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Critical Mistakes Made by Lenders and Producers

By Dr. David M. Kohl

The easy money is waning, particularly in the crop sector of agriculture. Slowdown in emerging markets, changes in the ethanol mandates, and Federal Reserve tapering are all ingredients contributing to moderation of the great economic super cycle. The agricultural economic and financial landscapes are full of potholes for even the best of managers. As I travel, stories abound of critical mistakes being made by both producers and lenders. Let's discuss some of the issues, consequences, and possible corrective action.

Operating Lines of Credit

Over the past 18 months, many stories have arisen about incidences where producers cannot pay down operating lines of credit. The culprit in some of these cases may be that funds are being diverted toward farm and non-farm capital purchases, improper risk management programs, business growth, cost containment issues, etc. For instance, a lender made a carryover operating loan based on inventory, namely corn in the bin. Prices at the time were $7.00 per bushel, and the loan was made with the promise of selling this corn inventory to pay off the carryover operating money. The producer did not have price protection on the corn in the bin and now he is in "deer in headlights" lockup mode and will not make a decision to sell. Another twist to this story is that this account is now in the hands of a junior loan officer, who inherited it when the previous loan officer left the institution and took off to greener economic pastures. The story becomes more complex in that the lending institution encouraged the previous loan officer to make the marginal loan because they needed the market share, and he received a large bonus at that time. The junior officer is feeling pressured because a new lending institution that has just started focusing on the agriculture marketplace is aggressively courting this borrower because of all the equity involved.

A lesson to be learned in this case is loans should only be made after careful analysis of why the carryover losses occurred. Misallocation of proceeds and other management blunders would need to be carefully scrutinized. A weather or disaster issue is another story. In this case, the loan officer could extend the loan, with the caveat that the corn in the bin and the crops in the field in the upcoming year have a risk management program.

Another critical mistake by the lending institution was having a marketing incentive program for loan growth without policies in place for credit quality and loan officer performance. The competing lender who is new in the marketplace could be another

pothole in the situation. Aggressive lending by new entrants in the marketplace could be a potential train wreck on the agricultural lending landscape, if their goal is to build market share at all costs.

Coverage Ratio Issues

Many lenders and producers are finding producers' term debt and lease coverage ratios, as recommended by the Farm Financial Standards Council, to be marginal at best with moderating grain prices. Some lenders are circumventing accrual analysis and just using cash basis ratio calculations to justify a stronger coverage ratio to meet internal and external review and government guarantee standards. Others are using the last four prosperous years of data for trend analysis to justify weak coverage ratios. Some indicate conducting an accrual analysis will illustrate how bad the financial conditions in the business really are, and the producers do not understand it and say it takes too much time.

As a warning, these types of practices could be detrimental. Granted, trend analysis is very important in assessing risk; however, the coverage ratio is a forward-looking ratio, and it needs to be tested with various price, cost, and yield assumptions, and shared with the producer.

In 2014, accelerated depreciation limits were reduced from $500,000 down to $25,000. Depreciation schedules that have been supersized and are not consistent with the intermediate and long-term amortization schedules can skew the results toward a stronger debt coverage ratio. When accelerated depreciation is no longer available, coverage ratio can quickly become marginal at best. Accrual analysis of the income statement can quickly discover whether the canary is living or dying in the financial coal mine. In the next few years, accrual analysis on larger agriculture loans will not be an option, but a requirement.

Fixed Rate Operating Loans

Another critical mistake is a sound strategy, but it can be dangerous if not executed properly. With a possible rise in interest rates on the horizon, some lenders are making multiple year operating loans on fixed rates, leveraging equity particularly in land. While the concept of the strategy is sound, the danger of this critical mistake occurs when the fixed rate operating funds are misallocated and used to purchase long-term capital assets such as land, equipment, etc. It is often said that too much cash can burn a hole in your pocket. In these situations a high level of discipline and trust between lender and borrower is needed to properly execute the strategy.

Another critical mistake centers on a comment made by an arrogant lender. "If you've got the dirt (or the collateral), you can't get hurt." My only comment is that this is equity and collateral lending at its best, which is alive and well on the agricultural landscape. Remember, profits and cash flow backed up with sound liquidity reserves along with management acumen and character of the borrower is the recipe for success in both good times and bad times. A saying by Warren Buffet, the famous billionaire, is "when the tide goes out, you find out who is naked." This saying is very applicable to those

arrogant lenders who are collateral lenders. When land values soften, good managers will rise, while the others will be on the problem loan list. It is your choice when assessing risk, and there is no way of getting around sound lending practices.

Well, here are just a few the actions going on out there on the front lines of producer-lender relationships. If the duration of the current moderation is extended, these lending and producer practices will only sour!

Lender Tip: Education is Key

Sign up your young lenders to attend a good state or national lending school this summer for an educational experience. I encourage you and your regulators and examiners to participate in the schools because the economic moderation will require teamwork and understanding by all parties.

Global Economics

Global economics is on the front page, hitting headline news on the business channels and websites. A trek to Europe finds that the euro area economy is growing at a 0.5 percent year-over-year rate. Ukraine, which is the bread basket of both Europe and Russia, is featured in front page headlines, where approximately 60 percent of the population base desires ties with Europe, while 40 percent leans toward Mr. Putin and Russia. In the crosshairs is the energy supply to Europe, i.e. gas and oil, which constitutes over 50 percent of Russia's GDP. The unrest in this region has increased energy prices overall; however, in the U.S. and Canada, rail transport has been diverted from transporting grain to transporting more oil and coal to supply needs outside of North America. This has resulted in increased transportation cost to farmers and ranchers, and an inability to access the grain markets because of limitations and competition for rail cars. A recent trip to Canada found that the Canadian government has mandated that rail transport handle a certain percentage of grain.

On the other side of the globe, China has continued to experience a slowdown in economic growth rate. The economy is advancing at about a 7.4 percent growth rate as exports have contracted and growth in infrastructure and fixed investment has declined. Other emerging markets are observing GDP growth rates between 1 percent and 2 percent, to just below 5 percent, which are far below the robust advances in recent years.

Some other interesting perspectives from around the globe:

- Spain's jobless rate is 26 percent.
- Deflation risk is a major concern in the euro sector, with inflation at 0.5 percent, contrasted to 1.7 percent in the U.S.
- Japan's debt to GDP ratio is 227 percent, contrasted to the U.S. at 101 percent and China at 26 percent.
- Brazil's and Turkey's interest rates are in double digits at 10 percent and 11 percent, respectively.

Domestic Economics

The leading economic index (LEI) increased a whopping 0.8 percent in March, with a diffusion index of 70 percent, which is definitely in the green light area, illustrating potential growth in the economy. The purchasing manager index (PMI) is still above 50 percent in the U.S., indicative of a growing economy. Oil prices are still high, above $100 per barrel, and gasoline and diesel fuel prices are increasing because of demand for spring and summer driving periods.

Unemployment rate (U-3) is just above the 6.5 percent threshold the Federal Reserve has considered as a metric to raise interest rates. However, the U-6 unemployment rate is 12.7 percent. This rate includes discouraged workers and people who have given up in the workforce or who are marginally employed, which is being carefully observed by the Federal Reserve's Federal Open Market Committee (FOMC) for consideration and

possible interest rate rise. Automation, mismatch of job requirements and job skills, and an undereducated workforce are headwinds in the employment sector.

Housing starts are just under 1 million annually. Many younger Americans are moving to urban areas and renting and leasing apartments, which is a change in housing demographics. Factory utilization remains in the high 70s, indicative of strength in this economic sector. Core and headline inflation remain tame at 1.7 percent and 1.5 percent, respectively, which is another factor observed by the FOMC for an interest rate rise. If core and headline inflation creep above 2 percent, then there will be a possibility of an increase in interest rates.

Watch for the advance estimate of first quarter GDP growth coming out April 30. Expect the year-over-year rate to be down because of harsh winter weather and possible slowing of the U.S. economy. Since 2008, the U.S. economy has shown economic strength the first four to five months of the year, only to decline in the latter half of the year. Only time will tell if 2014 will follow this pattern.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	100.9	✓		
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	53.7	✓		
Housing Starts (millions)	0.946			✓
Factory Capacity Utilization	79.2		✓	
Unemployment Rate	6.7%		✓	
Core Inflation	1.7%	✓		
Headline Inflation	1.5%	✓		
Oil Price ($/barrel)	$104.27			✓
Yield Curve	2.70	✓		

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