Global & Domestic Economic Views

- worldwide surplus of most commodities
- wide spectrum of economic growth rates- BRICS & KIMT
- oil- the drive towards efficiency
- weather-July, August paradox
- Federal Reserve strong dollar
- elections in Europe
- international trade agricultural agreements
- NAFTA/Asian continent
- black swans
### Strategic Shifts in U.S. Agriculture - Commodities

- massive consolidation
- use of technology
- drive towards efficiency
- outside money
- debt concentration
- 12%/65% rule
- potential issues in portfolio
- exit
- growth vs. business acumen

### Strategic Shifts in U.S. Agriculture - Emerging Entrepreneurs

- organic, local, or natural
- diversified within agriculture
- diversified outside agriculture
- local, national, and international markets
- boomerangers
- youth, women, and minorities
- business plan emphasis
  - working capital
  - less core equity
- growth vs. business acumen
**Strategic Shifts in U.S. Agriculture-Tweeners**

- too big to be small and too small to be big
- 10-15% exit with equity
- 10-15% partial or total liquidation
- 10-15% negative cash flow, net worth
- transitional customer / inter-generational
- exit planning / wealth preservation

**State of Customers**

- deterioration in cash
- deterioration in working capital
- cash flow strategies/restructure
- less equity in collateral secured loans
- increasing loan balances
- more time and focus on loan monitoring
- 5 times rule: performing vs. non-performing
Producers’ Decisions Misdirected

- focus on production management to profitability
- adverse commodities- somewhere else philosophy
- balance sheet complacency
- grow the operation out of problems
- cut the wrong costs
- drive-by financials at year end

Agricultural Economic Cycle Spectrum: Stages of the Financial Statements

Opportunity
Profit/Cash Flow
Top 40% of producers

Opportunity
Liquidity/Working Capital
Tweeners

Opportunity
Core Equity
Bottom 30% of producers

Stress
Top 40% Proactive Producers

- 5 percent rule
- 10-25 percent marketing advantage
- lower rent cost $20- $50 per acre
- lower fertilizer cost $20- $50 per acre
- modest living expenses
- sound financial system
- systems approach

Bottom 30% of Producers

- marginal resources
- demographics cycling out
- rent & lease - equity in devaluing machinery
- lack of financial/marketing systems skills
- operate using Schedule F with “minimize taxes” mentality
- rusted out, worn out or faded out assets
- high maintenance living
- undisciplined pursuit of more
- lack HUT principle
- know it all/victim mentality
### Recent Views of Ag Lenders: Customers With Negative Profits 2016

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Midwest</th>
<th>Coast</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;10%</td>
<td>0%</td>
<td>40%</td>
</tr>
<tr>
<td>10-25%</td>
<td>41%</td>
<td>13%</td>
</tr>
<tr>
<td>26-50%</td>
<td>38%</td>
<td>33%</td>
</tr>
<tr>
<td>&gt;50%</td>
<td>22%</td>
<td>13%</td>
</tr>
</tbody>
</table>

### Recent Views of Ag Lenders: Losing Equity on Balance Sheet

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Midwest</th>
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</tr>
</thead>
<tbody>
<tr>
<td>&lt;10%</td>
<td>0%</td>
<td>33%</td>
</tr>
<tr>
<td>10-25%</td>
<td>16%</td>
<td>47%</td>
</tr>
<tr>
<td>26-50%</td>
<td>39%</td>
<td>20%</td>
</tr>
<tr>
<td>&gt;50%</td>
<td>44%</td>
<td>0%</td>
</tr>
</tbody>
</table>
### Recent Views of Ag Lenders: Refinancing/Restructure

**Customers Sought Refinancing/Restructure in Last 2 years**

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Midwest</th>
<th>Coast</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;10%</td>
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<td>41%</td>
<td>47%</td>
</tr>
<tr>
<td>26-50%</td>
<td>27%</td>
<td>20%</td>
</tr>
<tr>
<td>&gt;50%</td>
<td>5%</td>
<td>0%</td>
</tr>
</tbody>
</table>

### Recent Views of Ag Lenders: Land Values Last 2 Years

<table>
<thead>
<tr>
<th>Change</th>
<th>Midwest</th>
<th>Coast</th>
</tr>
</thead>
<tbody>
<tr>
<td>Increasing</td>
<td>0%</td>
<td>33%</td>
</tr>
<tr>
<td>Stable</td>
<td>16%</td>
<td>53%</td>
</tr>
<tr>
<td>Decline 1-10%</td>
<td>62%</td>
<td>13%</td>
</tr>
<tr>
<td>Decline &gt;10%</td>
<td>22%</td>
<td>0%</td>
</tr>
</tbody>
</table>
Recent Views of Ag Lenders: Factors Creating Financial Stress to Portfolio

<table>
<thead>
<tr>
<th>Factors</th>
<th>Midwest Ranking</th>
<th>Coast Ranking</th>
</tr>
</thead>
<tbody>
<tr>
<td>Negative Profits</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Growing/Expanding</td>
<td>6</td>
<td>4</td>
</tr>
<tr>
<td>Land Value Decline</td>
<td>3</td>
<td>6</td>
</tr>
<tr>
<td>High Family Living</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Loss of Staff</td>
<td>5</td>
<td>2</td>
</tr>
<tr>
<td>Competition/Financing</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>

Ranking Scale:
1 = Highest Concern
6 = Lowest Concern

2016 Family Living

<table>
<thead>
<tr>
<th>Household and Personal Expenses</th>
<th>All Farms</th>
<th>Low 33%</th>
<th>33 - 66%</th>
<th>High 34%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of terms</td>
<td>37</td>
<td>12</td>
<td>13</td>
<td>12</td>
</tr>
<tr>
<td>Average family size</td>
<td>3.6</td>
<td>2.4</td>
<td>2.9</td>
<td>4.6</td>
</tr>
</tbody>
</table>

Source: Nebraska Farm Business, Inc.
Thoughts on Financial & Credit Analysis

- Schedule F (cash basis) will postpone issues two to three years
- Conducting an accrual analysis requires one to ask critical questions
- The stress shows in the current section of the balance sheet first
- 96-4-50 rule of downcycle
- Drive-by financials – producer/lender
What the Schedule F Doesn’t Tell You

- disguises potential problems forward at least two years
- postpones crucial conservations concerning adjustments—i.e. payables, receivables, inventory
- failure to recognize potential deferred tax obligations
- producers in the tax minimization vs. tax management mode
- potential disaster in partial/total liquidation

The Burn Rate – Working Capital Defense

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Loss</td>
<td>$500,000</td>
</tr>
<tr>
<td>Current Assets</td>
<td>$2,000,000</td>
</tr>
<tr>
<td>Current Liabilities</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Net Working Capital $1,000,000 = 2.0 Years
Projected Loss $500,000

Green >3.0 Years
Yellow 1.0-3.0 Years
Red <1.0 Year
**The Burn Rate – Debt Service Payments**

**Offense**

<table>
<thead>
<tr>
<th>Revenue</th>
<th>$2,000,000</th>
<th>Current Assets</th>
<th>$2,000,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenses</td>
<td>1,800,000</td>
<td>Current Liabilities</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Profit</td>
<td>$200,000</td>
<td>Working Capital</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Debt Service Payments = $200,000

Net Working Capital $1,000,000 = 5.0 Years

Debt Service Payments $200,000

Green >5.0 Years
Yellow 2.5-5.0 Years
Red <2.5 Years

---

**The Burn Rate – Working Capital**

**Defensive**

Current Assets: $2,000,000

- Current Liabilities: $1,000,000

= Working Capital: $1,000,000

Projected Loss: $500,000

Working Capital = 2 Years

Projected Loss

Green >3.0 Years
Yellow 1.0-3.0 Years
Red < 1.0 Year

**Offensive**

Current Assets: $2,000,000

- Current Liabilities: $1,000,000

= Working Capital: $1,000,000

Debt Service Payments: $200,000

Working Capital = 5 Years

Debt Service Payments

Green >5.0 Years
Yellow 2.5-5.0 Years
Red < 2.5 Years
### Burn Rate on Core Equity

*(Assume $500,000 Earnings Loss & 20% land value decline)*

<table>
<thead>
<tr>
<th>Assets- Market Value</th>
<th>Estimated Value</th>
<th>Loan Maximum</th>
<th>Collateral Position</th>
<th>Remaining Principal</th>
<th>Equity Excess Reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Long Term (20% Decline on Land)</td>
<td>$6,000,000</td>
<td>$4,800,000</td>
<td>X 70% = $4,200,000</td>
<td>- $2,200,000</td>
<td>$2,000,000</td>
</tr>
<tr>
<td></td>
<td>X 70% = $3,360,000</td>
<td>- $2,200,000</td>
<td>= $1,160,000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Intermediate</td>
<td>$3,000,000</td>
<td>X 60%</td>
<td>= $1,800,000</td>
<td>- $800,000</td>
<td>$800,000</td>
</tr>
<tr>
<td>3. Current</td>
<td>$1,650,000</td>
<td>X 80%</td>
<td>= $1,320,000</td>
<td>- $860,000</td>
<td>$460,000</td>
</tr>
</tbody>
</table>

**Burn Rate: Land & Long Term Equity Reserves**

\[
\text{Excess Reserves} = \frac{\text{Burn Rate}}{\text{Earnings Loss}} = \frac{\$2,000,000 \text{ Earnings Loss}^{1}}{\$500,000} = 4.0 \text{ Years}
\]

**20% Decline**

**Burn Rate: Land & Long Term Equity Reserves**

\[
\text{Excess Reserves} = \frac{\text{Burn Rate}}{\text{Earnings Loss}} = \frac{\$1,160,000 \text{ Earnings Loss}^{1}}{\$500,000} = 2.32 \text{ Years}
\]

^{1} Assume Earnings Loss of $500,000

### Five Factors Influencing Burn Rate on Core Equity

- asset value decline
- advance rate
- amount of losses cash/flow profits
- taxation of sale proceeds - deferred tax liability
- sense of urgency - negotiations “101”
### Agricultural Lending Crossroads

#### Refinancing
- cyclical downturn
- weather, disease, etc.
- personal/business issue
- growth/management issue
- plan for improvement

#### Acceptable
- resilience
- growth & agility
- business acumen with growth

#### Repayment Ability/Liquidity/Management
- liquidation
- preservation of equity
- deferred tax issues
- reputation risk

#### Restructure
- plan for improvement
- partial liquidation
- restructure top balance sheet/bottom
- balanced approach to credit analysis

### Agricultural Customer Crossroads

#### Refinancing
- term debt EBITDA > 3.5:1 to 6:1
- erratic coverage ratios periodically <100%
- ROA 1-3%
- working capital/expenses 10 to 25%
- equity around 50%
- EBITDA/Revenue 10-25%
- flaws in management planning & execution
- higher family living withdrawals
- flaws in resources
- victims/‘know it all’

#### Acceptable
- term debt EBITDA <5:1
- equity > 50%
- coverage ratio >150%, three year average
- working capital/expenses <25%
- ROA > cost of capital/inflation
- EBITDA/Revenue >25%
- knows cost of production
- modest family withdrawals
- balanced 5% rule
- marketing risk management
- communications

#### Repayment Ability/Liquidity/Management
- term debt EBITDA >8 to 1
- pattern of negative margins
- negative working capital
- coverage ratio significantly under 100%
- high maintenance/toys
- lack of focus/lack of management
- percent equity under 30%
- lack of communication/people skills
- major character flaws
- fraudulent activities

#### Restructure
- term debt to EBITDA > 6:1
- equity percent under 50%
- working capital/expenses under 10%
- ROA zero or negative
- coverage ratio consistently under 100%
- high maintenance living/non productive capital expenses
- bigness on the brain/production focus
- multiple refinancing
- some character flaws
- below average financial reporting, management, and marketing

Adapted from Curt Covington, Sr.
Vice President Agricultural Finance,
Farmer Mac.
Questions