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Serious Questions for Serious Times

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This has certainly been an interesting summer as I have been traveling extensively conducting lending schools and seminars throughout North America. As the hot sun scorched much of the country and the crops and livestock have become stressed, the weather has certainly given the agricultural landscape a serious gut check. Many of you as ag lenders have told me stories of the stresses on your customers as these conditions and the economic slowdown progresses worldwide. The economic turmoil has been spotty, similar to a story from the Midwest. A livestock farmer indicated his hogs and cattle were dying of heat stress while his neighbor with irrigated corn was considering purchasing a new tractor and combine. Welcome to the world of economic inequality, circa 2012.

A banker at the Graduate School of Banking at Colorado asked me a good question. What questions should lenders be asking their borrowers, and what procedures should lenders be conducting given these economic and weather uncertainties that create a surprise around every corner? Here are some thoughts concerning your individual customer discussions and management of your agricultural portfolio.

First, it is important to stress communication, which is a critical trait of a winning agricultural lender-producer team. When times are difficult, it is easy to simply put off or ignore the financial changes taking place in a business. Anyone with a 401(k) knows the feeling we got when the equity markets corrected in recent years. We just did not want to open the statements! However, communications amongst producers, lenders, and various parties and alliances can be the first line of defense in developing action plans and adjustments in business strategy.

Periodically check the level of profit or losses given possible weather and economic scenarios. A livestock producer told me that he has the potential to erode $1 million of equity off the balance sheet over the next 18 months if certain economic and weather scenarios play out. A lender who is working side-by-side with this customer could provide a perception of stability in this economic whitewater, which can result in customer loyalty for a lifetime. A periodic check-up using variance analysis to compare projections to actual results on the cash flow and income statements can be a tool to navigate through the tough economic and financial waters.

Next, lenders can add value by going through the various components of the risk management plan. What are crop insurance coverages? Are there margin calls, and what are the financial resources needed internally or externally to meet these obligations? Are there inventory or crop resources in place to meet contractual agreements? As a lender, your role as a facilitator and advisor can be an invaluable resource to the customer in difficulty.

Some customers are liquidating livestock or other assets as a strategy to cover losses or avoid purchasing expensive inputs to feed livestock. Before action, a lender can be a valuable resource to assist in assessing the deferred tax liabilities on the sale of the assets. Often the sale of current assets, like crops or livestock, are taxed as ordinary income, which can result in tremendous tax liabilities, reducing cash flow in the year of the sale, or the next year when taxes are paid.

The lender can play a role in short and long run planning. The major question to ask customers is, "What are the short and long-term goals for you, your business partners, and family?" This provides an objective format to keep customers out of emotional decision-making. Make sure the goals are written out and maintained in the file to be used as a guide in navigating current and future economic and weather difficulties.

Next, analyze the possibility of a back-to-back weather situation, whether it is drought or too much rain. Forward thinking has big implications on the design of risk management plans, crop insurance, capital expenditures, overall growth plans, and in case of an exit plan.

Lenders can prompt their customers to examine year-end tax strategies. One of the big uncertainties is possible elimination of the Bush tax cuts and the new health care plan which can have some serious implications on major decisions in the farm and ranch business. Scenario planning and objective observation by both the producer and lender can be critical not only for the remainder of this year, but 2013 and beyond as well.

Finally, as lenders, use this opportunity for face-to-face contact with customers. This can be critical to deepen the relationship with customers, some who are facing economic whitewater, while others are experiencing smooth sailing ahead. Remember that it is often not the bad times that get businesses in trouble; it is the good times that lack proper proactive planning.

Lender Tip

In my summer travels, three producers and their sons and daughters shared with me that they were upset with their current lender because the lender would not take time to go over their financial statements with them and share financial and management benchmarks to assess how they were doing. The bottom line is that they were considering leaving their current lender because they felt their lender's financial acumen needed to be much higher. Lenders, more of your producers are expecting this analysis as a value added service.

Global Economics

Three overriding themes are impacting the outlook of the global and domestic economies. First, the European Union and the euro zone are impacting the economic health of businesses and families. Currently, 12 of the 17 euro zone countries are in recession, with Germany and France barely maintaining positive economic growth. The struggle in Europe will continue to play out the remainder of this year and into next year, and will have immense political and economic implications on the rest of the world. Angela Merkel, the Chancellor of Germany, is attempting to keep the euro zone together; however, she is losing important political capital given her reelection bid next year. Economic experts indicate that there is a 35 percent probability that the euro zone will break up, and nearly 100 percent chance that Greece and Spain may be asked to leave the euro zone. The result could be a strengthening of the U.S. dollar, and revaluation of currencies worldwide. The rise of a currency like the Chinese yuan will be discussed as a currency taking the euro's place and competing against the dollar.

This leads to a second front in the global economic storm clouds. China's largest trading partner is the euro zone, which is 26 percent of the world economy. China is the second largest economy in the world. A slowdown is occurring in China's GDP, which is currently 7.4 percent, compared to recent years' 10.8 percent growth rate. The United States' slowing economy has little assurance of increased consumption of Chinese goods, which leads the Chinese leaders to encourage their citizens to consider consuming more products. With a savings rate of nearly 50 percent in China, this will be a difficult transition. The emerging BRICS nations, including Brazil, Russia, India, China, and South Africa, are observing a slowdown in their economies. This translates to a decrease in demand for commodities overall, which was well in progress until the major drought in the U.S., Russia, and India provided a spike in corn and soybean prices.

Domestic Economics

The final front is here in the United States. The potential of the fiscal cliff, i.e. tax increases, healthcare uncertainties, and regulatory changes, along with a slowdown of economic growth through lack of consumer and investment spending are storm clouds for the fall elections and beyond. Some economists estimate the combination of these factors could reduce economic growth by 2 percent to 3 percent, possibly placing the U.S. into a recession. The silver lining in the dark storm cloud is housing, which appears to be making a slow recovery and U.S. factories, which are near capacity.

The leading economic indicators projecting the health of the U.S. economy are showing mixed signals. The LEI was down four tenths of one percent in June, but then bounced back strong for July. The LEI Diffusion followed a similar path, and is now at 75 percent. The purchasing manager index (PMI), which has been above 50 for the last 24 months, has been below 50 the last 2 months, showing signs of contracting growth. The PMI indices in the euro sector and China have also been below 50 in recent months, which is evidence of a slowing global economy as well.

Oil prices have increased as a result of tensions in the Middle East. A ten dollar per barrel increase in oil price represents a $0.25 increase in gasoline price at the pump and a quarter percent off GDP growth. Watch this variable between now and elections.

U.S factory capacity utilization remains very strong at 79.3 percent, which is near full utilization. The last time the U.S. factory capacity utilization was at full utilization, or 80 percent, was in early 2008.

Core and headline inflation are within the Federal Reserve's benchmarks, suggesting very little chance of interest rate hikes. Headline inflation year over year should rise in the next reporting period due to increases in fuel and food prices. As a side note, with 47 percent of the world's population living on less than a dollar per day, increased food prices caused by this summer's drought will impact these households.

The reported unemployment rate is now 8.3 percent, with U-1 to U-6 unemployment at 15.0 percent. Expect unemployment to have a prominent position in the political debates this fall. Many companies are reluctant to hire additional workers with the uncertainty of regulations, taxes, and health care. Another component contributing to high unemployment is once people are out of the workforce for 12 months or more, they become less employable as job skills decline.

Housing starts are slowly recovering. At last report, annual housing starts were 746,000, far below the ideal metric of 1.1 million annually, but showing some improvement over previous periods. The U.S. economy is in a slow growth mode with second quarter GDP at 1.5 percent. Any positive or negative change in GDP in the next six months may predicate Federal Reserve action on additional economic stimulus.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	95.8	✓		
LEI Diffusion Index	75%	✓		
Purchasing Manager Index - PMI	49.8		✓	
Housing Starts (millions)	0.746			✓
Factory Capacity Utilization	79.3%		✓	
Unemployment Rate	8.3%			✓
Core Inflation	2.1%		✓	
Headline Inflation	1.4%	✓		
Oil Price ($/barrel)	$102.94			✓
Yield Curve	1.37		✓	

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