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A Balanced Approach to Credit Analysis

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A recent webinar with Moody's Analytics set an attendance record at over 1300 lender participants. The follow up response was tremendous, including a large array of topics. In fact, if I addressed each one, I would be busy well into next year! However, the follow up questions provided valuable insight into the evolving approach to credit. Agriculture is a cyclical industry; and one that is currently in an elongated downturn. Thus, the best approach to credit and customers is one of balance. Actually, a balanced approach is necessary to maintain the stability of credit in agriculture.

Many lenders shared that regulators and reviewers are emphasizing the importance of cash flow; and of course, cash flow is stressed by today's economic conditions. Yes, profits and cash flow are important in any cycle, positive or negative. However, a balanced approach to credit must include the traditional "five C's" plus one: cash flow, capital, conditions, character, collateral, and the sixth, the cranium. The "sixth C" measures the customer's ability to strategize, plan, execute, and monitor.

Generally, only the top 40 percent of farms are generating positive profits in today's economic environment. Often, these managers follow the "5 percent rule" as termed by Dr. Danny Klinefelter of Texas A&M University. That is they are 5 percent better in several aspects of their business when compared to other managers. This includes areas such as production, marketing, finance, and risk management. These top managers establish realistic expectations through scenario planning, which uses different production, price, and cost assumptions. Usually, the scenarios are based on the best, worst, and average cases. Also unique to this group is their practice of considering possible outcomes according to their available resources. They do not give into a "shoot from the hip," or reaction based approach to management. In short, the top managers balance their passion for farming with the logic of economics.

This top group builds working capital to serve as a secondary line of defense should cash flow and profits turn negative. Normally, working capital is measured by the current ratio, or working capital to expenses or revenue. Yet, the key to assessing working capital is not necessarily the ratio, but rather the quality of inventory, the marketing and risk management plan, receivables and collectibles, prepaid expenses, as well as the crop in the field. The quality and potential of these items make up what one might call true working capital.

When assessing the value of working capital, it is important to consider both sides of the equation. What is the status of accounts payable and operating lines of credit? Additionally, consider how many times the customer has refinanced previously. In fact, relationship managers and credit analysts sometimes rely too heavily on the numbers and ratios, and neglect a closer inspection in their due diligence. If there are losses in the business, as is the case for many of today's farms, the burn rate on working capital becomes an especially important factor. This is calculated by dividing losses into net working capital. In a balanced approach to credit analysis, the burn rate categorizes the level of urgency for a customer.

In cases where cash flow and profits have been negative for multiple years, the customer has most likely already burned through most of the available working capital. This makes the next step an examination of core equity. Yes, collateral and equity are good, but they must be measured carefully. One must establish advance rates on land, machinery and equipment, livestock, and equity reserves without compromising the lending institution. For those producers pursuing a farming lifestyle rather than a farm business, the burn rate on excess core equity might look something like the fuel consumption of a rocket. Often, those that have spent their life farming have built considerable equity. However, in many of these situations, that equity is supposed to fund retirement. The capital of the business is the final line of defense for many; and in the down cycles, critical decisions will be required to avoid a total loss of wealth.

Based upon experience, character and management are often linked; and neither should be underestimated. Though difficult for an analyst to quantify, these qualitative factors can measure a customer's commitment to repayment and willingness to execute change. In the balanced approach to credit, it is important to assess whether the customer has identified and made necessary adjustments. One dangerous mistake some credit analysts and others make is using an average for family living costs in cash flow analysis. Today, family living costs range anywhere from $40,000 to $125,000 depending on family size and several other variables. This is a difference of approximately $85,000 of free cash flow. Clearly, defaulting to an average is not adequate for accurate analysis and could cause considerable problems.

Another sign of character is often the customer's willingness to cooperate and be interdependent. Is the customer willing to rely on the lender in a side-by-side business relationship? Covenants are great, but a one page plan of improvement, written by the customer, can be especially helpful in today's economic environment. Is the customer open to advice? Will the customer commit to a simple plan, and then, monitor? In other words, if the customer is set in old ways, risk increases. Especially with a credit assessment that indicates risk, the strength of a customer's character is a telling factor in long term sustainability.

In summary, the balanced approach to agricultural credit includes more than financial ratios and cash flow analysis. Other quantitative and qualitative factors reveal information that may impact sustainability more than the numbers. It is true that the lasting relationships between customers and lenders are often built during times of economic stress. While numbers and averages may be more concrete, a complete credit analysis encompasses each component of the credit spectrum. Therefore, remember to step back and examine the customer and credit from the full viewpoint.