted. Knowing what they are may help you determine how they will affect your firm's operations.

Generally speaking, loan limitations will be connected to:

a) Repayment terms,

b) Pledging (the use of security), or

c) Periodic reporting.

The actual restrictions in a loan agreement will actually be found in a section best known as "covenants." Negative covenants are those items, which the borrower *may not*

*do* without prior approval from the lender such as making further additions to the total debt load, pledging assets to others, or issuance of dividends in excess of those specified in the loan agreement. Positive covenants are those items, which the borrower *must do* such as the maintenance of a minimum working capital balance, carrying specified levels of insurance, or supplying the lender with particular financial reports on a regular basis. Positive and negative covenants may be renegotiated from time to time and some provisions may be waived under special circumstances. However, for his own protection, the successful borrower will read the covenants of the loan agreement comprehensively before signing on the dotted line.

Remember, many loan terms are negotiable. Chances are that the lender will "give in" on a few points. Also keep in mind that while the terms are being negotiated, it may be wise for you to discuss them with your business associates and outside advisors. In short, try to get those terms, which you know your firm can live with. Once those terms are agreed upon and the loan is made, it is your managerial responsibility to see that the terms are met.

**Summary**

Experience shows that those agribusiness managers who succeed at making money are likely to be equally successful at borrowing it. In fact, successful borrowing may result in the single greatest contribution to the firm's profit. Success, however, is not automatic and requires a manager's willingness to improve his understanding of the borrowing process. This paper was designed to provide a guide for this improved understanding.

Discussions illustrated that a manager's credit attitude was an important pre-loan factor. Credit worthiness was shown to rest on the borrower's ability to answer six basic questions related to: 1) character, 2) use, 3) repayment, 4) amount, 5) outlook, and 6) financial statements. A budget and cash flow forecast were found to be important in determining the amounts of funds requested and numerous forms of collateral were described. Finally, loan restrictions were considered in both a positive and negative sense.

Ken D. Duft
Extension Marketing Economist