

Financial Leverage through Risk Management - Leverage and The Lender

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■ Introduction

The lender has used the debt to equity ratio as a definition of leverage and traditionally this ratio rarely goes above 1 to 1. Equity is defined as the total assets – total debt. Total Assets are valued using a market value assessment. This allows for fluctuations in asset value to be considered as equity. This is different than the cost approach to value assessment where the value assigned to the asset is based solely on cost. Quite often long term farmers will under value some assets; for example a quarter section of land that has been owned for a long period of time. We have seen in recent years an appreciation of land values from a strengthening demand.

The total debt includes accounts payable and operating loans. It does not include postponed shareholder loans as we consider these as equity. This ratio does not address problems of internal structure of the debt, which can adversely effect cashflow and debt service capacity. The lender will use the debt to equity ratio as the starting point for analysis and as a guide to interpret debt service capacity.

Some other factors that are taken into consideration are working capital. This is important to preserve for volatile periods and a working capital ratio of above 1.5 to 1 is important. Lenders will often like to see sensitivity analysis completed in order judge what level of equity and working capital will be required in each operation. This will also be dependent on the perceived place within the hog cycle. Credit history also plays a factor as the credit bureau is having a greater influence in the credit decision of both individuals and companies.

The lender may also have a reduction in risk if the producer is an above average manager with a proven history and therefore equity position could be

reduced. In most instances a proven producer could expect the lender to agree to a debt to equity ratio 1.5 to 1. This would be a closely monitored situation, and the expectation would be for a more rapid reduction of debt so that if the hog cycle were to turn against this operation, they would have a cushion available to weather the storm and be able to remain viable. The lender may also request other risk mitigation techniques to reduce the volatility.

For example a client who operates a 500 sow farrow to finish operation would have an overall capital cost of \$2,500,000. At a ratio of 1 to 1 the client requires an input of \$1,125,000. If we assume the production and sale of 18 pigs per sow per year and long term average prices of \$140.00 per pig gross revenue is \$1,260,000. Operating expenses of 75% or \$945,000 leaves \$315,000 for depreciation, rent, taxes, (fixed cost) and debt service and living expenses of the owner. Debt service annually over 15 years at 7% would be \$120,588.72. With this kind of production and expense ratios most lenders would give strong consideration to finance this operation.

The lender is particularly concerned with cash flow to repay the debt and a number of factors can influence this scenario. An increase in feed costs through higher prices or poorer feed conversions could drive the operating expenses higher. We would anticipate that they are going to be higher this year until feed prices return to more normal levels. An increase in operating expenses to 85% leaves only \$189,000 for debt service, living expenses and fixed costs.

This coupled with low prices could quickly erode the equity position. At that point the lender is considering refinancing these losses and expecting the producer to increase production. This would increase the cash flow but verification of the viability of the operation in the long term now comes into play. A simple restructure of the debt could help the cashflow and debt service capacity. This would be considered if working capital is improved to the point of both long term and short term viability without adversely affecting the security position of the lender. Repeated restructure or refinance is a warning sign of below average management.

Based on this information, it is clear that volatility in both the revenue and expense side of the income statement can make it difficult to peg the debt carrying capacity of a hog operation. As lenders, it is our nature to err on the side of caution, and that is typically why you'll hear target equity levels of 40% or more before a lender may be interested in financing your expansion.

- **Importance of Cash Flow**

We all know that cash flow pays loans – not security. These target levels are the lenders' way of mitigating the risk associated with volatile cash

flow...providing some degree of buffer for those times when the industry takes the kind of downturn we have recently seen.

But – what if you knew what your revenue was going to be? Even better – what if you knew your cost of production up front? ...Or, at least, a within some sort of range.

As soon as you start eliminating some of the volatility and your cash flow becomes more predictable, it follows that the lender should place less emphasis on the value of the security. Did you ever wonder why a non-farmer, with a steady source of employment income can get a house mortgage with very little down? Well, now you know.

■ Reducing Risk With Contracts

Across the country, the hog industry has moved toward more and more animals being raised and/or sold under some sort of contract. FCC views many of these contracts as significant risk mitigators – to the extent that the equity levels traditionally required can be greatly reduced. There are a variety of contracts available, but when you boil it all down, there are really only three basic kinds:

Delivery Contract:

- A contract between the producer of the finished hogs and a packer;
- Gives the producer the right to deliver a set number of hogs over a set period of time;
- Pricing is based on a grid that is subject to normal cycles;
- Provides assurance that the hogs will be accepted by the packer, but does not address any volatility in pricing or cost of production;
- FCC finances expansion to producers holding these contracts at more traditional equity levels;

Supply and Pricing Contract:

- A contract between the producer of finished hogs and a packer;
- Gives the producer the right to deliver a set number of hogs over a set period of time;
- Floor and ceiling prices are set (i.e.: the “price window”), with the producer paid either the floor, the ceiling or somewhere in between, depending on the market;
- The price window moves as the cost of feed changes;

- Assuming a contract term of 5 years, FCC can finance expansion to producers holding these contracts at 75% - 80% of the cost of construction – more if additional security is offered (e.g.: breeding stock).

Hog “Loops”:

- Affectionately referred to by the lenders as “Pig Hotels”
- Farrowing, raising weaners, and finishing is normally carried out by three different parties.
- From weaner through to finishing, those raising the hogs do not own the animals or the feed. They only own the facilities.
- In some cases the owner of the sows (and, in turn, the farrowing facilities) is the owner of the market hogs. In other cases, the owner of the hogs is a completely separate entity.
- The owner of the hogs is generally linked to a packer and, as such would have a Supply & Pricing Contract, and are financed accordingly.
- The contract is between the owner of the hogs and the facility owner, who is paid a flat fee per pig/space for the use of their facility. Out of this fee, the owner is required to cover utility costs, maintenance and their own management fees.
- As such, financing is available for expansion under this kind of contract at levels ranging from 75% - 90% of cost.

While the existence of a contract goes a long way toward offsetting risk, I would be misleading you if I said that this is all that is needed to make the lender happy. The next article by Doug Wolff addresses risk management in more detail.

■ **Conclusion**

Through the use of a variety of techniques, the debt to equity ratio that lenders feel comfortable with can be influenced to allow growth with limited additional equity. Though the presence of a contract of sorts is one technique, the lender will be looking for other risk mitigation steps taken by the producer which reduce volatility, while ensuring profitability and long term viability of the farm enterprise. As a result, discussions with your lender will include production and financial management issues, environmental concerns, debt structure and collateral - all of which can influence the debt to equity ratio requirements.