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Warren F. Lee
Professor

Dept. of Agricultural Economics
and Rural Sociology

Ohio State University
Cooperative Extension Service

TITLE: CREDIT MANAGEMENT

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Introduction

The term "credit" is defined as the capacity to borrow. The word "borrow" means to receive something on the understanding that it or its equivalent will be returned or repaid at some future date. The objective of credit management is to maximize the capacity to borrow. Credit can be used by actual borrowing, or it can be held in reserve as protection against adversity. Thus, even a debt-free business has credit -- all of which is being held in reserve. Credit is an important resource whether it is used or held in reserve, and it should be properly managed.

Credit Management Strategies

Maximizing borrowing capacity involves understanding how lenders evaluate credit worthiness, and organizing the business so that lenders would respond favorably to your loan applications. Many factors enter into the loan decision. These factors have been summarized as the three C's of credit; Character, Capacity and Collateral and the three R's of credit; Risk-bearing ability, Returns and Repayment ability. In addition to the 3 C's and the 3 R's, lenders consider factors such as purpose of loan, financial position, management ability, etc. The borrower's task is to sell credit worthiness to the lender.

A. Character

Most lenders would put character, integrity, honesty, etc. at the top of any list of credit factors. All borrowers should strive to maintain the complete confidence of the lender. Some specific suggestions include:

1. Always meet loan payment due dates. If a payment cannot be made on time, be sure to provide the lender with a complete explanation before the due date. Where justifiable reasons exist, most lenders will extend the due date or refinance the obligation.

2. Maintain communication. Lender-borrower misunderstanding can be avoided through frank and open communication. Presenting the lender with complete past and projected balance sheets, income statements and cash flow statements is one important form of communication. In addition, the borrower should acquaint the lender with the goals, objectives and plans for the business. Alerting the lender well in advance of major spending plans is particularly important. Try to avoid unpleasant surprises for the lender. Remember too that good agricultural loan officers are knowledgeable people whose advice should be sought and used when developing plans.

3. Avoid using too many sources of credit. Most borrowers use more than one credit source because lenders tend to specialize in either real estate or non-real estate lending; however, the use of many different credit sources creates a great deal of uncertainty for both borrower and lender. If several creditors are involved, repayment schedules become difficult to budget and the individual lenders are less certain of their security. To the extent feasible, avoid "split lines" of credit, and if more than one source must be used be certain that all lenders are fully acquainted with the complete financing picture.

B. Purpose of Loan

Very often the intended use of borrowed funds becomes an important factor in loan approval or rejection. Generally, lenders prefer to see loan funds used for production as opposed to consumption uses. For example, a loan application for needed farm machinery or livestock will be more favorably viewed than one for a recreational vehicle.

Lenders also prefer loans that generate good collateral. Good collateral has two characteristics: 1) it has a stable or rising market value and 2) it can easily be reclaimed and sold if necessary. Examples of good collateral include land, livestock, and stored crops. Machinery and buildings are also generally considered to be good collateral although they do depreciate in value over time. Less desirable collateral includes items such as fuel, fertilizer and pesticides which "disappear" in the production process and, therefore, cannot be easily reclaimed. Most consumer goods are also less desirable because their market values typically decline rapidly. Loans for everyday living costs or vacations generate no collateral whatsoever.

An important credit management strategy is to understand these lender preferences for different loan purposes and tailor loan applications accordingly. Use loan funds for "lender-favored" purposes and use cash reserves for expenditures that lenders might view with less enthusiasm. In any case, be sure to inform the lender in advance of all major business and personal expenditures regardless of how they are to be financed.

C. Financial Position

A thorough analysis of the balance sheet, as discussed in FMH XII 201 (Financial Statements), is an essential part of the credit decision. A carefully prepared balance sheet enables you and the lender to measure financial progress over time. Lenders pay particular attention to trends in the balance sheet ratios over time, and deterioration in any or all of the ratios is considered a danger signal.

In the short run, there is little the borrower can do to improve the overall financial position of the business, as measured by the debt to asset ratio. However, the balance between short, intermediate and long term assets and liabilities can be changed. Consider the balance sheets for borrowers A and B in Table 1. Both have the same total assets, total debt and owner equity. In other words, their overall financial position is identical, with debt to asset ratios of .5. However A's balance sheet would create a much more favorable impression because short, intermediate and long-term debts are distributed in the same proportion as short, intermediate and and long-term assets. A's current, intermediate and net capital ratios are all 2 to 1. B's balance sheet, however, reflects a weak current position, with current and intermediate ratios of only 1 to 1. B could very well have the same income as A, but experience repayment problems because of lack of balance in the debt structure.

Table 1
Debt Structure and Balance for Borrowers A & B

Assets

	A	B
Current	$ 20	$ 20
Intermediate	20	20
Long term	60	60
Total Assets	$100	$100

Liabilities and Owner Equity

	A	B
Short term debt	$ 10	$ 20
Intermediate term debt	10	20
Long term debt	30	10
Total debt	$ 50	$ 50
Owner Equity	50	50
Total	$100	$100

The two more common causes of imbalance in the balance sheet are asset conversion and failure to match loan repayment terms with the life of assets being financed. Some asset conversion is normal, especially for an expanding business. One common example of the conversion of current assets to intermediate assets is holding back young stock for the breeding herd. Gilts and heifer calves (current assets) become sows and cows (intermediate assets). A similar conversion occurs when current assets are sold to help finance intermediate or long term assets. Suppose borrower A in Table 1 sells $10 worth of stored crops (a current asset) and buys a $10 worth of machinery (an intermediate asset). As a result of this transaction, the current ratio drops from a relatively strong 2 to 1 to a marginal 1 to 1.

Many repayment problems are a direct result of attempting to pay off capital loans too rapidly. As a general rule, the repayment period on loans for breeding livestock, machinery, buildings and other capital assets should be at least one half to two thirds of the anticipated life of the asset. Consider a $10,000, 12% loan for a building with a 20 year life. If the loan is repaid over 4 years the equal annual payment would be $3292. By stretching the repayment period to 10 years, the annual payment is reduced to only $1770. For a $100,000 loan the difference would be $15,220 per year - a difference that could have a significant effect on the liquidity of the business. A similar error is made when land or permanent improvements such as tile drainage are financed over only 5 to 10 years when 20 to 35 years would be more appropriate.

In general, repayment periods should be based on asset life. Some borrowers resist the idea of setting up long repayment schedules because total interest costs are higher; however, most lenders will accept additional payments without charging prepayment penalties, so if things do go better than expected, capital loans can be repaid sooner than originally scheduled, thereby reducing interest charges. At the same time the lower payment obligation provides a cushion in bad years.

If, over time, asset conversion or inappropriate matching of loan terms and asset lives lead to a poorly structured balance sheet and liquidity problems, the situation can sometimes be resolved by refinancing some of the short or intermediate term debt. Borrower B in Table 1, for example, could restructure the balance sheet by increasing the long term debt to $30 and using the $20 net loan preceeds to reduce current and intermediate term debt by $10 each. This solution may not resolve repayment problems, however, if high loan transactions costs are involved or if current interest rates are significantly higher than the interest rates on the existing loans.

Another approach to balance sheet restructuring is to sell assets Borrower B in Table 1, for example, could sell $20 worth of long term assets and repay $10 each on current and intermediate term debts. Most borrowers are understandably reluctant to sell assets to restructure the balance sheet because reducing the amount of assets may reduce income. However, unproductive assets can be sold without reducing income. Excess inventories and super adequate machinery are examples. Sometimes the control and use of capital assets sold to resolve balance sheet structure problems can be maintained with appropriate sale and leaseback arrangements.

D. Repayment Capacity

Adequate size and efficient use of all resources are the keys to generating and maintaining repayment capacity. Lenders evaluate repayment capacity on the basis of past performance and projections. If the borrower is just starting, or if a major change or expansion is planned, greater weight will be given to the projections. Several factors must be considered before loans are extended to a new business or to finance major expansions or changes.

1) Does the borrower have the management ability to handle the new or expanded business? The old adage "get better before you get bigger" is an important rule in any expansion program. Minor management problems in a small business can become major ones in a large business. Even with superior management, efficiency tends to drop off during the early stages of an expansion or change.

2) Is there enough net worth? There is a limit on the extent to which a business can be safely expanded from a fixed equity base. As a general rule, lenders

prefer an equity of 50 percent or more and cases with less than 30 to 40 percent equity are very carefully scrutinized. Borrower A in Table 1, for example, would probably not have enough equity to carry out a debt-financed expansion from $100 to over $200 in total assets.

3) Are yield and price expectations realistic? Most farmers are optimistic by nature, but overly optimistic projections of yields and prices to budget loan repayment plans will only hide possible cash flow problems. It is better to use realistic estimates and perhaps be slightly conservative to provide a cushion for the inevitable below-average years.

4) Is there adequate financing for the total plan? Many borrowers and lenders fail to account for the total amount of financing needed in expansion programs. Moreover, they do not take into consideration the lag between the time of start up and receipt of income. Consider a plan to buy additional land and buildings and to expand a livestock enterprise. The outlay for the land and buildings must be made immediately. Almost inevitably there are expenses for needed repairs and maintenance. It may be several months before feed produced or the new land is harvested and available for the additional livestock. Often this type of expansion will require outlays for larger field equipment, as well as the additional operating expenses. The point is that depending on the enterprises involved, it may be one or two years before the expansion program begins to generate additional income. If this time lag is not anticipated, cash flow problems are almost certain to occur.

Summary

Credit management requires careful attention to the "Three C's" and "Three R's" used by lenders to evaluate loan applications. Borrowing capacity can be enhanced by 1) Maintaining the lender's confidence, 2) using credit for lender favored purposes, 3) maintaining a balanced financial position and 4) demonstrating repayment capacity.

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