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Financing modernization: What your banker wants to know

Contributed by Timothy Beck and Heather Weeks

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When planning a dairy modernization, the first questions that come to mind are probably of the building and construction variety. However, before the builders can break ground, the bank financing the operation has to approve the plan. For most major renovations or expansions, a lender will want a business plan to outline how the farm made these modernization plans and the goals for the farm's future success. For that plan to be approved, a comprehensive financial plan must be included that proves the farm's past profitability and justifies the expansion for further profits down the road.

Here we outline five key financial ratios any farm should consider when creating a plan:

Current ratio

The current ratio is taken from the balance sheet – a summary of the farm's assets and liabilities. It measures liquidity, or whether the ~~current~~ assets could pay off all current liabilities. Current assets are anything that would be used or sold within a year and includes all cash or checking balance, the value of crops and feed, and the most recent milk check. On the liability side, this includes any accounts payable over 30 days, including credit cards or lines of credit. The current ratio gives the lender an idea of whether the bills get paid on a regular basis and if the farm will be able to make its loan payments on time.

A ratio of 1.75 would mean that a farm has \$1.75 to cover every \$1 of current debt. Banks would like to see a ratio of more than 1.7 to indicate a strong financial position. A higher ratio is desirable since it provides more resilience during financial downturns.

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Debt-to-asset ratio

While the current ratio compares those aspects of the balance sheet that change over the course of a year, the debt-to-asset ratio compares total farm debt to total farm assets. In effect, it represents the bank's share of the business. The higher this ratio, the more risk the farm has, and a high ratio may limit the ability to borrow additional money. ~~This measure~~ is included in the "solvency" bracket of financial ratios ~~and can~~ be imagined as how well the business is able to remain "afloat." A ratio of 28 percent indicates that for every $1 of assets a farm has, it can cover $0.28 of debt. 28000 2,800,000

Another way to look at it is the bank owns 28 percent of the business. In this case, a lower ratio or percentage is positive. Banks prefer a debt-to-asset ratio below 60 percent for farms considering expansion. ~~Well-established dairies may have~~ debt-to-asset ratios below the 30 percent "comfort" benchmark.

Term-debt coverage

Term-debt coverage measures the repayment capacity of a farm. This measure compares the ability of a farm to pay all intermediate (between 1 and 10 years) and long-term (greater than 10 years) loans. If the term-debt coverage ratio is less than 1, then the farm has to liquidate assets – sell inventories, increase accounts payables or borrow on the line of credit to cover loan payments.

In order to stay out of the danger zone (a red area), term-debt coverage should be greater than 1.2 but needs to reach levels of 1.5 or more to be in the green zone. The higher the ratio is, the more positive the outlook. Many lenders require a term-debt coverage of at least 1.25 to consider a plan viable. A ratio at this level provides some "cushion" to withstand business downturns and still keep loans paid on time.

Net farm income

While no one number can capture the desired "net farm income," this measure is generally considered one of the most important financial measures for a business. It measures profitability, or at its most basic level, the value of goods produced (milk, replacements) compared to the cost to produce those goods.

Lenders look for this number to show steady growth over time, as reflected by increasing net worth. Net farm income represents the returns to the farm owner's labor, management and equity in the business. Historical goals for net farm income would be $800 to $1,000 per cow per year.

Rate of return on farm assets

Also categorized under farm ~~profitability,~~ rate of return on farm ~~assets~~ measures the average interest rate all the investment on the farm earns (both from the bank's and the farm owner's standpoints). When looking at farm assets, one of the major items that leaps off the page is land. Farmland does not depreciate, and land values can increase, especially over the many years the farm has been in operation. This can hurt the rate of return on farm assets as it pushes the asset side of the equation out of proportion to the income and interest earned on the farm. However, banks that are experienced in agricultural lending are aware of this and look for the same sign of profitability that they do with net farm income: gradual increases over time.

On the financial scorecard rubric, a rate of return on farm assets greater than 8 percent is considered most positive. The larger the ratio, the better. For the last 50 years, ~~agricultural~~ businesses have averaged a 3 to 5 percent rate of return on assets, so the financial scorecard goals reflect above-average performance. 8%

When a lender looks at these ratios, it is important to remember that in a modernization, a farm will not be perfect in every area. A business plan that can show how the farm improves on these ratios over time will show the business's abilit[y] to grow and be successful. Farms a[nd] lenders should consider the overal[l] goals of the business and how the improvements will help position t[he] farm for long-term success. **PD**

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