Financing Alternative Farm Enterprises

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Agriculture today is proving to be an economic test for everyone involved. Farmers and the banks financing their operations need to become resourceful and open to diversification of operations in order to survive today's economic environment in agriculture. Farmers in Oklahoma are aware of diversification through crop and livestock rotation. Diversification in the past generally meant using more than one of the mainstream crops to increase income. Knowing and doing seem to be two different things. Alternative agriculture has been an avenue traveled by few farmers. New ideas in crop development and alternative products have been met with some reluctance. Some obstacles exist that keep our farming community from diversifying their operations.

Legacy Bank has been financing alternative agriculture producers with the farming community in our area for several years. Through our experience of financing alternative farming operations, we would like to provide some insight into the need for diversification and the key to obtaining financing for alternative agricultural operations.

A key issue to remember that plagues many is the disappointment of a "quick fix" that doesn't materialize. The transition into alternative farming operations is slow and methodical and will test the emotional, physical, and financial strength of the operator. The basic principles do not contain any magical formula, nor are they significantly different from financing traditional farming.

Let's look first at the need for diversification. The need to diversify becomes increasingly important as we look at some very basic facts about the evolution taking place in our family farms. First of all, farmland values are a great barometer of the farm economy. A review of farmland values over the previous twenty-year time frame indicates that farmland value, while fluctuating yearly, is relatively flat for this period. Inflation has outpaced the value of our farmland. As well, the average farm size is now 330 acres, a declining number.

Secondly, as we consider farm and farmer profitability over the past ten years, we notice that income (no surprises here) is on a trend of flat to declining. Farm income has become largely dependent on government subsidies, which are in contrast to long-term goals of governmental policy.

On a larger scale, when we consider the overall economic factors of our Midwestern region, the 2000 census indicates the Midwest is plagued with significantly declining job growth as well as declining population. Only the recreational areas along lakes and mountains have positive growth patterns relative to the prior census.

Our regional economy is still largely driven by agriculture. The Federal Reserve Bank of Kansas City indicates that agricultural loans remain the largest loan segment for our region and indicates that nonperforming loans are rising.

Of additional concern is the fact the average age of the farmer in Oklahoma has risen from fifty-four in 1978 to over sixty as of 2001. And considering the fact that more than half the farmers in Oklahoma are over the age of fifty-five, the future definitely indicates that a change is forthcoming and necessary. A quote from William Arthur

About Michael Chaloner

Michael S. Chaloner was named President of Legacy Bank in 1996. However, he has over 20 years of banking experience with the bank. He currently oversees the operations of the home office in Hinton, as well as three additional offices in Weatherford, Binger and Hinton. His banking career has given him experience in consumer, commercial and agricultural lending.

A graduate of Southwestern Oklahoma State University in 1981, Chaloner has attended many OBA and ABA banking schools and seminars. He graduated from the graduate School of Banking at Louisiana State University in 1995. As one of his graduate school projects, he developed a software program, *Farm Plow*, used for the analysis of agricultural lending. *Farm Plow* is used to spread, calculate ratios, scores and graphs based on the Farm Task Force "Sweet Sixteen" ratio analysis.

In addition to banking, Chaloner is involved in numerous civic and community activities. He is currently the trustee and secretary/treasurer for the Hinton Economic Development Authority. He has also served as president of the Hinton Chamber of Commerce.

He and his wife Teresa reside in Hinton, and have three children: Cody, 20; Aaron, 19; and Melody, 13.

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Ward sums up the need for change in our farm economy: "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."

After establishing the need for diversification, the next item to consider briefly is the process of transition to alternative farming.

First and foremost, the fact is, transition is difficult, and an uphill process must be recognized. Get-rich schemes or quick fixes are not the reason, nor the result of alternative farming. The transition is a slow process, taking several years to accomplish. It involves research, experimentation, consultation, and even failures in order to discover methodologies and implementation relative to each specific farm and environment for successful operations to come to fruition.

Developing marketing strategies for an alternative crop takes time and effort. It also involves developing relationships with key individuals within your specific market. Consideration has to be given as to the impact of governmental programs and subsidies both negatively and positively as the transition from one crop type to another occurs.

Flexibility is key. It may require shifting gears. The journey to alternative farming may start down one path, and you may then discover a substitute, a replacement crop, or byproduct actually becomes the final product. Be willing to adjust the sails.

That brings us to the age-old question of how to finance the transition. Of course banks and other lenders such as the PCA or FSA come to mind initially. However, sometimes research into venture capital investors would be an avenue to consider, especially for the undercapitalized operation.

As you consider financing your operation and transition to an alternative farming product, it is helpful to put yourself in the shoes of your creditor. This may be an area of unfamiliarity to them as well, thus breeding a host of questions and even a lack of confidence in the process. Expect roadblocks and stumbling blocks to occur. It is the nature of the beast. Understand as well that your creditors have regulations and limits to which they must adhere. Creditors are "risk averse," and increasing pressures from regulators, stockholders, and management add to their anxieties. Don't give up on the first "No" you hear. Fear of the unknown will often cause a creditor to stall. Most of all, become a team player with your creditor. Together, you can work through the majority of issues that will present themselves during the process.

Let's look at six rules that are important for you to succeed in obtaining the financing you need. The rules are virtually the same for traditional and nontraditional farm operations.

1. Cash flow

As you might suspect, if an operation cannot demonstrate cash flow, it will not receive the approval of your lender. As a rule of thumb, you need to have a 1.3 debt service coverage. This means you need to show that income after expenses (minus interest and depreciation) will pay loan obligations 1.3 times over. Less than 1.3 may cause the lender to require guaranties, additional pledge of collateral, or a stronger equity position. Since nontraditional crops initially pose a higher-than-average risk, expect the lender to require conservative cash flow and budgets.

Normally, the transition increases expenses in the early years while income is limited due to initial experimentation to develop procedures and markets to maximize production and profits. Plan ahead and be realistic in your projections. If traditional crops are not providing sufficient cash flow, movement to alternative crops will increase the risk of cash flow deficiencies, at least initially.

2. Capital

This is also known as net worth or equity. The definition in a simple form is the excess of the value of your assets after subtracting liabilities (debts). Normally a lender would like to see that net worth is positive and that total debts are not larger than three times capital. If debt exceeds worth by more than three times, the lender is taking an abnormal risk relative to the risk of the borrower. Basically, this means that for every dollar of risk the borrower is taking, the lender takes three dollars of risk. From the lender's viewpoint, as this number increases, the borrower takes on less risk and thus has less to lose and subsequently is not as motivated toward success.

3. Conditions

A number of variable elements contribute to the overall success or failure of any operation. Knowledge of the alternative crop is an essential. Extensive research, including farm visits of those involved in the alternative crop, knowledge of markets, and the strengths and weaknesses of the risk you are taking are vital. The lender assumes and expects you to be the expert prior to any transition to an alternative farm product. The lender also expects that expertise to expand with experience.

It is necessary to consider many issues surrounding the project. Is special equipment necessary? Do you have a well-thought-out and documented plan? Can you communicate your plan well to your creditor? We are all familiar with the old cliché that "most people do not plan to fail, they just fail to plan." Make a valiant effort to consider Remember that it is necessary to remove emotional attachment and remain focused on the operations. Flexibility is a key component. You have to be ready and willing to alter plans without changing your commitment to the process. A balance beam of flexibility versus commitment exists.

4. Collateral

The pledging of collateral is the security the lender receives in the event all else fails. The lender knows he can rely upon assets pledged to him to recover his investment in the event the repayment does not happen in accordance with the plan. The lender also leaves a cushion from the market value of collateral pledged to allow for repossession expenses, repairs, freight, etc. Unless special financing is available through equipment dealers or suppliers, expect to be able to borrow no more than 70 percent of the market value of the equipment.

However, if the equipment is specialized, the loanable value of the equipment could easily be in the 50 to 65 percent range. Policies regarding the value a lender will give on certain assets vary. Government programs allow higher ratios than standard lending at the local bank. Real estate, for example, could have a loan value at low as 70 percent of the market value or as much as 100 percent, depending on the lender. Banks tend to be on the lower side, taking less risk.

5. Credit

While this is a small component, it packs a powerful punch. The historical record with your current and previous lenders is an important barometer of how you will perform in the future. Credit bureaus record the method and manner with which you have handled the payment of your loans. Lenders consider this component a serious indicator as to future repayment. Guard your credit rating and make certain your performance matches the commitment of your loan documents.

6. Character

Last, and certainly not least, is the issue of character. I know some farmers who are characters, but that is not the issue here. This component speaks to the integrity of the borrower. The lender will be asking, "How trustworthy is this borrower?" This is the component wherein a trust relationship is developed between the lender and borrower. If the lender does not have a relationship of confidence in you, the opportunity to finance alternative farm products diminishes considerably. The lender needs to have confidence that every bit of information you provide him, written or verbal, is accurate to the best of your knowledge. The lender also finds comfort in knowing how you will react if the operation does not go as planned. Character is of utmost importance when considering a lending relationship.

In closing, financing alternative farm products is a challenge that requires dedication, commitment, and financial stability. The relationship with your lender is a significant factor. Transition to alternative farming can be a religious experience!

The economics of our region indicate that if we remain in the mode of operations we currently are in, we will continue to see diminishing profits and a weak and unstable farm economy. Opportunity awaits us as we are faced with a challenge that history says we can conquer based on the fortitude and resilience of the Oklahoma farmer.