02/26/14

Destructive Behaviors

By Dr. David M. Kohl

The agriculture economy is now in transition as cycles ebb and flow. The red-hot grain sector, fueled by the great commodity super cycle, appears to be waning. At the other end of the spectrum, the livestock, horticulture, and retail entrepreneurial sectors of the industry are emerging and appear to be in position to be profitable. These economic cycles rise and fall as a result of emotional behaviors, which drive approximately 80 percent of economic decisions. Let's examine some of the good, bad and ugly behaviors influencing the cycles, and some other perspectives that need to be top of mind for ag lenders and producers in 2014.

Greed

One of the most dangerous emotional behaviors that ag lenders must guard against is greed, leading to the undisciplined pursuit of more. Greed is usually rewarded in times of prosperity and wealth building in the emerging part of a cycle. The go-go mentality often leads to "bigness on the brain" or "swinging for the fences" as a baseball analogy, attempting to hit a home run in every major decision, whether it is an investment, marketing plan, or risk management strategy.

Recently one producer on a lender school panel commented that he left $500,000 profit on the table as a result of following a University risk management program. At another educational event, a producer indicated that he paid premium prices for land and cash rent because no more land is being made. These behaviors become destructive in the down part of the cycle. Lenders will need to pay close attention to producers' liquidity and working capital reserves, and how profits and cash are being invested and distributed. A tight leash may result in losing some of these aggressive "alpha dog" producers to the competition, which may reduce market share and profits in the short run, but may save you from headaches due to problem loan workout in the long run.

Place particular attention on the "alpha pups" or the younger producers who have extremely aggressive growth expectations. Many under 40 years of age, or even under 30 years of age, have garnered unusually high profits in the recent super cycle, especially in the grain industry. Since some of these producers were less than 10 years of age during the farm crisis, they have little perspective on the financial and, more importantly, emotional stress of an economic moderation over a period of time. This applies to lenders also as the ag lender workforce transitions. Many experienced lenders will retire soon, and inexperienced entrants will fill their shoes, which could be a lethal variable should an extended or deep downturn take place.

The Cure

What is the cure? Ag lenders should use these times as teachable moments for those who are willing to adapt and adjust. Be careful of those who have a victim or know-it-all attitude. Victims will blame everyone else for their problems, including you as a lender, and will not own up to the problems or issues. A know-it-all, which is sometimes the behavior of go-go alpha dogs and alpha pups, has forgotten how to learn or to take counsel.

A major concern on the horizon concerning alpha dogs and alpha pups lies with underwriters and credit analysts. That is, while many of these folks do an excellent job analyzing numbers, if they are only data-driven in making assessments and decisions, they may miss important personal cues, which could be detrimental. Behaviors and psychological issues will often precede financial issues by up to two years. A recommended best practice is having loan officers work closely with analysts. Analysts need to spend at least one day per month on customer visits to understand the quickly changing marketplace and its impact on individual borrowers as well as overall portfolio health.

Complacency

Another behavior worth mentioning is complacency. The worst mistakes are frequently made during good economic times. When the tide turns, many producers will expect to turn the business around with one major strategy, or what is referred to as a magic silver bullet. Success in turning a business around and making adjustments does not depend on doing one thing 100 percent better, but 100 little things 1 percent better. Advice from the moderating times of the 1980s is to focus on efficiency and getting back to basics. Lenders will have to use more financial and business benchmarking, i.e. trend analysis and peer comparisons. Cash to accrual analysis and enterprise budgeting will be critical, along with soundly executed marketing and risk management programs. The key words are execution and follow through. Recently a banker from Nebraska commented that some of his customers were stubborn, seeking higher prices now and exhibiting a “deer in headlights” approach by locking up and doing nothing. That, my friend, is a dangerous recipe for disaster.

High Living Withdrawals

Another dangerous behavior that has been more prevalent recently during the commodity super cycle is taking high living withdrawals as well as making large nonfarm capital investments. Living expenses will vary, but north of $200,000 annually for living expenses is very common amongst those who enjoy prosperity. Purchasing nonfarm capital assets that do not generate earnings has been common also. The key in these cases is whether or not the producers will adjust their spending habits given $3.00 to $4.00 per bushel corn prices. On the other hand, will livestock producers who are experiencing newfound prosperity be able to maintain reasonable withdrawal patterns? Another component to observe will be income tax sticker shock as a result of Section 179 depreciation limits, tax surcharges, and deferred tax liabilities that may be paid out of cash flow.

<u>Lack of Lender Loyalty</u>
Finally, be careful of the chief financial officers (CFOs) on your larger accounts. Some lenders have indicated that CFOs are very interest rate sensitive without regard for relationship or loyalty to the lender. They are often enticed by a new lender offering lowball rates and unique loan structure. Will the CFO, and frequently the CEO and owners, be able to psychologically handle a downturn? This will be the multimillion dollar question in the economic moderation, which most likely will create issues in individual accounts, particularly for those lenders who are collateral-based, building market share and avoiding prudent rules.

This transition will separate the winners economically, but behaviors behind the economics will require a lender to be an analyst and psychologist. When handled properly, a downturn will lead to long-term relationships, so it can be looked upon in a positive light.

<u>Lender Tip</u>: Learn from the 80's

At your institution or at the next conference or training event you attend, ask a lender who weathered the 1980s to discuss some of the destructive behaviors they saw, and how they were mitigated. It can help to learn from the past, instead of repeating it!

Global Economics

The front page headline from *The Economist* magazine on February 8 says it all for both the global and domestic economy: The worldwide wobble. Growth of emerging markets, such as the BRICS and KIMT nations, is expected to be higher than growth rates of developed countries, but lower than growth rates of recent years. A composite GDP growth rate for the BRICS and KIMT nations is now below 5 percent, which is one of the reasons some commodity prices are moderating. Commodity exporters will suffer from lower commodity prices due to reduced demand from consumers such as China, and the fact that the U.S. has increased its energy production.

Emerging nations are in the crosshairs of the Federal Reserve's plan to scale back stimulus, which will tighten credit in these nations and impact currency values. The economies of Brazil, Turkey, India, Indonesia, and South Africa were stymied by Federal Reserve action when investors sold off emerging market assets, which invariably influences currency. These nations, known as the "fragile five," are experiencing social and political issues, as well as significant current account deficits impacting economic growth.

China, which contributes nearly one half of the output of emerging nations, will exhibit slower growth as a result of banking reform, tightening of credit, and more attention to environmental issues. The government is currently stockpiling selected commodities such as wheat, corn, rice, and soybeans as a hedge to market volatility and possible internal social and political backlash. China's purchasing manager index (PMI) in recent months is now below 50, an indication of the slowdown of China's manufacturing sector.

Domestic Economics

The leading economic indicators, the LEI and PMI, are still positive but they are exhibiting signs of possible slowdown in the U.S. economy. The PMI dropped dramatically from the mid- to low 50s in January. The direction of these indicators will bear watching over the next few months to determine whether it is a monthly aberration or a longer trend.

The U-3 unemployment rate declined to 6.6 percent, nearing the level established by the Federal Reserve at which they will likely increase interest rates. Keep a close watch on this metric going into the spring and summer Federal Reserve meetings for a possible rise in interest rates.

Factory utilization is remaining quite strong in the high 70s. Close attention to inventory buildup will determine whether sustained demand for products exists.

Housing starts, which temporarily rose above 1 million annual starts, have now settled in at 880,000 for January. Higher interest rates and modest income growth are headwinds in this important sector of the economy.

Recent core and headline inflation are both at 1.6 percent year-over-year. This is well below the metric the Federal Reserve utilizes as a guide for stimulus and interest rate direction.

In summary, both global and domestic economies are wobbling along with lack of a definitive direction.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	99.5	✓		
LEI Diffusion Index	60%		✓	
Purchasing Manager Index - PMI	51.3	✓		
Housing Starts (millions)	0.880			✓
Factory Capacity Utilization	78.5		✓	
Unemployment Rate	6.6%		✓	
Core Inflation	1.6%	✓		
Headline Inflation	1.6%	✓		
Oil Price ($/barrel)	$105.09			✓
Yield Curve	2.59	✓		

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