

Retooling Your Credit Analysis Workshop

by Dr. Paul Ellinger

Computer and information technology has changed our working environment. The Internet has provided a wealth of information at our fingertips. Electronic and voice mail are part of our daily routines. Growth in electronic commerce continues to exceed expectations.

Has your credit analysis tool kit kept pace? Are you taking advantage of the advances in computer software and hardware technology? Are pencil, paper and a calculator still your most valuable tools?

The recent economic downturn in production agriculture has created new challenges and opportunities for agricultural lenders. Profit margins of agricultural products have tightened, and considerable uncertainty exists regarding future commodity prices and government payments. The increasing complexity of farm operations and the current economic environment dictate a more precise assessment of your borrowers. You need to have the appropriate tools to help analyze complex questions such as:

- ◆ What are the effects of a stress test on borrowers' financial performance under various short- and long-run economic scenarios?
- ◆ What are the impacts of alternative risk management strategies on the likelihood of loan repayment capacity and financial success of my borrowers?
- ◆ How do you assess short- and long-run feasibility of alternative farm and off-farm investment strategies?

Decision Aids

A wide range of decision aids and portfolio analysis software is available for agricultural lenders. Many commercial products such as Farm Equity Manager and FINPACK permit lenders to credit score portfolios, stress test portfolios and assess portfolio and borrower risks. However, limited database systems at many institutions restrict the ability to perform portfolio monitoring and evaluation. In the April issue of *Ag Lender*, John Penson discussed the limitations of database systems and the potential benefits of updating your information management systems.

The traditional projected cash flow statement is still an extremely valuable tool for evaluating borrower repayment capacity. Does your cash flow tool need a financial tune-up? Some important factors to consider when developing or evaluating projected cash flow and other pro-forma financial tools follow:

- ◆ The projection program should be able to calculate profitability as well as cash flow. With a few accrual adjustments, a projected cash flow can also be

used to develop a pro-forma income statement. Projecting profitability as well as cash flow provides as much richer evaluation of financial performance and assessment of the future viability of the farm operation.

- ◆ The program should require and provide enough data to generate capital debt repayment capacity.

You can then evaluate the sensitivity of capital debt repayment capacity to changes in production and marketing plans of the agricultural producer. See my "Credit Analysis" column in the July issue outlining a framework to perform sensitivity analysis of capital debt repayment capacity.

- ◆ You should be able to easily change price and production parameters to evaluate the sensitivity of a borrower to stressful conditions.
- ◆ The program should permit you to change crop and livestock budget coefficients to determine the effects of alternative production plans.
- ◆ The program should permit feasibility analysis of alternative investments.
- ◆ The ease and speed of data entry are extremely important. Test the software prior to purchasing.
- ◆ Be sure to understand the information required by the program. Does the program require data that may be difficult or unreasonable to collect based on your knowledge of your customers? Your adoption of the program will likely be closely related to the ability to gather the data efficiently for your agricultural borrowers. Consider developing a worksheet for the borrower to complete if the program does not come with one.
- ◆ A useful feature of a projection program is the ability to allow comparisons to actual cash flows.

Implementation Process

Appropriate implementation of your projection tool is as important as the tool itself. Here are some implementation considerations:

- ◆ Establish realistic commodity price parameters and implement them consistently across all borrowers. State record-keeping associations and the Farm Service Agency set year-end price levels you can use for valuing inventories.

- ◆ Evaluate the quality of data used in the projection process. Are production levels based on long-run histories of the farm? Is the estimate for family living withdrawals reasonable? Perform quality control checks on costs and revenues per unit of production.
- ◆ Consider monitoring the borrower's actual performance with the projected values. This process can be educational for you and the borrower and is very helpful as you prepare and refine projection plans in future years.
- ◆ Remember your assumptions and quality of the input data as you analyze the output. A common error is over reliance on computer generated financial reports.
- ◆ Can the borrowers or their consultants initiate the analysis? Consider methods to improve the data acquisition process.
- ◆ Communicate the results with your borrowers. Financial projections are good opportunities to educate borrowers and communicate the strengths and weaknesses of an operation.

The projected cash flow is only one tool. Remember that you should not use the same tool for every job. Other computerized decision tools to consider adding to your toolbox include long-range planning projections, capital purchase and lease analysis, land rent estimators, land bid price models, crop insurance evaluation and crop storage analysis. In addition to commercial software firms, land grant universities often provide these decision tools. A collection of farm decision aid spreadsheet software and links to commercial software firms are available at <http://web.aces.uiuc.edu/finance/>.

Expand you analysis tools. Acquire computerized tools that have the features you need and understand. You are probably not ready to throw pencils and calculators away, but your mouse and computer screen will become more important tools to remain competitive in the future.

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