

AGRICULTURAL ALTERNATIVES

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Financing Small-scale and Part-time Farms

Small-scale farm operations are not for everyone, but they can support a healthful way of life in the country, away from the problems of urban congestion. Tens of thousands of households throughout Pennsylvania cherish the unique lifestyle of small-scale farming. They get satisfaction from watching their farms prosper and their net worth grow over the life of their business. But because many of these operators are new to agriculture, they may lack knowledge of business practices and lending institutions that finance farm loans. This publication explains why many small-scale farms succeed in Pennsylvania, and examines the steps a farmer should take to secure a loan, as well as the major lenders that serve the small-scale agricultural sector.

Business Climate

Agriculture is the largest industry in Pennsylvania, generating cash receipts of over \$4 billion. Two out of every three farms in the state are small-scale, part-time operations. Various factors combine to create a favorable economic climate for small-scale and part-time farms.

■ **Access to markets.** The 12 million residents in the state provide a large market for farm produce, and half of the U.S. population is within a day's drive of Pennsylvania farms.

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■ **Diversity of enterprises.** Pennsylvania has a more diverse crop and livestock mix than states such as Kansas or Illinois, where primarily wheat and corn are grown. Dairy, poultry, swine, sheep, and beef provide an important livestock base and account for 70 percent of farm sales in the Commonwealth. Fruits, vegetables, mushrooms, ornamentals, and other high-value crops make up about 25 percent of sales.

■ **Strong infrastructure.** Pennsylvania's lenders, equipment dealers, feed mills, cooperatives, and farm organizations offer a well-developed and competitive infrastructure that supports the business of agriculture.

■ **Stable land values.** Unlike Midwestern farmers, who live in areas where land prices are more volatile, farmers in the Commonwealth have benefited from steadily rising land values that exhibit more stability.

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■ **Opportunity for off-farm income.** Pennsylvania farmers and their families have greater access to off-farm jobs than those in most other major agricultural states. Off-farm incomes are important for strengthening and diversifying the financial resources of small-scale farm households.

Despite a favorable economic climate, a small-scale farming operation requires a commitment of purpose, time, and money. Even operations that are too small to provide an adequate family income are usually large enough to require specialized expertise in crop or livestock production to be profitable. A long-term economic plan and a willingness to learn and implement sound business practices also are needed for profitability.

If you are to succeed in starting a new business enterprise, you will need to develop solid management skills. Factors such as timing and marketing are critical to success. Because the business aspects of agriculture have grown in importance, even small-scale farmers must begin to view themselves as businesspeople. Agriculture is a large, competitive industry that stretches across states, regions, and even countries. A small-scale vegetable farmer in southeastern Pennsylvania, for example, can face competition from as far away as Florida and Mexico.

U.S. agriculture is and will continue to be capital intensive. Since most agricultural production activities require more capital than a business owner personally possesses, loans of one type or another are typically required.

Obtaining a Farm Loan

Most small-scale farms in Pennsylvania are considered to be both businesses and family residences, which can cause problems when small-scale farmers apply for credit. Owners of large farms also have special credit needs, but because they are usually more knowledgeable about their credit options, they are more likely to be viewed by lending institutions as businesspeople.

When applying for a loan, small-scale farmers can increase their chances for success by observing the following management practices:

■ **Know your farm enterprise.** The trend in both agriculture and industry is to do fewer things, but do them better. Small-scale farmers should focus on only one or two enterprises and should develop the production and marketing expertise needed for profitability.

■ **Budget your cash flows.** The ongoing surplus of revenues over expenses is an important indicator of how much debt you can handle.

■ **Know your collateral value.** Lenders will determine whether you are eligible for a loan by considering your repayment ability (or cash flow) and the value of your assets. Collateral can be land, buildings, livestock, machinery, personal property, and financial assets such as stocks and bonds. However, permanent specialized structures do not necessarily have great resale value and therefore may not be a major asset.

■ **Have a written plan.** In farming, it makes good business sense to write down goals, investment priorities, and time-tables. Agricultural lenders are finding there is no substitute for good planning.

■ **Prepare financial statements in advance.** Lenders typically prefer loans that are self-liquidating, meaning that the income generated from the investment that precipitated the loan is sufficient to repay loan principal and interest within the maturity period. Small-scale farms often have a relatively large amount of off-farm income. Therefore, lenders are sometimes uncertain to what extent farm loans should be based on the small-scale farm enterprise or the off-farm income. Also, most small-scale farmers apply for loans under \$100,000. Many lenders, however, prefer to make larger loans to business clients, because loan-processing costs per dollar loaned are often highest for small-scale business loans. To minimize these costs, you should have important financial statements for the past 3 to 5 years already prepared when applying for a loan, including balance sheets listing assets, debts, and net worth; income statements listing sales, expenses, and overhead costs (such as depreciation and changes in inventories); and cash-flow statements for family expenses and loan payments. In the event that the loan is for an investment where no past financial information is available (e.g., a new enterprise), *pro forma* financial statements should be constructed. Financial statements are actually less complicated than they may seem. Their accuracy and early preparation can help you gain loan approval.

■ **Use your records to make informed decisions.** Maintain accurate farm records and use them when making management decisions, such as whether to upgrade or modernize facilities.

■ **Treat the lender as a valuable asset.** Because most agricultural loan officers work with 100 or more clients and have a broad knowledge of agriculture, their banking expertise can help make a small-scale farm more successful. Finding a lender that you are comfortable with and can build a long-term business relationship with may be to your and the lender's advantage. Agricultural bankers are recognizing that small-scale farm loans can be good for their business, increasing not only lending activity, but also savings deposits, insurance sales, and other transactions that make small-scale farmers valuable customers. Also, lenders are finding that small-scale farmers tend to have excellent repayment histories.

Lenders include the following:

- Commercial banks and credit unions
- Farm Credit System of borrower-owned cooperatives
- Farm Service Agency, a U.S. Department of Agriculture lender
- Individual and agribusiness suppliers
- Programs available through Commonwealth and bank participation

Commercial Banks

Commercial banks are an integral part of the communities they serve. They offer a wide range of financial services to small-scale and part-time farm operators. Many banks have agricultural banking departments that specialize in providing banking services to farmers. They are staffed by employees with agricultural backgrounds and educations, as well as experience with community-based agricultural programs, such as FFA, 4-H, and cooperative extension. Bank representatives are often able to meet with clients at their farms or businesses.

Lending Services

Commercial banks offer many types of credit designed to match the term of the loan with the life of the asset being financed, including the following:

■ **Short-term operating loans.** These are used for annual expenses, such as seed and fertilizer, and can be in the form of a short-term loan payable in less than a year or an operating line of credit. Credit lines allow the borrower some flexibility to take advantage of any seasonal discounts that become available for supply purchases. A credit line can also be used to prepay future expenses prior to the end of a tax year. Generally, the balance owed on an operating credit line is paid off sometime during the year.

■ **Intermediate-term loans.** These loans are used to finance capital purchases for such items as machinery, equipment, and livestock. Loan terms are usually 2 to 5 years, with longer terms available for remodeling or constructing buildings and facilities. Revolving lines of credit, which provide flexibility for making small capital purchases, also are available.

■ **Long-term loans.** These loans have terms of 10 years or more and are used to purchase real estate or finance construction of major structures. Loans may have a fixed interest rate over the life of the loan or may have an adjustable (sometimes called variable) rate. The interest rate on an adjustable rate loan is typically tied to prime rate of interest and therefore changes over the maturity of the loan as general economic conditions change. Unlike home and auto loans, loans for agricultural real estate may have prepayment penalties, which assign a fee to borrowers for repaying a loan before maturity. Typically, loans with prepayment penalties have lower interest rates.

Many banks participate in the guaranteed loan programs of the Farm Service Agency of the USDA, which provide additional opportunities for making and servicing agricultural loans. Banks can also provide farmers with information on potential sources of financial and technical assistance outside of the bank. Some of these programs may present opportunities for banks to co-finance projects along with outside agencies.

Commercial banks also sometimes issue credit cards, which are a convenient way to pay for items ordered over the

telephone, such as livestock medications and other supplies. Consumer loans also are available for financing nonbusiness expenses, such as a college education, automobile purchase, or home-improvement project.

Deposit Accounts

Banks provide many nonlending services to farmers, including deposit accounts. The most widely used is the checking account, which can be tied to a line of credit to provide overdraft protection. In addition, certain types of checking accounts pay interest. Recurring payments, such as a dairy farmer's regular milk check, can be deposited directly into an account, saving time and eliminating the risk of checks being lost or stolen. ATM (automatic teller machine) cards provide 24-hour access to the account nationwide and in some foreign countries.

Savings accounts and money market accounts provide a way for customers to invest excess funds for the short term. Savings certificates are used to invest for a specific period of time, from several days to several years. Individual retirement accounts (IRAs) provide for retirement and are used increasingly by farmers to defer income taxes.

Other Services

Banks provide trust services, leases, and safety deposit boxes. Trust services help with both retirement planning and the transfer of assets within a farm family. Leasing is a way of financing items that need to be replaced or upgraded regularly, such as computers. No down payment is required for a lease, which can help with income tax planning. Safe deposit boxes are a secure, fireproof place to store valuables and important documents.

Banks are staffed with local people and are committed to the communities they serve. They offer a one-stop place to obtain many financial services.

Farm Credit System

Since 1916, the Farm Credit System has been a premier provider of credit and financial services to farm enterprises, agriculture-related businesses, and rural communities. In this nationwide system of cooperatively organized institutions, the customers own the local entity providing the service. When farmers borrow from a Farm Credit cooperative, they acquire an equity interest in the entity and gain the privileges of stock ownership, including voting and patronage dividends. A board of directors, which is elected by cooperative members who are both borrowers and members of Farm Credit, manages each cooperative locally.

Most Farm Credit lenders have farm backgrounds. All are specially trained to understand the needs and challenges of today's agriculture. They offer a wide range of products and services. Account executives will meet borrowers on their farms, in their homes, or at their businesses.

Farm Credit's primary business is credit and lease financing for full-time and two-career farmers, although they are permitted to make some home loans. There is no minimum or maximum loan size, acreage, or farm size. If you farm for a living or own rural property, Farm Credit can meet your funding needs. Depending on loan size and credit risk, a minimal amount of credit information is required for small loans, and requests are quickly approved.

Lending Services

Several types of loans are available through Farm Credit:

■ **Long-term loans.** Farm Credit specializes in long-term loans (10 to 30 years). These loans can be used to purchase small and large farms, refinance existing long-term loans, construct new livestock facilities and buildings, and purchase additional acreage.

Farm Credit rates are competitive with local markets, and credit is structured with each operation's specific cash flow in mind. Fixed, adjustable, and variable rates are offered for all types of long-term financing, as well as monthly, quarterly, semiannual, and annual payment plans. Because one-time closing construction loans are a Farm Credit standard, you do not pay for more than one loan closing on any construction loan. Country Home Loans, which are unique to Farm Credit, include financing for purchasing, remodeling, constructing, or refinancing a home in the country. There are no acreage or outbuilding limitations, so the entire value of the property being bought or refinanced is considered in the appraisal.

■ **Intermediate-term loans.** Fixed- and variable-rate, intermediate-term loans (2 to 10 years) are another important service offered by Farm Credit. These loans are typically used for machinery and equipment, vehicles (including cars and pickup trucks), livestock and poultry, property improvements, and personal and family needs (such as financing a college education).

■ **Revolving credit lines (RCLs).** RCLs are one of the most popular financing tools available. They are tailored to specific borrowing situations, and repayment is tied to cash flows. AgriLine checks make it easier for you to access your RCL by writing your own check on the credit line. In some areas, funds can be electronically transferred directly into your checking account.

■ **Short-term loans.** These loans are easily arranged and require full repayment within a year. As with all Farm Credit loans, these are structured to fit cash flows with monthly or less-frequent repayment. These loans are often used for farm operating expenses and feed or livestock purchases. Farm Credit variable rate loans are based on published financial indices—prime rate and London Inter-Bank Offered Rate (LIBOR).

Lease Financing

New and used equipment and fixtures can be lease financed through Farm Credit Leasing (FCL). Leasing can be useful

for managing taxes and minimizing down-payment requirements. Leases can be designed to include such programs as deferred first payments (Harvest Plan) and flexible residuals. FCL programs also can be used to lease finance vehicles, such as heavy transportation equipment, pickup trucks, and cars. Special purchase plans and direct-from-the-factory ordering and pricing also are available.

Other Services

Farm Credit also offers farm appraisal services, insurance (both crop and life), AutoDraft, FastCash, and online account access. Farm business consulting, taxes and record keeping, as well as estate planning are also offered in some areas.

How to Contact Farm Credit

Two Agricultural Credit Associations operate a network of branch Farm Credit banks in Pennsylvania. To find an office, visit one of the Web sites listed below:

- MidAtlantic Farm Credit: <http://www.mafc.com/>
- AgChoice Farm Credit: <http://www.agchoice.com/>

Farm Service Agency

The Farm Service Agency (FSA), formerly the Farmers Home Administration, makes and guarantees farm loans and provides technical management assistance to eligible applicants who will operate family-size farms. The FSA is a temporary source of credit whose goal is to graduate its borrowers to conventional credit once they become financially strong enough to meet commercial credit standards. Applicants must demonstrate adequate farm experience, training, and managerial ability to have a reasonable chance of success in their proposed option. They must also be citizens of the United States (or legal resident aliens), have a satisfactory history of meeting credit obligations, possess the legal capacity to meet the obligations of a loan, and be unable to obtain sufficient credit elsewhere even with a FSA guarantee.

Direct Loans

Direct loans are made and serviced by the FSA. Applicants who can obtain credit with a guarantee are required to do so rather than obtain a direct loan. In some instances, direct loans are made at limited-resource interest rates. When the applicant's projected cash flow demonstrates a need for a reduced interest rate, the limited-resource program can offer a temporary reduction in interest. The interest rate increases along with the ability of the business to pay.

Guaranteed Loans

The FSA can guarantee loans made by eligible agricultural lenders to family farmers. Guaranteed loans are made and serviced by legally organized, private lending institutions, such as commercial banks, Farm Credit associations,

insurance companies, and savings and loan associations. The FSA provides lenders with a guarantee not to exceed 90 percent of any loss of principal and interest on the loan. FSA loan guarantees can enable a private lender to serve, or continue to serve, a farmer who cannot be served on a wholly conventional basis due to financial risk factors.

Lending Services

Following is a brief description of the FSA loan types.

■ **Farm ownership loans.** Direct and guaranteed loans are available to buy, improve, or enlarge farms. Loan funds can be used for construction, improvement, or repair of farm homes and service buildings; improvement of on-farm water supplies; installation of pollution control or energy conservation measures; refinancing debts; and establishing nonagricultural enterprises that help farmers supplement their farm income.

■ **Farm operating loans.** Direct and guaranteed loans are available for a variety of farm operating expenses, including livestock, farm and home equipment, feed, seed, fertilizer, fuel, chemicals, family living expenses, minor building improvements, debt refinancing, and other types of short- or intermediate-term credit needs. Operating lines of credit can be guaranteed by the FSA.

■ **Youth project loans.** The FSA makes direct loans to individual rural youths who are 10 through 20 years of age to establish and operate income-producing projects of modest size in connection with their participation in 4-H clubs, FFA, and similar organizations. Each project must be part of an organized and supervised program of work. Projects can be either agricultural or nonagricultural in scope and must be planned and operated with the help of the organization's adviser, must produce sufficient income to repay the loan, and must provide the youths with practical business and education experience.

■ **Disaster emergency loans.** When a state or county is declared eligible for emergency loan assistance, low-interest direct loans are made available to farmers who have suffered losses due to a natural disaster.

■ **Special assistance for beginning farmers.** Because of the concern over the future of agriculture and the need to find ways for young people to enter farming as the older generation of farmers leaves the profession, the FSA has created special programs to help young people who want a career in agriculture. These programs include the Down Payment Farm Ownership Loan and Special Operating Loan programs. Applicants to these programs must be considered beginning farmers as determined by the FSA county committee.

A beginning farmer is an individual or entity who:

- has never operated a farm or ranch, or has not operated one for more than 10 years,
- participates materially and substantially in the operation of the farm or ranch,
- provides substantial day-to-day management and labor,
- agrees to participate in FSA loan assessment and borrower training programs,

— does not own farm property, or who, directly or through interest in family farm entities, does not own land totaling more than 30 percent of the average farm or ranch acreage of the county where the property is located.

If the applicant is an entity, all members must be related by blood or marriage, and all stockholders in a corporation must be eligible beginning farmers or ranchers.

■ **Down payment loans.** These provide an amount equal to 40 percent of the purchase price or appraisal value (whichever is lower) of the property to be acquired. The interest rate is set by law at 4 percent. The applicant must make a 10 percent cash down payment, and the remaining balance, not to exceed 50 percent, must be provided from another credit source. In some cases, the secondary source of credit can be guaranteed by FSA. The non-FSA down payment can hold the first mortgage-lien position. The purchase price or appraised value of the farm, whichever is lower, cannot exceed \$250,000.

How to Apply for FSA Assistance

Applications for loans and loan guarantees can be made at the FSA office serving the county in which the farming operation will be conducted. Applicants can also contact their loan lender to determine whether a guarantee is possible. The local FSA office is listed in the telephone directory under U.S. Government, Department of Agriculture, and Farm Service Agency.

Individuals and Agribusiness Suppliers

Often overlooked, individual investors can be a significant source of capital and risk sharing. Taking on a partner or obtaining capital to finance expansion or other business activities from a relative may be a cost-effective way to achieve business goals. While it is tempting to keep such arrangements relatively informal, tax consequences relating to business organization—not to mention the importance of maintaining business and family relations—suggest that the appropriate documentation should be completed.

Most agribusinesses that supply farm businesses with input offer credit as well. For example, feed, seed, herbicide, fertilizer, and veterinary fees can all be obtained on credit. In addition to offering “buy now and pay later” type credit, many of these agribusinesses also offer cash discounts for timely payment. Terms of sale such as 2/10 net 30 are common and suggest that buyers (borrowers) can take a 2 percent discount off of the amount owed if their bill is paid within 10 days or pay the full amount within 30 days. It is tempting to conclude that a small cash discount such as 2 percent is too small to influence when a borrower should pay. However, a 2/10 net 30 policy is equivalent to an annual rate of interest of approximately 40 percent. Cash discounts, no matter how small, should always be taken in all but the most extreme situations.

Commonwealth of Pennsylvania

The Commonwealth of Pennsylvania has established four loan programs for agriculture through the Department of Community and Economic Development. The applications and programs are administered through the Economic Development Corporations in each county. The programs are the Next Generation Farmer Loan Program (NGF), Small Business First Fund for New Farmers (SBFF), the Machinery and Equipment Loan Fund for New Farmers (MELF), and SBA 504 for New Farmers.

The NGF program is for new and existing farmers who own less than 30 percent of the agricultural acres of the median farm size in the county where the farm is located, or with a fair market value in excess of \$125,000. Loans for up to \$250,000 are available at an interest rate that is typically 80 percent of the prime rate. Maturity is determined by the borrower's bank but typically ranges from 7 years for equipment to 15 years for real estate. Loan proceeds can be used to finance the acquisition of land, buildings, machinery, or equipment with the bank providing anywhere from 80 to 100 percent of the capital needed.

The SBF program is designed to provide financing for land and building acquisition and construction, machinery and equipment purchases, and working capital. The previous requirements for job creation or job retention for SBF loans now waived for agricultural operations. The program requires the borrower to have matching funds either from another lending source or owner capital. The maximum loan amount for capital purchases is \$200,000 or 50 percent of the total project. The maximum loan amount for working capital is \$100,000 or 50 percent of the total project. Currently, the interest rate for SBF loans is 2.75 percent. Terms of the loans are:

- Real estate—10 years
- Machinery and equipment—7 years
- Working capital—3 years

The MELF program is designed to provide funding for machinery and equipment only. Funds may only be used to acquire and install new or used equipment; repairs to existing machinery and equipment are excluded. The maximum loan amount for the program is \$500,000 or 50 percent of the total project cost, whichever is less. Machinery or equipment may be ordered and received, but not installed or operated prior to MELF approval of the loan. However, it is recommended that you secure the funds before purchasing any equipment.

The SBA 504 loan program is available to new and existing farmers as well as agricultural processors. Loan amounts up to \$1.3 million at fixed interest rates are possible with maturities of 20 years on real estate and buildings and 10 years on machinery and equipment. The purposes of SBA 504 loans are to finance land and building acquisition and expansion, construction and land site improvements, and machinery and equipment purchases. The required participation is 50 percent from a bank and 40 percent from SBA with the remaining 10 percent from the borrower.

Contact Information

SMALL BUSINESS FIRST

Telephone: 1-800-379-7448

Web site: <http://www.inventpa.com/>

MACHINERY AND EQUIPMENT LOAN FUND

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