



10/28/13

## **Major Credit Risks in Agriculture**

By: Dr. David M. Kohl

Many ag lenders are now embarking on the late fall and winter operating line renewal season with existing customers and analyzing credit requests of possible new clients. As lenders examine credit files and financial statements, the major focus is on identifying credit risk. Let's examine some of the areas of potential credit risk in the agricultural industry and rural businesses that serve the sector.

### Fragile, Fragile, Fragile!

Whether globally, domestically, or in agriculture, the current state of the economy can be sized up in one word: fragile. Producers can go from being in the financial and economic penthouse to the outhouse as a result of a sea of economic variables along with geopolitical risk. Ag lenders must observe for a systems approach to management of operations, finance, marketing, and overall risk management as prudent behaviors of agricultural producers. This fall and winter loan season will require financial scenario planning by examining outcomes using various price and cost assumptions. The high prices of land and cash rent can look very favorable with \$7/bushel corn and \$15/bushel soybeans, only to be relegated to a risky situation or possible financial disaster with corn at \$3/bushel to \$4/bushel levels, and soybean prices in the single digits.

In farm customer meetings, a proactive step will be to objectively outline outcomes and how they impact financial benchmarks, cash flow, and debt servicing ability. If the customer is not interested or threatens to seek another lender, this may be a screening method that could save some problems in the future. As the agricultural economy moderates, those business savvy producers with high financial acumen are your long-term sustainable customers.

### Alpha Dogs and Alpha Pups

Beware of alpha dogs and alpha pups, which are aggressive producers in the older or younger generation, respectively. Alpha dogs and alpha pups can be described as producers who expand and grow with the mentality of the "pedal to the metal" approach. In recent years, the great commodity super cycle has rewarded the behavior of these individuals with record profits and land appreciation. The "bigger is better" approach has been beneficial to lenders and borrowers, resulting in quick portfolio growth for lenders and record profits for producers

These alpha dogs are very vulnerable to a profit margin squeeze as they get caught up in the undisciplined pursuit of more. If you finance these types of producers, watch working capital reserves, overall debt levels, and, more specifically, profit margins closely as they could have a decline in profit or possibly negative margins as a precursor to cash flow and short run liquidity problems in two or three years.

Be aware that these dominant producers' behaviors will dramatically change in tough times, resulting in strained relations with creditors. Remember alpha dogs and particularly alpha pups, who have not experienced a downturn, can "bite" when they feel economically challenged.

### Interconnectedness and Third-party Risk

Agricultural statistics verify that while average nationwide debt-to-asset ratios are at a record low, debt concentration is an issue. Of the 2.3 million farms and ranches in the U.S., 270,000 generate 80 percent of the agricultural production and carry 60 percent of the U.S. farm debt. The issue is not only debt concentration, but farm debt interconnectedness and third-party risk.

In a recent farm tour it was interesting to visit a large dairy that purchases feed grown and harvested by a cash grain grower, and outsources replacement heifer raising to another farmer. This large dairy purchases commercial feed from a local cooperative. This dairy has a vested interest in two other dairies in the region.

The key here is that a lender has both short and long-term loan exposure to all of the entities outlined above. The interconnected third-party risk in the total exposure amounts to over \$25 million. One only has to examine the recent economic downturn and interconnected activity of banks and lending entities around the globe as a prototype of how portfolios can end up looking like a fragile house of cards that can get out of hand very quickly.

### Family Living Expenses and Outside Capital Expenditures

The recent strong agricultural economy has opened the pocketbooks concerning family living withdrawals and non-farm capital purchases. Farm record systems' living expenses hit the \$100,000 average in 2012. However, further examination finds that the top one third of living expenses is \$65,000 higher than the low one third.

To further compound the issue, non-farm capital expenditures were over \$330,000 for the high-end spenders. "Killer toys" ranging from lake houses, helicopters, airplanes, and travel trailers, to large square footage homes are being spotted throughout rural America as the poster child of the boom in agriculture.

The important point is that these expenses are becoming fixed or an entitlement that often fails to correct in an economic down cycle. The result is many of these expenses

are rolled over from operating debt into refinanced term loans, accounts payable, and large amounts of credit card debt. An earned net worth analysis is a requirement in this winter renewal season to ascertain how much cash flow is being drained by living withdrawals and luxury capital purchases. Be on “killer toy watch” since these assets usually sell at about 25 cents on a dollar in an economic downturn.

### Asset Bubble Pops

When will the land asset bubble pop? This is the \$1 trillion question. The U.S. farm balance sheet is bloated with paper wealth, which is an illiquid type of asset. Those customers who do not exhibit the discipline to build and monitor working capital reserves and profits will be destined to experience cash flow and debt servicing issues in an extended downturn. The key is for the customer not to sell the assets during the downturn but establish risk management and financial management practices that can ensure a continuing operation without the sale of the discounted long term assets.

These are just a few of the credit risks that should be placed as a high priority in loan committee discussion and loan analysis this winter. Being proactive by having corrective measures in place can be a strong step toward building a sound portfolio and strong long-term relationships with your customers.

### Lender Tip: 4-H and FFA Involvement

Many forward-thinking lending institutions are making a concerted effort to invite 4-H and FFA students to educational venues. Recently the *Economist* magazine indicated that one of the reasons for American agriculture’s leadership globally is the integration of technology into 4-H programs as a way to get innovative thinking to the adults in agriculture through their children.

**Global Economics**

Much has transformed from a global perspective since my last article. Europe's economy and political scene has stabilized with the reelection of Angela Merkel, Chancellor of Germany. This was a critical election result for the continuation of the euro and the combined European Union. While economies are sluggish, some lead economic indicators, such as the purchasing manager index (PMI), would suggest that this region of the world may be pulling out of a recession.

Latest data from China finds a 7.8 percent GDP growth rate, well beneath the booming growth rates in recent years, but still above a sluggish level. Warnings by the Chinese leaders concerning a political stalemate in Washington, D.C. and its impact on interest rates and economic growth should be heeded. It is quite clear that the U.S. economy is becoming much more globally interconnected. China in particular is gaining economic status worldwide due to the indecision by U.S. political leadership.

Moving to the other emerging nations, Brazil has increased interest rates for the fifth time this year to fight inflation. India's economy is struggling, and of course the Russian economy is very dependent on energy. In summary, emerging nations' economies appear to be moderating, which may eventually link to slower growth in the agriculture and rural sectors of the U.S.

**Domestic Economics: Government Shutdown/Dashboard Shutdown**

One of the unfavorable outcomes of the government shutdown is lack of access to economic data. Even though the government has reopened, the data trends covered in Dave's GPS will have minimal value because the timing and the influences of Washington, D.C. on the economy. Thus, this section will discuss some of the qualitative perspectives being observed in the domestic economy.

First, the government shutdown is placing many businesses and consumers into mental bankruptcy. That is, uncertainty and lack of direction by our leaders has resulted in business decisions being postponed or canceled and employment expansion being deferred or eliminated. Some economists estimate that the government shutdown could result in 1/3 to 1 percent off the fourth quarter GDP growth rate.

On the consumer side, sluggish employment growth and wage stagnation is resulting in sluggish retail sales. The new healthcare provisions being instituted are not fully understood, which has both businesses and households on high alert, foregoing spending and investment decisions.

Both core and headline inflation are benign because of the slow velocity of money. Velocity is the number of times money is turned over in the economy. Households are deleveraging financially and businesses are holding cash reserves because of the political and regulatory risk. Despite the Federal Reserve continuing to stimulate the

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money supply, which appears likely to continue well into 2014, inflation will remain under control until the velocity of money increases.

Another major change in the domestic economy will be new leadership at the Federal Reserve. Dr. Janet Yellen will most likely be confirmed in January as the new Chair of the Federal Reserve Board, replacing Dr. Ben Bernanke. Dr. Yellen is a very thorough economist who actually anticipated the housing bubble issue much before it occurred. Most likely, she will continue a stance toward stimulus to avert possible deflation or recession.

Of course, the deal in Washington is only temporary, lasting until early next year. Radio and TV talk shows will be fully slated with politicians presenting their views. The public is becoming mentally bankrupt with a strong desire for some direction and leadership from all parties and leaders, particularly in Washington, D.C.

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**Lender and Business Dashboard Economic Indicators** (for the months of August/September)

\*Most recent releases are listed below. Many September indicators are delayed due to the government shutdown.

<u>Indicator</u>	<u>Current</u>	<u>Green</u>	<u>Yellow</u>	<u>Red</u>
Leading Economic Index - LEI	96.6 (Aug)	✓		
LEI Diffusion Index	85% (Aug)	✓		
Purchasing Manager Index - PMI	56.2 (Sep)	✓		
Housing Starts (millions)	0.891 (Aug)			✓
Factory Capacity Utilization	78.3% (Sep)		✓	
Unemployment Rate	7.2% (Sep)		✓	
Core Inflation	1.8% (Aug)	✓		
Headline Inflation	1.5% (Aug)	✓		
Oil Price (\$/barrel)	\$105.61 (Sep)			✓
Yield Curve	2.60 (Sep)	✓		

**Lender and Business Dashboard Economic Indicator Benchmarks**

<u>Indicator</u>	<u>Green</u>	<u>Yellow</u>	<u>Red</u>
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 <sup>1</sup>	>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 <sup>2</sup>	0%-4%	4%-5%	>5% or <0%
Oil Price <sup>3</sup> (\$/barrel)	<\$50	\$50-\$100	>\$100
Yield Curve <sup>4</sup>	Steep	Flattening	Inverted

<sup>1</sup>Ten indicators make up the LEI - measures % that are increasing; <sup>2</sup>Includes food & energy;

<sup>3</sup>Consumer's perspective; <sup>4</sup>3-Month Treasury Bill rate to 10-Year Bond rate