Texas and Southwestern Cattle Raisers
Association Young Leadership Series

Ranch Business Management Tools

"Lending in the Cattle Business"

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“It is not the situation, but what you do about it that determines the result!” *Stan Parsons*

The Three Legged Stool

A three-legged stool is a very effective way to sit. Its design is simple because of its light weight, durability and efficient use of material. However, take any leg away, shorten it or loosen it, and the stool gets wobbly, and the likelihood of a fall increases dramatically.

The cattle business is comparable to a three-legged stool. Each leg is important independently, yet each is also reliant on the strong support from the other two legs**. I'll name the first leg economics, the second production and the third finance.**

As a banker, I won't spend much time discussing production. However, I will say that we cannot lose sight of our competitive advantage in the animal protein business; <u>***taking a low value material like grass, crop residue or grain byproduct, and converting it into the most nutritious, safest and best tasting protein you can buy.***</u>

The problem with production is, ***you may do it well, but are you doing the right thing well? “Head down, butt up, going like hell and getting nowhere!”***

I will focus on the other two legs of the stool, economics and finance. These are two entirely different aspects of the business. Economics is about profit, the way the business is structured, how the “engine” that pushes the business is designed. Finance is the fuel for the engine. No fuel, no business.

From an economic perspective there are three things that determine your profit;

1. How much you produce,
2. The gross margin per unit, and
3. Overhead expenses or fixed costs

To generate more profit we must either produce more from the same direct investment, spend less to produce the same pounds or lower fixed costs.

“Profit is to business as breathing is to life!” ***Dave Pratt***

The Three B's of Cattle Business Management

Budget

Benchmark

Back Up

Budget – Establish a cash flow projection to determine what sources of cash are coming into the business and what uses of the cash the business has. The greatest value of the cash flow is not the plan itself, but the process of completing it. The thought put into reviewing previous revenues and expenses is much more important than the numbers put on paper. Finally, prices are meaningless unless you know what it cost to produce the product. Do you know your cost of production? Have the cost changed since you started? If your budget is changing, why? Can you fix it, or do you need to?

"If you make enough gross dollars, some of them are going to stick to you, but if you don't have gross dollars, I'll assure you aren't going to have any net dollars."

Benchmark – Utilize time working ***"on the business"*** to monitor your progress. Update your budget monthly to see the actual movement of cash into and out of the business. Look for signals that expenses are not in line with projections, or that revenues are coming up short. Don't stop with the budget; also update your financial statement each month. No matter how tedious, sitting down the same time every month to update your assets and liabilities will pay great dividends.

Back Up – Worth is important but ***liquidity is king!*** Working capital is the amount of your worth invested in earning assets! That is why they call it working capital! Don't get caught in a situation where you have to lean on fixed assets, or worse, the Bank's equity to see your business through. Be smart about the structure of your balance sheet. We all want to have the land paid for, but retiring long term debt at the detriment of your working capital position is a recipe for disaster.

The 5 C's of Credit

Your bank is in business to make money. Consequently, when a bank lends money it wants to ensure that it will be paid back. The bank must consider the 5 "C's" of Credit each time it makes a loan.

Character is the moral obligation that a borrower feels to repay the loan. Since there is not an accurate quantifiable measure to judge character, the lender will decide subjectively whether or not you are sufficiently trustworthy to repay the loan. The lender will investigate your past experience, review a credit bureau report, and consider your history in the business.

Capacity to repay is the most critical of the five factors. The prospective lender will want to know exactly how you intend to repay the loan. The lender will consider the cash flow from the business, the timing of the repayment, and the probability of successful repayment of the loan. Payment history on existing credit relationships - personal and commercial - is considered an indicator of future payment performance. Prospective lenders also will want to know about your contingent sources of repayment.

Capital is the money you personally have invested in the business and is an indication of how much you will lose should the business fail. Prospective lenders and investors will expect you to contribute your own assets and to undertake personal financial risk to establish the business before asking them to commit any funding. If you have a significant personal investment in the business you are more likely to do everything in your power to make the business successful.

Collateral or guarantees are additional forms of security you can provide the lender. If the business cannot repay its loan, the bank wants to know there is a second source of repayment. Assets such as equipment, buildings, accounts receivable, and in some cases, inventory, are considered possible sources of repayment if they are sold by the bank for cash. Both business and personal assets can be sources of collateral for a loan. A guarantee, on the other hand, is just that - someone else signs a guarantee document promising to repay the loan if you can't. Some lenders may require such a guarantee in addition to collateral as security for a loan.

Conditions focus on the intended purpose of the loan. Will the money be used for working capital, additional equipment, or inventory? The lender will also consider the local economic climate and conditions both within your industry and in other industries that could affect your business.

Risk Management: Risk in Agriculture

"We tend to buy when we want to and sell when we have to."

Risk Management: "Being prepared to successfully respond to unforeseen *negative or positive* events."

Risk is an important aspect of the cattle business. The uncertainties of weather, yields, prices, government policies, global markets, and other factors can cause wide swings in farm income. Risk management involves choosing among alternatives that reduce the financial effects of such uncertainties.

Five general types of risk are described here: production risk, price or market risk, institutional risk, human or personal risk, and financial risk.

- **Production risk** derives from the uncertain natural growth processes of crops and livestock. Weather, fire, disease, pests, and other factors affect both the quantity and quality of commodities produced.

- **Price or market risk** refers to uncertainty about the prices producers will receive for commodities or the prices they must pay for inputs. The nature of price risk varies significantly from commodity to commodity.

- **Financial risk** results when the farm business borrows money and creates an obligation to repay debt. Rising interest rates, the prospect of loans being called by lenders, and restricted credit availability are also aspects of financial risk.

- **Institutional risk** results from uncertainties surrounding government actions. Tax laws, regulations for chemical use, rules for animal waste disposal, and the level of price or income support payments are examples of government decisions that can have a major impact on the farm business.

- **Human or personal risk** refers to factors such as problems with human health or personal relationships that can affect the farm business. Accidents, illness, death, and divorce are examples of personal crises that can threaten a farm business.

"It is only when the tide goes out that you learn who's been swimming naked*!*"

Warren Buffett

Remember: There is a trade-off between risk and return. If producers knew gains, death loss, costs and prices with certainty, they would bid up the price of calves until costs equaled returns. The factors of production would be competitively priced, but this scenario offers no profit!

Risk Management: Risk Management Strategies

Options for managing the risks you face. Most producers use a combination of strategies and tools. Some strategies deal with only one kind of risk, while others address multiple risks. Following are some of the more widely used strategies.

- **Enterprise diversification** assumes incomes from different crops and livestock activities do not move up and down in perfect correlation, so that low income from some activities would likely be offset by higher income from others.

- **Financial leverage** refers to the use of borrowed funds to help finance the farm business. Higher levels of debt, relative to net worth, are generally considered riskier. The optimal amount of leverage depends on several factors, including farm profitability, the cost of credit, tolerance for risk, and the degree of uncertainty in income.

- **Vertical integration** generally decreases risk associated with the quantity and quality of inputs or outputs because the vertically integrated firm retains ownership or control of a commodity across two or more phases of production and/or marketing.

- **Contracting** can reduce risk by guaranteeing prices, market outlets, or other terms of exchange in advance. Contracts that set price, quality, and amount of product to be delivered are called marketing contracts, or simply forward contracts. Contracts that prescribe production processes to be used and/or specify who provides inputs are called production contracts.

- **Hedging** uses futures or options contracts to reduce the risk of adverse price changes prior to an anticipated cash sale or purchase of a commodity.

- **Liquidity** refers to the farmer's ability to generate cash quickly and efficiently in order to meet financial obligations. Liquidity can be enhanced by holding cash, stored commodities, or other assets that can be converted to cash on short notice without incurring a major loss.

- Crop **yield insurance** pays indemnities to producers when yields fall below the producer's insured yield level. Coverage may be provided through private hail insurance or federally subsidized multiple peril crop insurance.

- Crop **revenue insurance** pays indemnities to farmers based on gross revenue shortfalls instead of just yield or price shortfalls. Several federally subsidized revenue insurance plans are available for major crops in most areas of the United States.

- Household **off-farm employment** or investment can provide a more certain income stream to the farm household to supplement income from the farming operation.

What Is Your Risk Tolerance?

Your risk tolerance is reflected in the ways you choose to manage risks. Understanding your choices and considering each of them may cause you to change your management style to more closely reflect your tolerance for risk.

Risks can be handled in one of five ways, or in certain combinations of the five:

1. **Retain**--With no protection from downside risk, as in holding an unpriced commodity.
2. **Shift**--A contractual arrangement where someone else takes on some of the chance of a negative occurrence in exchange for a premium. The more risk you shift, the higher the cost.
3. **Reduce**--Keeping fences in good repair to keep livestock off the highway and a marketing plan that locks in some level of guaranteed return are examples of reducing risk.
4. **Self-insure**--Emergency reserves funded from previous years profits.
5. **Avoid**--Not selecting a particular enterprise...not pushing either end of planting windows...not increasing your debt-to-asset ratio beyond your comfort level.

Any risk must be evaluated for its frequency of occurrence and its possible negative consequences. **As a general rule, formal insurance strategies are available for risks with low occurrences but with severe negative consequences. Examples include disability insurance, health insurance, crop insurance, and life insurance.**

Questions for Your Risk Management Check-Up

- Have I identified my risk tolerance?
- Have I communicated my tolerance for risk to the professionals who provide me with risk management services?
- Which risks can keep me from attaining my goals?
- Which risks am I comfortable retaining and managing with my own resources? Which risks will I shift to others? Which will I avoid?
- When was my last insurance check-up for health, life, casualty, property, liability, disability, long-term care, rain, and crop insurance?
- Have I established a confident relationship with reliable risk management advisers so that they can help me assess my business and personal risk exposure?

Basic questions about risk.

1. **Do you have a will? Do you review it often?**
2. **Are you the “key man”? If so, what happens if you cannot call the shots?**
3. **Do you have a plan for management succession?**
4. **Can you withstand a catastrophe and remain solvent?**
5. **Are copies of vital records in a safe place?**
6. **Don’t forget the Killer D’s! (Disability, divorce, drugs, death ….)**

<u>THE TWELVE COMMANDMENTS</u>
<u>OF AN AG LENDER</u>

by Carl Clayton

The most commonly asked questions of many farmers and ranchers are: “What should I look for when selecting a lender?” and “How do I know if I am doing business with a good lender – the right one for me and my business?”

Are you a good professional lender? Asking yourself how you measure up to the following “commandments” will help answer that question.

1. **<u>Be an authority on agricultural financial management</u>**. Be familiar and comfortable with the tools of financial analysis and be able to understand and interpret good business records.

   Can you explain to your customers the key financial ratios and relate them to their business? Do you have a good understanding of income and cash flow statements? Can you look at a set of business records and tell if expenses are out of line, or if income opportunities are being missed?

2. **<u>Have a good knowledge of agriculture and its people</u>**. Keep abreast of current production and management practices, government policies and programs and international developments.

   One can’t be effective and helpful without a good understanding of the industry and of ranch people. New ranching practices, new government programs and international developments are always changing. Lenders must keep up with the changes and use this knowledge to work more effectively with their customers.

3. **<u>Make periodic visits to the customer’s farm or ranch</u>**. This provides an excellent opportunity to become educated about the operation, and to learn the customer’s accomplishments and future goals. The lender can see first-hand how the money loaned is being used. It also allows an opportunity to identify strengths and weaknesses about the business and the customer’s management ability.

4. **<u>Be committed to agriculture and to serving customers</u>**. Adversity hits agriculture from time to time. A lender truly committed to serving agriculture will do everything possible to serve the customer during these periods, instead of being an “in and outer.” This assumes the use of sound lending practices, of course. Good cattle operators wouldn’t want it any other way.

5. **<u>Be cooperative and sincere and willing to listen</u>** to the customer’s plans and credit requests. The customer has a right to the lender’s undivided attention when discussing business plans and borrowing needs. Create a comfortable atmosphere – one that says, “I care about you.”

6. **<u>Provide prompt action on credit requests</u>**. Look at a request from two standpoints: the customer’s needs, and sound credit analysis and good banking policies.

   Prompt action doesn’t mean making a decision the next day for a major loan commitment. It does mean, however, that action on the loan request will start quickly and that the lender will stay with it as it goes through the decision process.

7. **Explain in detail reasons for declining a request for credit**, allowing customers the opportunity to ask questions and present their views.

   Loan customers have the right to know why their request for a loan has been denied. They may not agree with the decision, but it's important to level with them and create an atmosphere that encourages them to ask questions and discuss. Good communication is essential for a trusting relationship.

8. **Honor commitments to customers** and provide a dependable source of credit when justified, at a competitive price and on reasonable terms. Interest rates and loan terms are very important to customers, but are not the only reason for doing business. What good are attractive rates and terms if lenders don't live up to their commitments and provide customers with a dependable source of credit?

9. **Keep all matters confidential and exercise business integrity and professionalism**. Anytime this commandment is violated, customers should run as fast as they can to another lender that will abide by it.

10. **Explain to customers all the services the bank can provide**. Make sure they receive the best service possible. The lender has a responsibility to make customers aware of all the features and benefits of the lender's services and products.

11. **Make sure customers know other people of authority** in the company so they can call on more than one person for information and service. Customers enjoy having their own personal loan officer, but sometimes that person may not be available when they need assistance.

12. **Show appreciation for the customer's business**. Have an interest in and concern for their welfare and financial success. It's prompt, friendly and courteous service, plus a caring attitude, that keeps customers. A lending institution that does not provide this does not deserve the customer's business.

Texas Livestock Marketing Association and its affiliate National Finance Credit Corporation of Texas

Founded by ranchers as a cooperative in 1930, Texas Livestock Marketing Association and its affiliate National Finance Credit Corporation of Texas continue to serve the livestock industry. For over seventy-five years, our organizations have served ranchers in marketing their livestock and by providing a reliable source of production financing for their credit needs. As a cooperative owned and managed by people who understand the livestock business, our attitude is one of service to our customers and to the livestock industry.

Texas Livestock Marketing Association's board of directors are strategically located throughout Texas and the Southwest and are active in all aspects of livestock production. Up to seven of these member/directors serve on the executive committee that sets policy and reviews the operations and activities of the organization. Management and staff are traditionally experienced in livestock marketing and financial management and are dedicated to keeping abreast of the industry's needs and changes.

Our service philosophy and commitment to the livestock industry holds true for our financing company as well. National Finance Credit Corporation of Texas has provided a dependable and competitive source of financing for livestock producers since 1930. Throughout its history, the company has maintained its stability through a strong financial base while possessing the flexibility to adjust to changing market and lending environments.

The philosophy of our organizations is best summarized by the founding chairman of our companies, Mr. H.L. Kokernot, Sr. who is quoted at an organizational meeting as emphasizing "What we do here today is to be done to last a long time." This attitude is present today as we emphasize commitment, integrity, and reliability for the long term.

Our customers rely on National Finance Credit Corporation of Texas as a dependable source of credit for their operational needs. As a company, we focus on middle market loans ranging in size from three hundred thousand to fifteen million dollars. Our capital strength, combined with the relationships we have built with the investment banking community, allow us to grow with our customers. Currently we have in excess of two hundred twenty million dollars in loan commitments outstanding to borrowers in eight states.

At National Finance Credit Corporation of Texas, we strive to provide production financing at the most competitive interest rates possible. As a specialized finance company, we can also provide flexible loan structures to meet the needs of your operation. We customize financing for cow/calf, yearling grazing, feedlot, sheep and goat operations throughout the Southwest.

PAUL D. BURROUGH

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EDUCATION

The University of Texas at Austin - May 1989	Master of Business Administration
Texas A&M University, College Station - August 1984	Bachelor of Science, Animal Science

PROFESSIONAL EXPERIENCE
4/92 to Present
NATIONAL FINANCE CREDIT CORP. OF TEXAS, Fort Worth, Texas
Senior Vice President and Corporate Secretary

Manage and direct key accounts for a livestock finance company. Contribute to the oversight of a $200+ million loan portfolio containing more than 100 direct, participated and syndicated loan relationships, providing direct executive contact with clients, directors, professional staff, trade associations, other banking officials as well as investors.

TEXAS AMERICAN BANCSHARES and TEAM BANK, Fort Worth, Texas
6/89 to 4/92
Banking Officer and Credit Analyst

Contributed executive oversight of specialty loans for one of the largest bank holding companies in Texas. Serving the mid-west and western United States, solicited, verified application and funded working capital loans primarily for feedlot and stocker operators.

GRANADA GENETICS, Marquez, Texas
10/85 to 9/86
Technical Service Representative

Delivered multi-faceted, technical sales and service for state-of-the-art biotechnology organization with customers located throughout the continental United States. Possessed authority to structure fee schedules, performance contracts and production logistics to meet client needs.

BARNHART RANCHES, Houston, Texas
9/84 to 10/85
Herdsman

Managed and directed marketing and promotion for this imported-livestock business for an absentee owner-investor. Enterprise had 7 ranches and over 4,000 cows. Position required extensive travel in the Central and Western United States. Developed computerization of the ranch's information systems and promoted sales of ranch products.

ACTIVITIES and BACKGROUND
- Own and operate a cow/calf, stocker and cattle feeding enterprise
- Board Member of $158 million Texas Church Extension Fund
- Texas Agricultural and Natural Resources Summit Initiative – Advisory Committee member
- Texas Rural Fire Advisory Council – Past Committee member and Sub-Committee Chairman
- Treasurer of Trinity Lutheran Church – Weatherford, Texas
- Graduate of the Texas Agricultural Lifetime Leadership Program (TALL) & Past President of TALLA (TALL Alumni organization)
- Recipient of the First Charlie Scruggs Trailblazer Award for Excellence in Agriculture
- Past Treasurer of the Outriders of the Fort Worth Herd, a City of Fort Worth support group
- Former President and Director of the Fort Worth Farm & Ranch Club
- Superintendent of Collegiate Livestock Judging Contest - Fort Worth Stock Show and Rodeo
- Recipient of the Sword Scholar Award for excellence in academics, University of Texas
- Member of 1983 Texas A&M University Intercollegiate Livestock Judging Team.
- Born in Houston, Texas in 1960 and raised in Bellaire, Texas. Graduated from Bellaire Senior High School where I was active in the FFA. Married 25 years to Molly Peterson of Austin, Texas. One daughter age 14 and one son age 12.