

CREDIT

Credit

1

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

Credit

2

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

Credit

3

Three important considerations in credit:

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

Credit

4

Using credit successfully

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

Credit

5

How to strengthen repayment capacity:

- Build equity - solvency
- Try to maximize net income--*profitability*
- Select production methods that make maximum use of self-liquidating loans

Credit

6

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.

Credit

7

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

Credit

8

• Balancing types of credit

- Current
- Intermediate
- Long term

• Flexibility

- Prepayment privilege
- Line of credit

Credit

9

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)
- **Amortized notes:** each payment contains some interest and some principal (more interest in early periods mostly princ later.

Credit

10

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

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.

Credit

11

–Add-on interest loan

–Amortized loan

- Interest on unpaid balance
- Equal payment loan

Credit

12

- Interest only loans
- Balloon loans
- Other
 - Compensating balances
 - Required stock purchase
 - (These will affect effective interest payments)

Credit

13

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

Credit

14

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

Credit

15

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

Credit

16

Questions for your lender

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

Credit

17

How borrowers and lenders view their roles



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

Credit

18

- **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