35 Keys to Success

Securing a Land Resource

Caution Pays

High land and cattle prices offer accelerated opportunity and risk.

by ***Wes Ishmael,*** *freelancer*

"It has never been more challenging than it is today to get started in the cattle business," says Gary Cotterill, vice chairman and senior agronomic officer at Kansas-based Community National Bank and Trust (CNB&T).

Cotterill may understand the power of that simple statement better than most. Besides his banking endeavors, Cotterill and his wife, Marie, grew Cotterill Ranch at Cherryvale, Kan., from scratch. Today, sons Paul and Rex are also part of the operation.

"Land prices are at an all-time high (see "Higher and Higher," page 102)," Cotterill says. "Cattle prices are at an all-time high, too, but all of that holds a lot of risk."

The high economic cost of entry is one obvious reason so many beginning farmers and ranchers entering the business these days have already built a financial stake from other careers (see "No Cheap Tickets," page 92).

"Beginning farmers often report that their biggest challenge in getting started in farming is access to enough capital and farmland to operate at a size capable of earning a sufficient profit," according to USDA's *Beginning Farmers and Ranchers At A Glance — 2013 Edition.* "The average beginning farm was 200 acres in 2011, compared with 434 acres for established farms."

"Not only should a beginning farmer expect to have low returns in the startup phase, but even established farms must be of a significant size before they are likely to earn positive returns."

When considering full-time ranching, James McGrann, a noted livestock economist and owner of Ranch Management Economist explains, "In today's cow-calf ranch operation, economic environment, reproduction, indirect or overhead cost control and production, and marketing flexibility in a volatile price environment are necessities for profitability. Business management is of highest priority. The business manager must be proficient in using tools like QuickBooks™ for bookkeeping and Excel™ spreadsheets decision aids."

In part, due to significant swings in inventory from year to year, McGrann notes the need for cattle producers to go beyond cash accounting.

"Cash accounting to meet IRS

PHOTO BY LYNSEY MEHARG

requirements does not measure profit," McGrann explains. "An accrual-adjusted income statement is required to measure profit and return on assets (ROA). Profit is what generates repayment capacity.

"You must have your own financial data, as the cost and profitability information that is published is incomplete and inadequate for decision makers. Cash income or margin leaves out depreciation and often includes no compensation for owner management and labor. You will go broke breaking even when all non-cash and overhead or indirect costs are left out of cost. Calculate your total unit cost. All projections should include a profit target."

For part-time producers, McGrann says, "To avoid the IRS classification as a 'hobby farmer' that will eliminate operation loss deductions, maintain a separate account for the ranch and living and other business activities. Have a business plan and demonstrate a profit motive. Non-ranch earning for repayment capacity dictates the financial feasibility. Operating like a business makes ownership less costly even for the part-time operation."

This economic challenge to new producers is one reason the federal government authorized the Beginning Farmer and Rancher Development Program (BFRDP) as part of the 2008 Food, Conservation and Energy Act.

Federal, state programs for new producers

In June, USDA also announced implementation of new Farm Bill measures and policy changes aimed at improving the financial security of new and beginning farmers and ranchers. Think in terms of things like waiving service fees for enrolling in the Non-Insured Crop Disaster Assistance Program and eliminating payment reductions under the Conservation Reserve Program (CRP).

"New and beginning farmers are the future of American agriculture," explained U.S. Agriculture Deputy Secretary Krysta Harden. "The average age of an American farmer is 58 and rising, so we must help new farmers get started if America is going to continue feeding the world and maintain a strong agriculture economy."

USDA unveiled a new website in June (*www.usda.gov/newfarmers*) intended to be a one-stop resource for new farmers and ranchers. You'll find everything from a description of available programs to help developing a business plan, to a description of USDA loans available through the Farm Service Agency (FSA).

FSA has a long history of making direct loans and guaranteeing loans through commercial lenders for borrowers who may not qualify for conventional loans. As part of that, FSA targets a portion of its loan funds to small and beginning farmers and ranchers.

FSA defines a beginning farmer or rancher as someone who:

- ►has not operated a farm or ranch for more than 10 years;
- ►does not own a farm or ranch greater than 30% of the average size farm in the county as determined by the most current Census for Agriculture;
- ►meets the loan eligibility requirements of the program to which he/she is applying; and
- ►substantially participates in the operation.

Some states have programs aimed at helping folks get started in the cattle business, too.

For instance, the 100 Beef Cow Ownership Advantage (BCOA) program at the University of Nebraska College of Technical Agriculture (NCTA) helps students carve out ownership opportunities as they acquire formal education and experience that has everything to do with beef cattle production management.

BCOA represents a partnership between NCTA and the Nebraska Department of Agriculture. The Nebraska Cattlemen and Nebraska Farm Bureau endorse the program.

CONTINUED ON PAGE **112**

Caution Pays CONTINUED FROM PAGE 111

In a nutshell, students interested in gaining a stake in the business complete a two-year program that focuses on beef cattle management. Along the way they develop a business plan for the cattle business they envision. The school helps them line up a mentor willing to work with them, not just providing students with their wisdom and offering experience, but also providing a business opportunity.

Graduates utilize their business plans to secure loans from conventional lenders or FSA. Participating mentors who sell land or an entire operation to BCOA graduates over time can also be eligible for tax credits.

A few borrowing basics

"Lending in the cattle sector is primarily based on the equity position of borrowers. Lenders look at equity after discounting the market value of cattle," McGrann explains. "Cattle are a very liquid asset; they can be quickly turned into cash."

Whether someone is just beginning or is already established in the cattle business, borrowing money from a commercial bank has everything to do with those dog-eared five factors of credit-worthiness — the 5 Cs. In general terms, they are:

- ►**Character** — This includes the borrower's history of servicing debt, as well as consideration of the borrower's experience and ability to make the loan successful for the borrower and the lender.
- ►**Capacity** — This determines how the loan will be repaid and whether the borrower has adequate resources to service the loan.
- ►**Collateral** — Is the value of the collateral adequate to secure the loan and is the collateral marketable at that value?
- ►**Conditions** — Current business conditions that will affect the ability of the borrower to repay the loan, including the financial strength of the borrower to withstand a business storm. This also captures the intended use of the loan, be it for establishing a program, expanding, operating, etc.
- ►**Capital** — How much equity the borrower has in the operation. It helps lenders identify borrowers most likely or less likely to do everything possible in order to make the business succeed.

McGrann adds **control** to this list.

"The borrower needs to take control of their business financial- and production-management information system. Use QuickBooks for bookkeeping. Have a separate entity for personal expenditures from the ranch business. Coordinate the setup with the business CPA," McGrann says. This helps avoid problems with the IRS. Use Excel to maintain cattle and feed inventories to calculate accrual-adjusted income or profitability. Calculate return on assets (ROA) and repayment capacity. This goes beyond cash accounting to comply with IRS requirements and develops an accrual-adjusted income statement that accounts for changes in cattle and feed inventories, payables, receivables and prepaid expenses.

Using Excel decision aids for production and financial budgeting are essential in the volatile environment. Forget cash or direct cost break-even goals. Financial and marketing management has never been more important."

Moreover, McGrann suggests, "Have the numbers together before meeting with the lender. Most frequently, if it won't work financially on paper, it won't work in practice. Make the numbers do the talking. It's the borrower's responsibility to take control and manage and report profitability and repayment capacity of their business to lenders. The numbers must support the capability to profitably borrow. Lenders are happy participants in profitable businesses."

More specifically, Cotterill explains for those seeking loans at CNB&T, "We want equity of at least 25% on chattel loans (young stock, equipment financed five to seven years)."

For land loans CNB&T requires at least 20% equity and can lock in a fixed rate for up to 30 years.

Tips for building successful financial relationships

Sweat the small stuff. Keeping accurate and detailed records encourages both short-term and long-term financial planning. Not only does it help you stay organized, it makes it easier for your lender to assess your financial situation.

Among essentials, says James McGrann, are accrual-adjusted financial statements, a business plan, a production plan and a marketing plan.

Develop a business and marketing plan. You will work smarter and improve your odds when you focus and organize your goals.

Evaluate your capital investments for profitability and payback. Keeping track of how long it will take to generate cash flow from a capital investment will help you make better financial decisions for the future.

McGrann emphasizes the need to conduct full cost calculations.

Know your costs. When you consider your cost of living and expenditures, including depreciation and family living, you'll have a better understanding of your overall financial situation. Your local banker can provide guidelines to monitor your financial ratios.

McGrann emphasizes the need to know costs per unit.

Decide on what type of operation you want to operate. New farmers and ranchers should either be very efficient, low-cost producers or should add value that someone else will pay for.

Consider supplementing your operation with off-farm income until your operation is large enough to employ you profitably full-time.

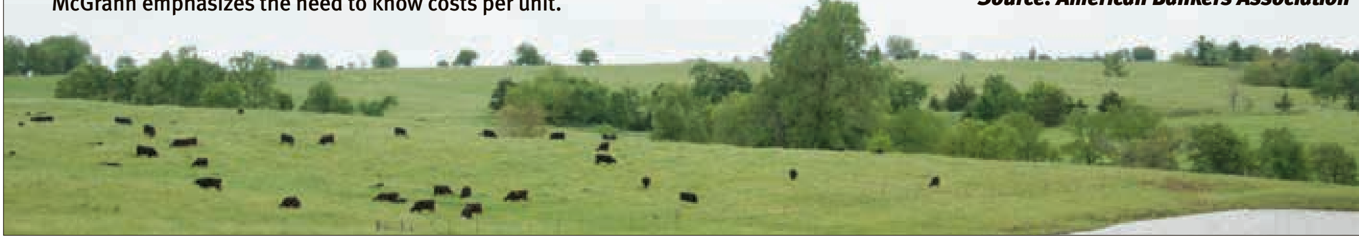
Consider renting farm equipment or custom hiring instead of purchasing.

Shop around. Getting price quotes on supplies such as feed, fertilizer and fuel can uncover lower-cost sources. Your research might get you a discount from a local, preferred supplier that gives excellent service.

Ask your banker about how to get access to state and federal credit enhancement programs. Some banks also offer special benefits for first-time Schedule F tax filers.

When in doubt, ask for help and guidance from someone you trust — an experienced farmer or rancher, a trusted advisor or your local banker. You don't have to make these important financial decisions alone.

Source: American Bankers Association



As with other lenders, interest rates on loans are tied to those previously mentioned five Cs, as well as other factors such as the type and length of the loan and net worth of the borrower.

"Depending on borrower age, we want to see a leverage ratio (debt-to-equity) of considerably less than 1:1, more like a maximum of 0.6-0.7:1.0," Cotterill says.

CNB&T also wants to see borrowers with debt service coverage of at least 115. In basic terms, after subtracting operating expense and living expense from cash flow, they want to see a minimum of $1.15 for every $1 of scheduled payments. They like to see $2-$3 of working capital for every $1 of liability. They look at credit scores and like them to be 700 and higher. They'll look at tax returns and balance sheets annually as a gauge of borrowers' financial health.

"Documentation is critical," Cotterill emphasizes. "Bank examiners and underwriters need it to keep both the borrower and the bank out of trouble."

Other considerations include life insurance — term or whole-life — for the life of the loan and beyond.

Risk management is essential for CNB&T borrowers, too. That can include everything from crop insurance to forward-contracting cattle.

"The need for risk management has never been greater," Cotterill says. "Borrowers need to understand the markets in which they operate." He adds that increasing global interdependence adds market risk and volatility — ripples from events across the globe can rattle markets here at the same time.

All of this applies equally to established cattle operations.

For anyone established in the cattle business and considering acquiring more land, Cotterill points out, "Record-high cattle prices and record-low long-term interest rates offer the chance to build equity rapidly." However, he also cautions that there is always the potential for a land bubble. So, make sure debt service coverage and the loan-to-value ratio make economic sense for what you have in mind.

In other words, there's cause for optimism about the cattle business currently and in the future. With so much equity required to participate in the cattle business, though, Cotterill believes caution is in order.

Editor's Note: *Wes Ishmael is a freelance writer from Benbrook, Texas.*