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This is one of a series of articles written by Dr. David Kohl for the Minnesota State Farm Business Management Education Program.
Vol. #104

Intellectual Collateral: Young & Beginning Producer Focus

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Many of you reading this newsletter know that I am heavily involved with educational programs for young and beginning farmers and ranchers. Most programs are two to three days long, which allows for interaction on a personal basis. Some groups request that I facilitate a discussion of what these young and beginning producers want and need from lenders and agribusinesses. A significant trend being observed is that these producers often do not fit the risk rating models of traditional lenders, even with government guarantees. Traditional lending risk rating models are often very land collateral-based and require large down payments to secure the loans. This often drives these individuals to nontraditional sources of financing for operating, production, or intermediate needs and to other lenders that are willing to take additional risks.

In a recent session, a producer and his spouse wanted to acquire their first farm parcel priced at $1 million. Let's elaborate on their situation. Both individuals had adequate nonfarm income through salaries and various "gigs" that established a diversified income flow. The farm business was profitable. However, the traditional lenders required a 20 percent down payment, which would utilize 80 percent of their total cash and working capital of $250,000, or a cosigner. The frustrated couple indicated that this requirement was a major obstacle in the acquisition and left no working capital buffer for any financial adversity. This situation is being played out across the country and may require our traditional lenders to think about a new concept called *intellectual collateral* that uses "soft," rather than "hard" assets such as land. As young and beginning producers move into the cycle of acquiring land and real estate assets as their business and lifestyles mature, the weighing of risk may need to be adjusted.

Cash flow

A major emphasis needs to be placed on cash flow and, when possible, using outside business income to leverage growth of the farm business. Many new producers have salaried or non-salaried income or outside gigs. They are often multitaskers, some with high income and strong debt service coverage ratios indicating the ability to service additional debt commitments. In the case of this young producer, their debt coverage ratio was well over 300 percent.

Modest living

Another part of the intellectual collateral is the ability to live modestly and sacrifice for the future. In this case, the young couple had a family living budget with no co-mingled business and personal expenses. They demonstrated the ability to build $250,000 in working capital, with a large portion in cash.

Profitability

The couple's existing operations, which were on rented ground, were very profitable with long-term lease agreements. They used these profits to build equity in machinery, equipment, and livestock. Most important was their ability to build working capital to a level over 50 percent of their business expenses.

Their asset turnover ratio was very high at .75, which is calculated by dividing revenue by assets. The couple's margins were 20 percent, which gave them a 15 percent return on assets (ROA). Their earned net worth growth averaged 15 to 20 percent annually over a three-year period.

Facilitated by their advisor, the couple completed the business IQ scorecard, which my team and I developed. Their business IQ score was 40, which is in the top 20 percent of business IQ benchmarks. They utilized crop and livestock consultants, and they also had an educational strategy for both crop and livestock production. The couple hired a marketing advisor in one of their areas of weakness within the risk management program. They also utilize crop insurance and other programs to mitigate risk.

Their equity before the land purchase was 85 percent. However, equity dropped below 40 percent with the land acquisition. They developed their own balance sheets, projected cash flows, and had a business plan that included goals and objectives.

Rejection!

Unfortunately, this couple's financing request was rejected by multiple traditional lenders and a government guarantee was requested. However, time constraints on the purchase and getting every detail aligned did not work in this situation. The lenders wanted the 5C's of credit (collateral, collateral, collateral, collateral, and collateral) as a major part of the global analysis. The frustrated couple was driven to a nontraditional lender with higher interest rates and less than appealing debt structure and terms.

Epilogue

As a champion of the next generation of producers, the traditional lenders will need to develop models that incorporate higher risk borrowers and adjust some of the factors going into these models. Refer to the Global Composite Credit Index for Emerging Ag Entrepreneurs as a possible model.

You will notice that the cash flow, profitability, and the fallback position of working capital is a larger component of this model. The business IQ, a sign of business discipline and character that often leads to profits, is a major part of the model. Both short and long-term operating and debt servicing efficiency are considered. One will notice that the debt to asset ratio, or the inverse of the equity to asset ratio, is still in the system, but comprises less than 20 percent of the total score.

This article is designed to provoke thought on the financing needs of our new Agri-entrepreneurs that do not fit the traditional financing models. The intellectual collateral, or the ability to generate cash flow using both farm and nonfarm income and an executive mindset with modest living expenses, is a large part of the proposed model. The ability to establish working capital to service debt as a fallback position is considered. Of course, profits and operational efficiency are critical. A set of questions to quantify the business IQ or an executive mindset is an important part of the lender's analysis. There are various risk levels quantified on this global scorecard. The couple we discussed in our example is in the Level 2 category, denoting modest risk and growth limitations.

As producers, lenders, farm management instructors, and agricultural stakeholders, think critically as you read this article. This model uses intellectual collateral to compensate for the lack of hard collateral, primarily land, and large equity positions. Yes, there is more risk. However, the model aligns with the attributes that the next generation is bringing to the table. Perhaps these characteristics, which some of the "vintage" agriculture producers with all of the land equity do not exhibit, are going to be needed over the next decade.

Global Composite Credit Index: Emerging Ag Entrepreneurs

This risk model is designed for startup/growing businesses with minimal land equity that rent or lease much of their asset base and have specialized or diversified revenue streams.

Variable	*Criteria*	*Year A*	*Year B*	*Year C*
Repayment Ability		**Index**	**Index**	**Index**
Term Debt and Lease Coverage Ratio	more than 200 percent	4	4	4
	150 - 200 percent	3	3	3
	125 - 149 percent	2	2	2
	100 - 124 percent	1	1	1
	less than 100 percent	0	0	0
Liquidity		**Index**	**Index**	**Index**
Working Capital / Expenses	more than 25 percent	4	4	4
	16 - 25 percent	3	3	3
	11 - 15 percent	2	2	2
	0 - 10 percent	1	1	1
	negative	0	0	0
Liquidity/Debt Service		**Index**	**Index**	**Index**
Working Capital / Debt Service	more than 5:1	4	4	4
	4:1 - 5:1	3	3	3
	2.5:1 - 4:1	2	2	2
	1:1 -2.5:1	1	1	1
	less than 1:1	0	0	0
Debt Servicing Efficiency		**Index**	**Index**	**Index**
Term Debt / EBITDA	less than 2.5:1	4	4	4
	2.5:1 - 3.5:1	3	3	3
	3.5:1 - 4.5:1	2	2	2
	4.5:1 - 6.0:1	1	1	1
	more than 6.0	0	0	0
Profitability		**Index**	**Index**	**Index**
Return on Assets Ratio	more than 8 percent	4	4	4
	6 - 8 percent	3	3	3
	3 - 5 percent	2	2	2
	1 - 2 percent	1	1	1
	less than 1 percent	0	0	0
Financial Efficiency		**Index**	**Index**	**Index**
Operating Expense / Revenue Ratio **(excluding interest & depreciation)**	less than 65 percent	4	4	4
	65 - 74 percent	3	3	3
	75 - 85 percent	2	2	2
	86 - 100 percent	1	1	1
	more than 100 percent	0	0	0
Business IQ Score		**Index**	**Index**	**Index**
Business IQ Score	greater than 40	4	4	4
	35-40	3	3	3
	30-34	2	2	2
	25-29	1	1	1
	less than 25	0	0	0
Solvency		**Index**	**Index**	**Index**
Debt to Asset Ratio	less than 25 percent	4	4	4
	25-39	3	3	3
	40-59	2	2	2
	60-75	1	1	1
	greater than 75 percent	0	0	0
	Total of All Indexes			

[1]Any classification could be countered with intangibles described in the art of lending, co-signatures, government guarantees, grants, and other special circumstances.

Level	**Index**	**Description[1]**
Level 1	27 - 32	Acceptable Risk, positioned to grow.
Level 2	20 - 26	Modest Risk, growth limitations.
Level 3	12 - 19	High Risk, growth inhibited, need risk mitigation tools.
Level 4	< 12	Excessive Risk, need risk mitigation plan.

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