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2/27/15

<u>Taking an Economic Punch</u>

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In my travels on the speaking circuit, many questions are being raised concerning characteristics of producers who will be able to take an economic punch. Former heavyweight champion Mike Tyson once said, "Everyone has a plan until they get punched in the mouth." While I'm not a big fan of Tyson, he does have a point, and plans will need to be adjusted. What are the characteristics of customers who will be able to withstand the down cycle and meet payments and risk criteria established by your lending institution and regulatory oversight?

One of the first factors to examine is historical profitability. If a grain producer has been generating marginal or negative profits the past several years during the commodity super cycle, this will be a customer to de-market. When examining profits, it is advisable to use higher quality financial information not just tax records. Whenever possible, conduct a simple accrual analysis adjusting cash records for inventory, receivables, crops growing in the field, and prepaid expenses along with accounts payable and accrued expenses. Accrual analysis improves the quality of the financials and can help achieve a more accurate assessment.

Did your customers have the discipline to build working capital and liquidity reserves during the positive side of the economic cycle? At risk will be the go-go alpha dog and alpha pup producers that have grown full steam ahead. It is interesting that these producers who are specialized with high growth were a quick way to build your loan portfolio. Now in the "hunker down" part of the cycle, being diversified and having modest growth expectations will be the mode. Those producers who build cash reserves and establish marketing plans on inventory to be sold will be able to take the economic punch.

In the "hunker down" strategy, calculate the burn rate on working capital. That is, if the customer exhibits negative margin, divide that margin into working capital to determine the burn rate in years. Even if the customer does not demonstrate a negative margin, divide annual debt service payments into working capital. Less than 2.5 years, while not critical, could put the producer in a risky position, while above 5.0 years is a strong indicator that shows a higher probability of withstanding a "haymaker" economic event.

When taking an economic punch, it will be critical that producers reduce or moderate family living withdrawals or dividends. In today's economic environment, it is difficult to estimate a family living cost for the total portfolio. In recent years a variation of $50,000 to $80,000 has been seen from the high family living withdrawals to the low family living withdrawals. The biggest competitors for cash flow and timely debt payments are expectations on family living withdrawals. Along with family living withdrawals, examine the balance sheet for excess nonfarm capital investments, i.e. killer toys. Lake houses, excessive expenditures on hunting trips or vacations, while affordable in the strong part of the economic cycle, are now competitors for the business' success. The agriculture industry is not alone in excesses, as it occurs in any business that experiencing strong economic times. One only has to watch "American Greed" on CNBC to see how expectations can get out of hand very quickly. Be careful of the customers that commingle business and personal expenditures or utilize operating lines of credit or credit cards to finance excesses in personal lifestyle.

What about millennial young farmers who are 18 to 34 years of age and have experienced only favorable economic times? I often hear producers that have been in business for a number years say that they made more money in 2007 to 2012 than in the previous 30 years. In this era, many young farmers and ranchers started at the right time, and thus they were able to garnish profits. In a very quick overview of the millennial generation, I find 25 percent of the young producers will be gone in a New York minute seeking fortunes and other endeavors; 25 percent will be borderline, and 50 percent will "hunker down" and be the leaders in agriculture from 2020 to 2040. Unfortunately, this will be disruptive to farm family businesses and you will see an increase in divorce among young farmers and older farmers. Many will quickly become disinterested because breaking even is not a lot of fun.

The younger generation that will "hunker down" will quickly adjust their lifestyle with agreement of spouses and business partners. Second, they will utilize education and lifelong learning opportunities along with a team of advisors to improve performance. They will be open to suggestions and work side-by-side with their lenders to seek alternatives. Similar to the 1980s farm crisis, these individuals and businesses will be lending institutions' loyal customers, so making an investment in the ones that will survive will be critical.

Finally, taking an economic punch will require hard choices such as shedding marginal assets like unproductive land, underutilized machinery, and unproductive people. These economic times in the cycle will require timely action, crucial decisions, and very close monitoring. As a producer who survived the 1980s indicated, honing his financial management skills during the downturn made his business stronger in the decades ahead. The same circumstances will likely happen in this cycle as well.

Lender Tip: Sweat the Small Stuff

There was a book that was very popular few years ago entitled, *Don't Sweat the Small Stuff*. In contrast, a lady on a producer panel I was moderating in Iowa said, "Do sweat the small stuff!" Success is not one magic silver bullet, but it often involves doing 100 little things each 1 percent better!

Global Economics

The world economy is experiencing tailwinds and headwinds. The European central bank has now implemented economic stimulus very similar to the U.S. Federal Reserve stimulus. The European central bank is starting on a 21-month series of bond buying of approximately $60 billion per month. In comparison to the United States central bank, the total stimulus, if carried out, will be approximately $1 trillion compared to $4 trillion in the U.S. The implication to the United States is a stronger dollar, which benefits consumers, but hinders producers, manufacturing, and to some extent the service sector that exports products overseas.

China is definitely facing economic headwinds or slowdown. Imports were recently down 20 percent. This has been noticed by agriculture producers of dairy, grain, and cotton that are exported globally. Some individuals indicate that the 7.4 percent GDP growth rate in China is too optimistic and that 5 percent to 6 percent GDP growth rate is a more accurate number. China's slowdown is stretching into other parts of Asia despite economic stimulus by Japan. A stronger dollar and slowing economies in the Asian and European regions are definite headwinds for businesses in agriculture and rural America that are dependent on exports.

Domestic Economics

The U.S. economy was growing at a clip of 2.2 percent last quarter and 2.4 percent year-over-year. Tailwinds to the economy are the LEI and PMI, with the LEI still positive although the diffusion percentage has fallen slightly, and the PMI above 50, which is indicative of a strong economy most likely through mid-summer. These leading indicators of the direction of the economy have been bolstered by lower oil prices, directly impacting fuel and related products. Keeping a close eye on short and long run oil prices will be critical, particularly if they fall into the $30 per barrel range. In my travels I have noticed layoffs in the oil patch, and lower wages are filtering through the regional economies that are heavily invested in the energy sector.

Manufacturing, while at near robust levels registering at capacity in the high 70s, is now experiencing inventory buildup due to the strong dollar, slowing demand abroad, and the West Coast port issues. Some estimate that the port issues have cost $2 billion per day to agriculture and manufacturing sectors.

Housing starts are still above one million annually, with many realtors having an optimistic outlook, particularly as the spring season approaches. Unemployment is currently 5.7 percent, and 11.3 percent when the U-6 figure is calculated, showing little change from recent months. However, wages and job numbers are increasing, which is a factor the Federal Reserve examines closely when determining interest rates.

Core inflation is 1.6 percent and headline inflation is -0.1 percent, which includes food and energy. Decreases in oil prices have affected the headline rate recently. Low inflation in the U.S. and abroad is a major concern of central bankers that are attempting to use stimulus to re-inflate major economies. Despite the coastal and southern U.S. economies experiencing economic tailwinds, global, agriculture and manufacturing economies are struggling with headwinds that are moderating various sectors and industries. Monitoring these economic headwinds and tailwinds throughout the spring and summer will be essential for agriculture and rural lenders.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	121.1	✓		
LEI Diffusion Index	55%		✓	
Purchasing Manager Index - PMI	53.5	✓		
Housing Starts (millions)	1.065		✓	
Factory Capacity Utilization	79.4		✓	
Unemployment Rate	5.7%	✓		
Core Inflation	1.6	✓		
Headline Inflation	-0.1	✓		
Oil Price ($/barrel)	$43.88	✓		
Yield Curve	1.62	✓		

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