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Kohl on the Hot Seat

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One of the fun components of conducting schools, seminars, and speeches is the challenge of questions from the participants. In the format of ESPN's Hot Seat, this article will focus on my answers to some of the questions I am most frequently asked by ag lenders.

<u>Question</u>: How long can farmland prices stay at their current level? How far could they fall?

<u>Answer</u>: This is probably the most commonly-asked question by both ag lenders and producers. First, the farmland price situation is not a credit bubble, but more of an asset bubble centered in certain regions of the country. Elevated land values are the result of a convergence of events. Growth in demand for food, fiber, and fuel by the emerging nations has aligned with land value increases. Yes, the increased use of ethanol and a weak dollar that has encouraged exports cannot be discounted in the land appreciation equation.

An extended period of low interest rates and low returns on competing investments, such as stocks and bonds, has contributed to land asset escalation. Of course, oil, mineral, and water rights have factored into the equation as well. If the convergence of these variables remains positive, land will continue to appreciate in certain regions of the country.

The next land value correction will be the result of the unraveling of these events, and will be regionally focused rather than nationwide. The quantity of converging factors in the negative direction will determine the duration and severity of the correction and whether it will be a 10 percent or a 50 percent drop. This bullish land market started 22 years ago. It will extend to a quarter of a century, unless there is a change in behavioral economics of producers and investors.

<u>Question</u>: What is the difference between commercial retail lending and ag lending?

Answer: This question has been asked of me at a much greater frequency during the past two years. It is the result of more commercial and retail lenders being moved to ag lending positions. First, for the most part, ag lending is much more relationship-based than commercial lending. That is, you must understand the customer's personal side, goals and motivations that often do not show up in his or her financial statements.

In commercial lending, the financial statements provided are often accountant-prepared, which contrasts to borrower-prepared tax and market value income statements and balance sheets commonly found in the ag industry. In commercial and retail lending, the lender will often deal with the chief financial officer (CFO) of a business; however, in ag lending, generally the owner and frequently their spouse will attend to these matters.

In ag lending you sometimes see less financial leverage on the balance sheet and liquidity in terms of inventory and prepaid expenses, compared to commercial lending. Both commercial and ag lending require that you know the customer and the industries with which you do business. Trust, honesty, and value systems are a trademark of ag lending. On a side note, in my travels I am seeing more interest from commercial lenders in the agriculture field because of the strong economic times.

Question: What is your best advice for producers who want to expand operations or invest in land despite the volatility and uncertainty in the economy?

Answer: Before considering expansion or investing in land, the business must first be profitable from an accrual-adjusted income standpoint, not just on the tax records. Business profits that are turned to cash flow will be used to service term debt or operating obligations with the increased size of the business.

Maintaining financial liquidity is paramount in any acquisition or expansion plan. Some recommended reads on the financial statements would be the following.

- Net working capital above 33 percent of revenue or expenses after expansion or acquisition.
- Cash on the balance sheet equal to or greater than the borrower’s two biggest years of losses, or one to two months of expenses.
- Some others metrics to consider are working capital per acre of $300 to $400 for a grain or row crop operation; $750 per dairy cow, or $200-$250 per beef cow. Working capital and cash are king in expansions and acquisitions of a long-term nature.
- Does the land purchase or acquisition allow the business to maintain a debt to asset ratio below 50 percent, particularly if there is a weakness in the liquidity metrics previously mentioned?

Financial leverage can be a killer in the down part of the economic cycle, particularly if it lasts for an extended period of time. Many of the recent record farm business failures and 1980s negative outcomes were the result of the debt to asset ratio exceeding 50 percent. That being said, one ratio cannot dictate success. If the financial leverage ratio exceeds maximums allowed, offset this with strong profitability and liquidity.

Question: Is there a template for cutting costs in a turnaround situation?

Answer: Yes, start out by identifying the five largest expenditures on the income statement. Develop a game plan with the producer to cut each of these expenses by 1 percent to 2 percent. This includes strategies, actions, and timelines, which should be monitored by the lender to provide accountability. This strategy must be in writing between the lender and producer. It should be monitored quarterly through variance analysis, comparing projected to actual results. Determine whether improvement was due to cutting costs, changes in prices received, or micro-level changes that management implemented. Cost cutting requires good old fashioned hard work and diligence by both parties because old habits are difficult to change.

In future columns, from time to time, I will discuss some additional frequently asked questions from inquiring minds of ag lenders in an ESPN Hot Seat format. If you have a question you would like me to address in a future article, please send it to me.

Lender Tip

Make sure you examine your portfolio for concentration risk. For example, if one or several of the largest agricultural producers in an area or region has difficulties, how will it impact other producers, agribusinesses, and customers in the area? A case in point is a large producer in the Midwest that filed for bankruptcy, which had a significant impact on not only the local rural community, but also many of the service businesses that actually served this borrower. Similar cases have also played out in the western region of the U.S.

Global Economics

The global economic scene has been volatile since the last time we visited. For example, world oil prices in early 2012 have shown noticeable increases due to a possible Iranian conflict that could shut down the Strait of Hormuz.

The European area is in a slow process of working through sovereign debt issues in Greece and Italy. This will continue to be a slow adjustment which needs careful observation since Europe is China's largest trading partner.

China and India are seeing a slowdown in their economics due to less demand for goods in Europe and North America. Real estate in China will need to be closely monitored for a possible bubble. The continued prosperity of the emerging nations that have above an 8 percent GDP growth rate will be imperative to sustained strong demand for agricultural products and services aligned with these countries.

As a special note, countries that represent over 50 percent of world GDP will have major political elections within the next 12 months. These potential new leaders' roles, changes in trade regulations and tax reform will cause uncertainty for businesses.

On the Home Front

The leading economic index (LEI), LEI Diffusion Index and Purchasing Manager Index are in a stellar positive mode suggesting that recovery is well in place for the U.S. economy. How much of this growth is the result of stimulus from the Federal Reserve's accommodative policy is yet to be seen.

With the strengthening of the U.S. dollar to the euro and yen, oil prices should be in the $80 to $85 per barrel range (NYMEX). However, concerns over Iran may continue into spring, trumping the strength of the dollar and resulting in higher gasoline and diesel fuel prices.

Both core and headline inflation have shown significant increases year over year, while remaining well within the range of the Federal Reserve's newly announced targets. This is occurring despite lower household incomes, which are down 6.8 percent since the year 2000. Factory capacity utilization is just below the ideal metric of 80 to 81 as plant efficiency, insourcing of jobs back to the U.S., and manufacturers in "full steam ahead" mode are positive factors affecting this sector. Housing starts are still in the doldrums at approximately 699,000, far below the 1.1 million needed for target housing starts.

The surprise has been the unemployment rate, which has dropped from 9.0 percent to 8.3 percent reported rate. The U-6 measure of 15.1 percent, which includes discouraged and displaced workers, has seen some reduction as well.

The US economy is in a nice recovery mode at the current time; however, an unusual event or black swan could result in an economic slowdown. The U.S. economy as a whole is rated a yellow light, showing slow improvement, very similar to last year before increased oil and gasoline prices hit the economy.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	94.9*	✓		
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	54.1	✓		
Housing Starts (millions)	0.699			✓
Factory Capacity Utilization	78.5%		✓	
Unemployment Rate	8.3%			✓
Core Inflation	2.3%		✓	
Headline Inflation	2.9%	✓		
Oil Price ($/barrel)	$111.11			✓
Yield Curve	1.74		✓	

*The LEI underwent comprehensive benchmark revisions at year-end, so regardless of the apparent decrease in the index value from the previous article, the LEI actually increased 0.5 in December and 0.4 in January. For details, see the press release at this link: http://www.conference-board.org/data/bcicountry.cfm?cid=1

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