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10/28/14

Hot Seat Perspectives: Questions and Answers

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Many of you who follow sports on ESPN have viewed a segment called the Hot Seat during which an informational and entertaining rapid-fire question and answer session ensues concerning the landscape of sports. This article will follow a similar format based on questions submitted by lenders for a recent webcast with the Commercial Ag Lender class of Farm Credit University, a blended educational program including both web-based and face-to-face instruction.

Could you identify the top factors impacting credit risk of agricultural borrowers and the ag portfolio? Cash flow is at the top of the list. For grain producers, corn prices at $3.00 per bushel and soybeans priced in the single digits are causing negative term debt and lease coverage ratios as well as negative margins, resulting in operating lines of credit not being paid down. The fall and winter of 2014 and early 2015 could be a game of "chicken" as producers attempt to protect rented and leased land, but balance it with economic logic given suppressed markets. Cash flow is also an issue in the livestock industry, but on the positive side. The credit risk here is the chance producers will spend margins unwisely, given the uncertain duration of the positive livestock cycle. It is only "once in a blue moon" that the industry sees the 3 x 3 x 3 Rule, that is, $3.00 per pound steers, $3.00 per bushel corn, and prime interest rate in the 3 percent range.

What is a reasonable family living cost? A major credit risk mentioned by lenders is cash flow being depleted for family living expenses and nonfarm capital expenditures. Realize you cannot plug an average number for living costs because there is wide variation in the lifestyles of farmers and ranchers. Farm record data summaries show high maintenance customers' living withdrawals are between $120,000 and $575,000 annually. Contrast this to the low one-third of customers at $50,000 to $75,000 annually. This is a wide range that impacts cash flow demands.

Numerous signs of large nonfarm capital expenditures, which are frequently unproductive assets, are being documented and observed. Condos on the lake, helicopters, airplanes, expensive vacation homes, and hunting camps are just a few examples. First, the grain industry experienced this and now it is the livestock industry's turn as cycles moderate and intensify.

How will transition management plans for producers and lenders impact ag lending? At an ag lending conference this fall, one of the leaders of the Farm Service Agency (FSA) indicated that up to 50 percent of their farm loan staff could retire within the next five years, with even higher percentages at the state and national offices. Similar trends are occurring in banks and the Farm Credit System. The loss of institutional memory from the 1980s could be an accident waiting to happen. Turning to the agriculture producers' side, a new group of young producers have been attracted to the industry lured by favorable economic times. This generational transition and the ability to take an economic punch and remain viable place a high premium on character and management for both the entering and existing generations.

What is your take on increasing competition for ag loans from traditionally non-ag lenders? The new lending competition on the scene with exotic "no money down" or interest-only loans that require minimal financial information, offered by staff who are very inexperienced in the lending industry, particularly agriculture, are a convergence of events for possible credit risk. Couple this with farmers paying cash for capital purchases such as land, machinery, and equipment, which depletes their cash reserves, reducing liquidity for a down cycle. These are pending signs of financial issues.

What is your opinion of large borrowers having multiple lenders? Having two or three institutional lenders is usually not a problem and can be a way to manage risk; however, more than five sources of credit, i.e. split lines of credit, is one of the 72 signs of a business headed south. That is, borrowers often "rob Peter to pay Paul" as the saying goes.

What trends are you seeing in farm records? A major credit risk is lack of good financial records and the business acumen to use records. In my tenure I have found that when the industry is in the strong part of the cycle, producers become very complacent and ignore sound record-keeping and management practices. Utilize the down part of the cycle as an educational opportunity to teach borrowers financial and business management and to build relationships. Remember, in the good times borrowers are often primarily concerned about prices and the lowest interest rates; the tough times are an opportunity to work side-by-side and build relationships.

How does one best assist young producers when they have limited financial credit history and equity? In those first few years, cash flow, liquidity, operating margins, and modest living withdrawals are areas of emphasis. This is also a good recipe for sustainability of the older generation farmers through any part of the cycle or any stage of the business.

While this may not have been as entertaining as ESPN, hopefully it has provided some insight and information with a few tips for this year's renewal season. This winter's lending season is going to be about sustainability and willingness to step up management from the producers' side regardless of where the business is in the economic cycle.

<u>Lender Tip</u>: 96-4-50 Rule

Remember the 96-4-50 Rule. In general, 96 percent of your portfolio will perform well, while 4 percent will present problems. You will spend approximately 50 percent of your time and resources on the 4 percent, but the key is not to ignore the other 96 percent

Global Economics

Global economies are slowing down and moderating in both developed and emerging nations. Europe, with a larger combined economy than the U.S., is on the verge of a recession. The recent Scottish elections, during which Scotland decided to remain a part of the European Union (EU) rather than separate, were critical for the EU continuing to be a united economy.

Germany, the fourth largest economy in the world, is growing slightly above 1 percent. Despite central bank stimulus in the European region, issues with Russia and Ukraine are economic storm clouds over this region. This winter will be interesting, economically and politically, as much of Europe's energy supply is in the militarily volatile regions of Ukraine and Russia.

China, on the other hand, is being influenced by the European region's slowdown which, by the way, is China's largest consumer. Recent estimates of Chinese economic growth show a slowdown to 7.3 percent, down from 10.8 percent growth rate in the past decade. Some estimates could see this growth rate slow to 3.9 percent over the next decade according to a recent article in the Wall Street Journal. This is reflective of the slowing housing market in China and natural resource issues related to toxic water, soil and air quality. Also, China has a shadow banking issue which could raise its ugly head in world economics.

Other emerging nations including Brazil, Russia, South Africa, and Argentina are involved either in political, economic, military, or social issues which is causing the bloom to come off commodities ranging from corn to oil. It will be interesting to observe global economics, particularly in emerging nations, and how they will impact U.S. agriculture and rural areas which have a direct link to these nations through commodities.

Domestic Economics

The U.S. economy is motoring along now with over 60 months of business expansion since the great recession. The Leading Economic Index (LEI) is still increasing with the diffusion index being 90 percent, which means 90 percent of the factors included in the index are positive. The purchasing manager index (PMI) is still quite positive and robust above 50. These are both indicators that the future economic growth over the next six months should be positive.

Factory capacity utilization is near 80 percent, a sweet spot for this sector. If your institution is in a region dominated by factories, this can be a very important variable indicating portfolio health.
Housing starts, a critical element of the U.S. economy, are approximately 1 million annually. This is still under the ideal level of 1.2 to 1.5 million. Headwinds in wage growth, tight credit standards, and consumer and student debt are factors inhibiting the level of this metric.

Unemployment, inflation rate, and economic growth, which are variables used ascertain interest rate direction, are illustrating some interesting trends. Reported unemployment rate is 5.9 percent, which is within the range in which the Federal Reserve would consider raising rates. This is also being compounded by GDP growth of 4.6 percent in the second quarter, which is another omen for possible rate hikes. However, headline and core inflation, both at 1.7 percent, with headline inflation probably going lower because of the lower oil prices, would suggest inflation is not an issue despite low unemployment and a growing economy.

In the fourth quarter, watch oil prices and equity markets in the U.S. and abroad. While lower oil prices increase consumers' ability to purchase goods and services, lower stock prices on the other hand result in households feeling poorer due to reduced balance sheets. It will be interesting to observe how one offsets the other. The U.S. economy will most likely muddle along at a modest to slow pace into 2015.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	104.4	✔		
LEI Diffusion Index	90%	✔		
Purchasing Manager Index - PMI	56.6	✔		
Housing Starts (millions)	1.017		✔	
Factory Capacity Utilization	79.3		✔	
Unemployment Rate	5.9%	✔		
Core Inflation	1.7%	✔		
Headline Inflation	1.7%	✔		
Oil Price ($/barrel)	$94.54		✔	
Yield Curve	2.46	✔		

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