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Advice for Young Lenders

By Dr. David M. Kohl

Recently I was in Austin, Texas, to address the 93rd annual Texas Bankers Association Agriculture and Rural Affairs Conference, the longest running agricultural banking conference in the United States. As usual, the participants were spirited and full of questions during a rapid-fire session at the end of the conference.

One banker made a point that led into a question. He entered banking in the early 1980s, fresh out of school. He was thrown into a full-scale farm and ranch recession. He described how he had to learn through the "school of hard knocks" in an agricultural lending landscape that was less than desirable. He asked if I had any advice for the many new lenders in the audience that day, based upon my years of experience. Here is some of my advice.

One of the biggest mistakes young lenders often make is depending too heavily on the numbers and just focusing on financial information. First, one has to be sure the numbers are accurate and reasonable. Too often, tax records that are not accrual-adjusted can be very misleading. This is particularly true for businesses in a growth or transition stage. Accepting a balance sheet's values without inspection is another issue. It is very important to document, verify, and conduct due diligence on financial information, even on accountant-prepared and audited statements.

Many problems and issues first occur on the human side of the lending equation. This is why relationship lending is back *en vogue*. When using scorecard lending, do not "check your brain at the door." Step back and observe to make sure the information and situation make common sense. A lesson learned from the recent financial crisis is that it can be detrimental when lenders get away from knowing their customers, industry trends, and circumstances surrounding the borrower's situation.

Another piece of advice is that certain financial metrics and analysis are more important today than in the past. Historically, many lenders were most concerned about equity and collateral. While these aspects are very important, profits turned to cash flow with a backup of liquidity in real working capital cannot be stressed enough. In today's fragile economic environment, scenario testing is not an option but a requirement in analyzing projections. Corn prices dropping nearly $1.00 per bushel in a short period of time should be a warning signal to lenders about the volatility of profitability that can occur in agriculture.

In today's red-hot agricultural environment, in some sectors it is very easy for a young or inexperienced lender to get bullied by customers, particularly experienced customers who are in an "alpha dog" growth mode. Again, stick to the core principles of lending, which include the five C's of credit: cash flow, collateral, character, conditions, and capital, all evaluated in an objective manner. Young lenders will be tested. Sometimes a mentor who has had experience can be a valuable resource in "team roping" a difficult account or a potential customer in an objective manner.

In this agricultural and rural environment, with the psychology of greed and complacency, many problems will emerge such as fraud and misuse of funds. Be aware of signs of possible issues such as avoidance of communication, customers who are too busy and "need the money yesterday," or those who seek only the lowest cost money. Sometimes these situations involve large borrowers who can build a portfolio rapidly, but quickly destroy a lender's or institution's reputation if something goes awry.

It is important to ensure that you have a supportive management team and board of directors that are going to be in the marketplace during both good and bad times. Are training opportunities for professional and personal growth and development offered? In today's world, lending is a knowledge-based industry, requiring two to six hours of education per week to keep abreast of the rapidly changing agricultural environment.

You will wear three hats as an agricultural lender. First, you play the role of a teacher, explaining the financial analysis, loan structure, and covenants to your borrowers. Second, as a coach, you can motivate and guide your customers. A suggestion here is to have up to five customers or others whom you respect that can act as your coaches and motivators as well. Next, you play the role of a facilitator. Sometimes you will need to assemble deals or act as a project manager, customizing each situation. This may require working with Farmer Mac, FSA, or even with your competition to provide the optimal solution for your customer.

An additional piece of advice is that you do not have to know all the answers. It is critical to network with people from inside and outside the industry so you will have a team of "go to" resource persons. In building your market, patience is a virtue. It is often said that it takes seven years to build your brand, called You, Inc. In the marketing side of the business, sometimes you will have to place yourself "number two" in a relationship and let "number one," the competition, screw up. With the transition of ag lenders due to retirements and the consolidation of lending taking place, this is a strategy that can pay dividends in the future in a long-term relationship.

Finally, if and when the agriculture downturn comes, do not view it as negative. Many of my longtime respected friends who are lenders built their portfolios and their careers during the difficult farm crisis years. In those times, customers were very appreciative of the lenders who worked side-by-side with them, providing candid but constructive solutions and alternatives.

Lender Tip: Professional Development is Key

Now is the time for all lenders, new and experienced, to sign up for some professional development. Training sponsored by banking schools, state associations, graduate schools of banking, and the Farm Credit System are valuable venues to sharpen your skill base, as well as network with like-minded ag lenders. If you do not have time for a lending school, national and state lending conferences are a great way to get a quick tune up. I hope to see you at some of the upcoming events this year. I always enjoy the eager attitudes of the young attendees, which makes me feel young again!

Global Economics

A quick trek around the globe finds the emerging nations' economies, i.e. the BRICS, at different levels of growth. Brazil, the sixth largest economy in the world, has slowed to a projected GDP growth rate of 2.5 to 3.0 percent. Russia, the "R" in the BRICS acronym, is nearly at a standstill, with growth at less than 1 percent. Both countries have perceived government intervention issues along with inflation and productivity challenges. India's growth has slowed to 5 percent, with inflation as an issue. China's economy, which is slightly bigger than the other BRICS nations' economies combined, has slowed to 7.8 percent, after growing for three decades at a rate of approximately 10.8 percent. South Africa continues to struggle with a 2.5 percent growth rate. Overall a composite GDP growth rate for the BRICS nations is 4.8 percent, which is not stellar. The question is whether this will eventually influence commodity prices here in United States.

As a side note, China is now moving from a state-directed capitalist nation under authoritarian rule with an emphasis on building infrastructure to more of an urbanized, consumer driven economy, with less dependence on exports to North America and Europe, and more focus on Asia. It will be interesting to see how this second-largest economy in the world makes the transition with its people and government.

European nations continue to struggle. An example of how fragile economies are in the Euro region is Cyprus, with an economy slightly smaller than the size of Vermont's economy. Cyprus is making major headlines, influencing markets and economic confidence in the world with its critical economic issues. The seizure and taxation of bank accounts has raised eyebrows regarding the soundness and security of investments and savings. This has elevated suspicions here in North America, in informal discussions at conferences.

Japanese and U.S. central banks are full steam ahead with economic stimulus. Stock and equity markets are appreciating rapidly, which is creating the wealth effect. That is, every time a stock ascends $1.00 in value, consumers spend $0.04 more. The wealth effect will need to be closely monitored because it has artificially pumped up our commodity markets and land values.

Domestic Economics

The U.S. economy is recovering, illustrated by the economic indicators. The leading economic index (LEI), while showing a slight decline in March, is still positive with a moderate diffusion index. Oil prices have moderated and gasoline and diesel fuel prices have declined, providing consumers more spending power. However, much of it is being taken away by increased payroll taxes and medical insurance premiums. Recently, weaker retail numbers suggest this is happening.

The purchasing manager index (PMI) is still above 50, but showed a decline in recent months. Housing starts are on a nice rebound, particularly in the South and the coastal areas. March's housing starts were above 1 million for the first time in over five years, which is a positive sign. Factory capacity utilization is near capacity at approximately 80 percent, which bodes very well for the economy. Core and headline inflation are both mundane at less than 2 percent.

The 100-pound gorilla is unemployment. While the reported unemployment rate is 7.6 percent, when U-3 to U-6 workers are included the rate jumps up to 13.8 percent. The real issue is the labor force participation rate which is close to 63 percent, a very low level historically. If this participation rate was at 2007 levels, the reported unemployment rate would be 11.5 percent to 12 percent. It will be interesting to see how many of the new crop of university graduates get job offers and will be hired. If not, many will start to question the value of a university degree. This may be an interesting perspective to analyze in future columns.

Lender and Business Dashboard Economic Indicators (for the month of March)

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	94.7	✓		
LEI Diffusion Index	50%		✓	
Purchasing Manager Index - PMI	51.3	✓		
Housing Starts (millions)	1.036		✓	
Factory Capacity Utilization	78.5%		✓	
Unemployment Rate	7.6%		✓	
Core Inflation	1.9%	✓		
Headline Inflation	1.5%	✓		
Oil Price ($/barrel)	$106.79			✓
Yield Curve	1.78		✓	

Lender and Business Dashboard Economic Indicator Benchmarks

Indicator	Green	Yellow	Red
The Conference Board Leading Economic Index® - LEI	Increasing	Flat to Decline	Decline 0.3% for 3 consecutive months AND >1% over the period
LEI Diffusion[1]	>60%	40%-60%	<40%
Purchasing Manager Index - PMI	>50	41.7-50	<41.7
Housing Starts (millions)	>1.5	1.0-1.5	<1.0
Factory Capacity Utilization	>80%	70%-80%	<70%
Unemployment Rate	5%-6%	6%-8%	>8% or <5%
Core Inflation	0%-2%	2%-4%	>4% or <0%
Headline Inflation[2]	0%-4%	4%-5%	>5% or <0%
Oil Price[3] ($/barrel)	<$50	$50-$100	>$100
Yield Curve[4]	Steep	Flattening	Inverted

[1]Ten indicators make up the LEI - measures % that are increasing; [2]Includes food & energy;
[3]Consumer's perspective; [4]3-Month Treasury Bill rate to 10-Year Bond rate