

NORTHWEST FARM CREDIT SERVICES

BUSINESS TOOLS

How Lending Decisions Are Made

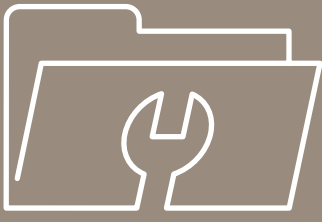
Tip: Northwest FCS' lending standards help customers achieve their goals.

Every lending institution has a set of credit standards or guidelines that are used to analyze and approve loans. At Northwest Farm Credit Services, these guidelines ensure constructive credit to help customers achieve their financial goals, which protects the interests of our member stockholders.

To help our customers better understand the decision-making process for approving and renewing loans, we commonly refer to these standards as the Five Cs of Credit — character, capital, capacity, collateral, and conditions.

How the Five Cs of Credit are used

New loans are made to customers with proven financial and production management capabilities, who are believed to be long-term contributors to agriculture, and whose loans will not present undue risk to the association's member stockholders. Loan analysis focuses on the strengths and weaknesses of five credit factors. However, the weight given to each factor varies depending on the unique circumstances of the loan request. In some cases, weaknesses in one factor may be offset by strengths in another.



Tip: Character is revealed in how a person can adapt to change.

Character

Every lending decision must answer a basic question: Is the customer of sound character and does he or she have the management capability to run the operation and repay the loan? Financial statements provide insights into the projected earnings and collateral available for loan security; however, these documents may not adequately reflect a customer's capacity for making sound business decisions or the ability to withstand financial, operational, or family crises.

Planning for the future

Character is the catalyst that transforms expectations, goals, and projections into realities. A key factor in the long-term success of a business is how well the owner can look to the future, understand the dynamics of the marketplace, and chart the best direction for the business in a written business plan. Since even the best-laid plans can change, a person's true character is revealed in how well he or she can manage within the plan, adapt to change, and make adjustments to the business plan when needed.

Management ability is part of character

Since earnings from the business are generally required to repay loans, a customer's ability to manage a profitable operation is a necessity. Farmers and ranchers make numerous decisions regarding production,

marketing and financing, and each decision has an impact on both profitability and risk management. How decisions have been made in the past and current attitudes and practices towards managing risk are key indicators of a customer's management ability. As financial risk increases, the management required also increases.

Resolve to do what's needed

For the purpose of making lending decisions, character is defined as the customer's willingness and determination to repay the loan, regardless of unforeseen adversity. Character includes such qualities as honesty (the customer's willingness to cooperate with the lender), openness, integrity (acting in good faith), and self-discipline. In addition to these character traits, family and other personal issues which could have an impact on the overall stability of the operation, affect a customer's loan performance. Most farming operations will experience growing pains, liquidity problems, production losses, and adverse market conditions. The customer's ability to withstand many different sources of stress simultaneously, and still make sound business decisions, is vital to performance.

Does the operation build strong business alliances and relationships that enhance the business? Character is often assessed not only of the primary customers, but also of family members, employees, customers, etc.,

Tip: Market planning blends expectations with financial requirements.

that have an impact on the operation and its ability to repay debt.

Sound production practices and risk management are essential

A customer's demonstrated ability to produce crops and livestock and what resources are used for production management information are key to managing the future success of the operation. Producers must be able to accurately assess the quality of production resources, such as land, facilities, breeding stock, etc., in order to make sound production decisions for the business. Disease, adverse weather events and pest infestations are all production risks that constantly threaten crops and livestock. Managing these risks is an indication of sound production practices.

A lender can assess the management ability of a customer by evaluating which strategies have been implemented to manage production risks. Diversification of production practices is one means of reducing risk. In addition, crop insurance is a means of managing risk by guaranteeing a specific return from production. Crop rotation and use of conservation practices and programs are other risk management tools.

Marketing management is important

An often-overlooked part of marketing management is market planning, which blends

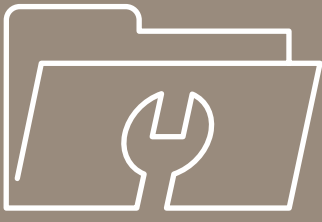
a producer's marketing expectations with the financial requirements of the business. This plan should be generated in conjunction with a projected cash flow statement. To be useful, however, the customer's projected cash flow statement must project future prices and planned sales. A lender will analyze the customer's historical use of market planning as an overall management tool, to match his or her cash flow needs.

Forward contracting and the futures markets are examples of making pricing decisions before the commodity is actually delivered. However, producers need to know the break-even costs of production in order to effectively market using these techniques. Past performance is also an indicator of whether customers include such alternatives in their decision-making framework and also demonstrates the presence or absence of risk management ability.

In assessing a producer's ability to manage the marketing of his products, lenders also consider how well a producer controls his marketing risk through direct retailing, processing, packing, or by forming cooperatives, alliances and partnerships.

Financial management provides a sound base

The ability of a customer to withstand or overcome adverse economic times is



Tip: Liquid reserves can ensure loans are repaid on time.

evaluated as part of overall management ability. Maintaining sound financial records and related financial tools such as cash flow budgets, inventories, enterprise accounting, etc., provides a sound base for financial management. The lender must evaluate the customer's ability to monitor and manage expenses and evaluate operational efficiencies (cost/unit, etc.). The lender will also evaluate the customer's past handling of debt obligations and ability to structure debt so he or she can invest in capital items. The lender must assess how well the producer understands his financial position and what the operation can and cannot do.

In general, sound character is viewed as a necessity, but not the only condition for acceptable loan performance. The importance of character is always balanced against the level of financing and overall risk to the lending organization. In addition to character, management ability, yields and other factors are considered during the loan analysis. The best intentions in the world cannot repay a loan when earnings are not generated from the operation.

Capital

Capital refers to the customer's financial position and progress, asset quality, working capital, liquidity, and debt structure. The analysis of these factors involves historical and current balance sheets so that changes in net worth can be evaluated. Part of the

analysis of capital is to determine if the customer's financial position has improved or deteriorated over time.

Liquidity helps manage risk and position for opportunities

Current assets that are not required to cover operating expenses and current liabilities, and that can be easily converted to cash, are an important source of reserves. These liquid reserves can be used to ensure loans are repaid on time and the operation can either manage through adversity or take advantage of opportunities for growth or investment. Several formulas may be used to describe a customer's liquidity position. The two most common are working capital and current ratio.

Working capital (current assets minus current liabilities)

As the amount of an operation's working capital increases, the owner's ability to explore options, withstand risks and take advantage of opportunities increases. To a lender, this liquidity assures the operation has money for investment beyond the funds being loaned and a reserve for future payments.

Current ratio (current assets ÷ current liabilities)

The current ratio provides similar financial information. For example, a current ratio of two indicates there is twice as much cash and cash equivalents as there are obligations due within a 12-month period. A current ratio

Tip: Solvency is a second line of defense for serious downturns.

of one or under indicates the potential for serious liquidity problems. This ratio indicates the operation's liquidity and, thus, its flexibility and ability to operate independently. It's important to note the cash flow for different types of businesses (dairy versus wheat) will impact what level of current ratio is needed for adequate cash flow.

Solvency compares asset values to loan obligations

Solvency is one of the most important risk measurements for a lender. It's an indication of the operation's risk-bearing ability. If the owner's equity is maintained or improves, the customer's options increase. Three measures of solvency that indicate the relationship between total assets, total liabilities and the customer's equity are: leverage ratio, debt-to-asset ratio, and owner-equity ratio.

Leverage ratio (total liabilities ÷ owner equity)

A leverage ratio of less than one means the customer's owned capital exceeds the amount of debt capital in the business. A value of greater than one means that creditors have a greater claim on the business than the producer does.

Debt-to-asset ratio (total liabilities ÷ total assets)

A debt-to-asset ratio of over 50 percent also means creditors have a greater claim on the business than the producer does.

Consequently, as the leverage ratio or debt-to-asset ratio increases, solvency decreases, management flexibility decreases, and earnings are more stressed to service debt.

Owner-equity ratio (net worth ÷ total assets)

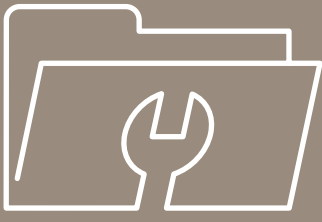
An owner-equity ratio of greater than 50 percent means the producer, rather than creditors, owns a bigger share of the business. This ratio is a direct inverse of the debt-to-asset ratio.

Solvency is the total risk-bearing ability of the operation. While liquidity provides quick and flexible options for opportunities and risk management, solvency provides the second line of defense for more serious downturns. It also provides the collateral base for major expansion.

Capacity

Capacity refers to the customer's ability to generate sufficient earnings to sustain current obligations, repay any new debt, and provide an adequate margin for family living, capital replacement, and accumulation of a reserve for adversity.

Earnings capacity is not the same as cash flow. Accrual adjustments, such as changes in inventories, accounts receivable, and investments in growing crops, must be made to cash income records to accurately determine net income or changes in net



Tip: Capacity analysis involves looking at the income statement.

worth earned. An operation can have sufficient cash flow to meet current obligations without having positive net earnings. The reverse can also be true. This is because the operation liquidates inventory and assets to enhance cash flow or it can accumulate assets and inventory to diminish cash flow. Earnings capacity takes into account the effects of asset and inventory liquidation or accumulation on sustainable cash flow from earnings.

Net income is used to cover living expenses, repay capital debts, interest, or replace capital assets. Income not used for these purposes is available to expand, invest, or build a reserve.

Historical and projected cash flows and income statements or changes in net worth are used to analyze repayment capacity. Over the long term, the repayment capacity margin must be sufficient to cover occasional operating losses and unforeseen expenditures.

Capacity risk is linked to capital

The risks associated with capacity are closely related to capital. As the chance of low or negative repayment capacity margins increases, it takes a correspondingly stronger capital position to ensure sufficient repayment reserves are available should there be an earnings shortfall.

Capacity analysis is accomplished by analyzing the income statement with further

confirmation from progress in the balance sheet. If they do not reconcile, the lender will work with the customer to determine the most accurate earned net worth change.

CDRC is used to analyze future repayment capacity

In addition to repayment history and income stability, Capital Debt Repayment Capacity (CDRC) and CDRC margins are tools used to measure future capacity for loan repayment. These tools are calculated as follows:

CAPITAL DEBT REPAYMENT CAPACITY

Earned net worth change for the period
+ Interest on term debt
+ Use cost (normal depreciation)
-/+ Capital gain loss
= **Capital Debt Repayment Capacity**

CDRC MARGIN

Capital debt replacement capacity
- Principal and interest on term debt payments
- Cash purchases on depreciable capital assets
- Any payment of previous operating losses
= **CDRC Margin**

Tip: The purpose of a loan should satisfy the financing need.

Collateral

If other credit factors are determined to be strong, some short-term and operating loans only require the signature of the customers on the loan agreement. For most operating and real estate loans, collateral is required as a condition to receive the loan. While loans are not written with the assumption that collateral will be liquidated for repayment, this is the lender's secondary source of repayment. Collateral must be evaluated to ensure that an adequate security margin or equity in the pledged asset will exist throughout the term of the loan.

In general, all property taken as security for a loan will be evaluated by qualified individuals who may be Northwest FCS employees or contract appraisers. All real estate appraisals should be signed by qualified persons, who are certified or licensed, as appropriate, by the state in which the property is located. Similarly, other collateral valuations must be completed by qualified persons who have demonstrated the ability to appraise property under Northwest FCS' specifications.

Collateral evaluations must meet established criteria

All valuations of real estate must be based on market value, be presented in written format, must take into consideration the property's intended use, and contain sufficient detail to reflect the complexity of the property and market. Real estate appraisals are completed

in conformance with the Uniform Standards of Professional Appraisal Practice and other regulatory requirements. Qualified individuals should complete evaluations of personal property. Valuation resources could include equipment guidebooks, auction sales, etc.

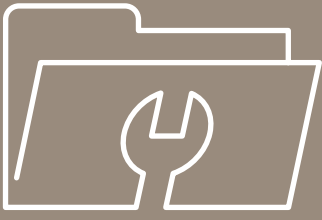
Conditions

The credit factor called conditions relates to the purpose of the loan as well as other items over which the lender has direct control, i.e., the loan amount, use of funds, and terms of repayment. The amount and purpose of the loan must be constructive and repayment terms must be practical for both the customer and the lender so that the customer will have the best chance possible to repay their loan. In addition to the loan agreement, the conditions of approval may need to be supported by a letter of understanding, loan agreement, additional collateral, appropriate insurance coverage, and other special conditions as the situation warrants.

Conditions and restrictions are evaluated

The amount of the loan is carefully considered during the loan process. Is the amount requested adequate to complete the project, operating cycle, etc.? Is the amount of the loan reasonable considering the size and scale of the operation?

Other loan considerations include the purpose of the loan. Is the purpose reasonable for the



FOR ADDITIONAL INFORMATION:

farm-credit.com

1.800.743.2125

Tip: As a lender, we individually look at the strengths and weaknesses of each credit factor.

farm business? Does the purpose satisfy the true financing need (i.e., short-term operating versus intermediate-term money for capital asset purchases). The loan decision-making process also takes into account conditions where the applicant may be moving farther away from the definition of a bona fide farmer or the risk-bearing ability of the customer may be declining.

Structuring the loan in the best interest of the customer and the association

Short-term loans are structured to coincide with the production and marketing cycles of the operation. Normally, repayment cycles will not exceed 18 months on operating loans and three years on revolving loans. Structuring intermediate- and long-term loans takes into consideration: the length of loan terms appropriate for repayment capacity; the need for monthly, semi-annual or annual payment, or periodic renewal requirements; the loan terms will assure principal is reduced at a rate consistent with depreciation of collateral; and terms will not exceed 10 years for intermediate-term loans and 15 years for aquatic loans. Most long-term loans secured by farm land are made for no more than 20 years.

Conditions of the loan also include developing an appropriate repayment schedule. On short-term loans, considerations include: source of repayment, timing of repayments, and amount of repayments.

On intermediate- and long-term loans, a lender will consider the following: repayment capacity; useful life of security; security that may warrant a shorter-term loan; future capital replacement needs; and loan monitoring capabilities offered by payments or periodic renewal requirements.

Lenders also consider who signs on the loan, who provides repayment, who owns assets that comprise the balance sheet, and who is managing the operation. Some partners may not be actively involved in the operation, but may have an ownership interest, so they may be required to sign the loan. Sometimes loans are enhanced by Farm Service Agency guarantees or assignment of proceeds from private or government sources.

Using the Five Cs of Credit

At Northwest FCS, we understand each customer and each loan is unique. The Five Cs analysis allows us to individually focus on the strengths and weaknesses of each credit factor as we make decisions for loan approval and renewal. If you have questions about how we make loan decisions, or if you have a specific loan request, please contact your Northwest FCS representative.