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Ag Lenders' Critical Mistakes

By: Dr. David M. Kohl

The recent robust economic times in agriculture have been a blessing to those involved in making agricultural loans. A nine-year super cycle ignited by the global emerging markets, low interest rates, and a low value of the dollar, have resulted in many asset and equity-rich producers, while profit and cash flow have been prosperous as well. This is a potentially lethal combination, and if not carefully managed and monitored, it could lead to issues in the future. Let us explore some of the critical mistakes being made by ag lenders in these days of prosperity in agriculture.

The number one mistake I see is the practice of conducting cash flow and profit analysis using tax records instead of accrual adjusted financials. Some will say that three years of Schedule F forms are all that is needed. A study by Dr. Freddie Barnard, Purdue University; Paul Ellinger, University of Illinois; and Christine Wilson, Kansas State University, provides evidence of a disaster on the horizon. Their study analyzed the difference between cash income and accrual income over a five-year period. The difference was as high as 61 percent! Lenders and producers are making 3-year, 5-year, and even 10-year decisions based on data that is totally inaccurate. The good times in agriculture have masked this issue as a result of increased paper wealth on the balance sheet and strong margins on the income statement. If the agricultural economy quickly turns negative, these issues will rapidly arise on financially stressed accounts and those in the growth mode. For those of you who want to know more about this, I will cover cash to accrual conversion in more detail in a subsequent article.

This first issue leads to the second critical mistake, which is the buildup of deferred tax liabilities on the balance sheet, particularly current and intermediate liabilities due to prepaying expenses and taking Section 179 accelerated depreciation. While prepayment of expenses is positive, and using depreciation can be a tool to reduce taxes, it is the extremes that can result in problems. In stressed financial situations where these tools cannot be used, producers experience high tax liabilities as a result of the inability to forward expenses, resulting in increased taxes in the year one can least afford them. This generally results in operating lines not being paid down or refinancing of operating monies.

The next big issue is the result of consolidation in agriculture. While the overall debt to income ratio in agriculture is currently $2.26 of debt to each dollar of income, which is very safe ground, the issue is concentration of debt. Many large agricultural customers are carrying the bulk of U.S. farm debt. Just recently, a very large operation in the Midwest failed, which was devastating to the bank, but also to many of the surrounding businesses and other farmers that had business arrangements and contracts with this producer. Ag lenders need to scrub their portfolios for concentration of risk, not only by industry, but by customers who make up a large share of the loans. Diving deeper, more analysis is needed to ascertain what contracts and agreements have been made with other producers and agribusinesses that have linkages to these businesses representing high concentration.

The next potential fatal mistake is failing to examine sensitivity to changes in revenue, expenses, and interest rates in the loan analysis process. One should examine financial scenarios depicting a 10 percent drop in revenue, a 10 percent rise in expenses, and a 3 percent increase in interest rates. If the projections and data represent uncertainty, higher thresholds should be calculated.

Next, determine how strong working capital reserves are to sensitivity shocks. If the producer does not have a risk management program on inventory or receivables, one must discount working capital significantly.

Good, old-fashioned cash on the balance sheet is vital; however, this goes against the age-old trend of agricultural producers who limit the amount of cash on the balance sheet. The amount of cash on the balance sheet should be enough to cover two years of your greatest business losses or two months of expenses.

Examine prepayments and ascertain the agribusiness firm's financial strength. Producers often forget that prepayments for inputs are essentially potential unsecured lines of credit with the agribusiness. If the agribusiness encounters financial stress or goes bankrupt, it could result in the liquidity of the producers who have prepaid drying up very quickly.

A sensitivity test of long-term collateral, including land, equipment and livestock should be conducted. One should avoid debating values placed on assets by producers. One suggestion is to reduce loan maximums in the institution's internal policy to account for any artificial inflation of producer's asset values. For example, with artificially inflated asset values, one may lower the loan maximum to 50 percent, rather than the standard 65 percent to 75 percent. Yes, land values will correct and building in this reserve through loan maximums is a third line of defense, particularly in an extended downturn.

Finally, the good times' crunched time schedule often results in complacency in monitoring accounts. Follow-up on covenants and variance analysis of projected to actual results are methods to ascertain the financial position of the customer. Watch for an increase in accounts payable, credit card debt, and the number of lines of credit by the customer, which can be signs of pending issues. Like the old Fram oil filter tagline, you can pay me now or pay me later. This is analogous to the monitoring process.

Yes, times are good and many portfolios are secure and sound. However, a proactive approach to loan decisions and portfolio monitoring is critical to maintaining a healthy loan portfolio in any economic cycle.

Lender Tip

A good way to maintain contact with your customers is to conduct benchmarking. That is, comparing your customers' financial data to others in the portfolio databases and providing a report of how they "stack up." Many of your better producers will find this beneficial and a value-added experience.

Global Economics

The struggles in Europe continue to arise like an ongoing soap opera. The most recent victim is Spain, which is requiring deep cuts in the economy. The April release of the euro zone Purchasing Managers Index (PMI) was quite bearish, well below the 50 threshold indicative of a growing economy. This news caused worldwide equity markets to decline, since the euro region combined is the largest global economic bloc. The situation in the euro zone is resulting in the slowdown of China, which is the euro zone's biggest trading partner.

China's GDP growth is now 8.1 percent, the lowest growth in three years. Will they embark on monetary easing to stimulate the economy? Only time will tell. China is attempting a soft landing of its economy as new political leadership takes over later this year. China is very critical to the fortune of U.S. agriculture, particularly for the grain and dairy markets, so a close eye must be kept on the Chinese economy.

U.S. Domestic Economy

The economic indicators foretelling the future of the economy are still continuing full steam ahead. The Leading Economic Index and its diffusion index are still showing a positive direction, as they have over the past 18 months. The Purchasing Manager's Index is still above 50, which is indicative of a growing economy. Keep in mind that the key behind these leading indicators is whether this is organic, sustainable growth, or the result of the Federal Reserve's economic stimulus.

Oil prices have had the usual spring run-up, coupled with a "fear premium" given possible unrest in the Middle East, which results in a $20 per barrel premium. Gasoline prices have recently averaged $3.97 per gallon nationwide and should subside unless a black swan event occurs relating to the oil industry.

U.S. factories are near capacity, staying consistently in the high 78 percent range. This is the result of the insourcing of factory jobs back to the U.S. We are seeing the end of cheap labor in China and throughout the Asian region, resulting in higher cost of production overseas.

Core and headline inflation have remained steady in the low 2 percent range, but are still much higher than one year prior. The stock market's equity gains have been a result of Federal Reserve stimulus attempting to induce the wealth effect to jump start the economy through consumer spending. Remember every time a stock increases one dollar in value, people who hold those stocks spend an average of four cents more.

Housing continues to be a drag on economy. Housing starts have declined since my last article from approximately 700,000 to 654,000. A note on housing is that the Chinese, Canadians, and Russians are purchasing homes at steep discounts in financially strapped areas of the U.S., particularly in the south and southwest.

The official unemployment rate has declined to 8.2 percent with a U1-U6 unemployment rate at 14.5 percent. These rates are still high based on historical terms and may cause much debate in the political elections over the next six months.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	95.7	✓		
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	53.4	✓		
Housing Starts (millions)	0.654			✓
Factory Capacity Utilization	78.6%		✓	
Unemployment Rate	8.2%			✓
Core Inflation	2.3%		✓	
Headline Inflation	2.7%	✓		
Oil Price ($/barrel)	$121.57			✓
Yield Curve	2.14		✓	

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