

CREDIT

Credit

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Two kinds of money used in the business:

- *Inside money*--owner's equity or owner's loan to the business
- *Outside money*--borrowed funds, creditor's money, rented money, other's loan to the business

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Uses of credit

- Help establish and maintain a farm business of adequate size
- Assist in making needed changes in farm business to meet changing conditions
- Improve efficiency of the farm business
- Keep business going in periods of income fluctuation
- Help provide the transfer of a profitable business to another operator

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Three important considerations in credit:

- *Returns*—profitability
- *Repayment capacity*--liquidity/cash flow
- *Risk*--long run stability--solvency

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Using credit successfully

- *Reasons people get into trouble using credit*
 - Inadequate analysis of situation
 - Poorly prepared budgets
 - Repayment schedule too rapid or not matched to investment
 - Too many creditors
 - Not enough volume of business
 - Failure to use profitable technology
 - Lack of experience, knowledge, or ambition
 - Inability to control costs

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How to strengthen repayment capacity:

- Build equity - solvency
- Try to maximize net income—*profitability*
- Invest in enterprises with quick payback
- Select production methods that make maximum use of self-liquidating loans

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Debt Structure is Critical....

- Plan repayment schedule to fit income using cash flow budget.
- Length of loan should correspond to length of time needed to recover investment.

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Investment priorities

- High and fast pay back potential
- Rating of investment priorities in the farm business
 1. Feed, seed, productive livestock
 2. Machinery and equipment
 3. Buildings and equipment
 4. Land
- (2) and (3) are a close middle pair and there may be exceptions to this rating in rare cases

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- **Balancing types of credit**

- Current
- Intermediate
- Long term

- **Flexibility**

- Prepayment privilege
- Line of credit

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Interest Rates:

- **Simple interest** (Borrow \$1000 @10% pay \$1100 in 1 year)
- **Add on loan** $(\$1000 + \$100) / 12 = \$91.67 / \text{month}$
- **Variable interest rates**
- **Balloon notes** (borrow \$1000 @10% for 5 years pay \$100/year four years and \$1100 at the end of the 5th year)
- **Discount interest on front end loan (points)** Borrow \$10000 @10% receive \$9800 (2 points origination fee)

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$$\text{True Annual Interest Rate} = \frac{2 I N}{B (n + I)}$$

Example: \$9,000 loan, end of year pay back \$10,000

$$(2 \times \$1,000 \times 1) / \$9,000 \times (1 + 1) = 0.1111 \text{ or } 11.11\%$$

I = Interest paid (or amount paid back minus amount received);

N = Number of payment periods in one year, (i.e., monthly = 12,

semi-monthly = 24, weekly = 52, annually = 1, semi-annually = 2);

B = Balance or loan amount;

n = Number of annual payments.

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–Add-on interest loan

–Amortized loan

- Interest on unpaid balance
- Equal payment loan

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- Interest only
- Balloon loan
- Other
 - Compensating balances
 - Required stock purchase

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- How much debt?
 - Return
 - Risk
- Calculating the amount of debt you can handle

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Calculating Debt Capacity

Item	Example
Cash Farm Income	+100,000
Cash Exp. (excluding Interest)	- 50,000
Subtotal	= \$50,000
Cash for capital goods / replacement or expansion	-10,000
Subtotal	\$40,000
Family Living, Tax & SS	-28,000
Subtotal	\$12,000
Net non-farm income avail.	\$10,000
Amount available for debt	\$22,000

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- Absolute vs relative size of debt
- Shopping for credit
 - Farm Credit
 - Commercial Banks
 - Farm Service Agency

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Questions for your lender

- What are the lending policies?
- Are credit conditions suitable?
- What is the repayment schedule?
- Concerns of lenders
 - Character, Capacity, & Collateral

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How borrowers and lenders view their roles



- Borrowers and lenders must work as a team to seek win / win transactions

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- **Sources of credit**

- Private (Banks or Family)
 - Line of credit / notes / mortgages / land contracts
- Cooperative (Farm Credit)
 - Line of credit / notes / mortgages
- Governmental (FSA)
 - Subsidized interest rates / load guarantees

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- **Other important considerations**

- **Currency type**
- **Inflation rate**
- **Exchange rate**

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