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The State of the Ag Economy

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The domestic and global economic environment provides a surprise a minute, which can lead to challenges and opportunities for your lending institution as well as the agricultural and rural customer base. Particularly for those in grain-based regions, economic times have been good based upon demand for alternative energy and economic growth in the BRIC emerging nations of Brazil, Russia, India and China. The livestock sector, mainly dairy and hog enterprises, has experienced a different story. Even the best of managers who are in the startup and growth modes are experiencing financial trauma. Moving forward in 2010 and into the next year, what is in store for those of you extending credit to agricultural and rural small businesses?

First, the United States economy is not out of the woods yet. The Leading Economic Index (LEI) and Purchasing Manager Index (PMI) both suggest economic growth; however, much of this may be related to economic stimulus both in the United States and abroad. When this stimulus is no longer available, will it result in sluggish economic growth or a possible double-dip recession, particularly hitting hard on the coastal economies? Strong headwinds to the U.S. economy's improvement are housing, manufacturing, and the large amount of sovereign debt in the U.S. and other developed countries throughout the globe.

Housing starts currently near 600,000 annually must reach one million to see an economic recovery to a segment that employs one in seven people in the U.S. Factory utilization, which is currently at 74 percent capacity, must be approximately 80 percent to be considered positive. The current levels of these two dashboard indicators, which comprise a large share of the U.S. economy, would suggest an extended period of high unemployment. Headline unemployment is near 10 percent, but including discouraged workers, the rate jumps to 16.6 percent. This has a large impact on agriculture and rural areas since 70 percent of farms are dependent on non-farm revenue.

In the upper Midwest, strong land values have been somewhat of a buffer to cash flow and working capital deficiencies. A warning however from an economist who experienced the 1980's farm economic downturn is that cash flow and earnings service debt, not sale of capital assets such as land. I am finding that some borrowers and a few lenders are becoming complacent in management of debt in agriculture by allowing inflated land values or overly optimistic growth expectations to bail out credit issues and management problems.

The agricultural and rural portfolio has a direct link to global economics. A metric to watch is China's economic growth rate. If China's gross domestic product (GDP) exceeds 8 percent, bullish grain prices and high oil prices will persist. Should China's growth abate to 3 or 4 percent and developed countries fall into a second recessionary cycle, commodity prices will suffer.

Finally, watch the trends in core inflation and unemployment as keys for movement of interest rates by the Federal Reserve. If core inflation remains below 2 percent and unemployment remains above 8 to 9 percent, do not expect much increase in interest rates.

Long term interest rates may be influenced by the level of U.S. sovereign debt. If government has difficulties financing new debt, or investors demand a risk premium, upward pressure on interest rates may result. This will initially have an impact on producers' margins, but could eventually cause devaluation of the farm and rural balance sheet.

What are the keys to moving forward in managing an agricultural portfolio?

- Good old school principles of ag lending are essential. This includes emphasis on trend analysis of balance sheets and income statements. Sensitivity analysis of income, cost, and interest rates needs to be part of the game plan in your loan narrative. How much can values decline before causing a financially stressed situation?
- Producers must have a good risk management plan to protect cash flow, working capital, profits, and overall equity. Failure of the customer to execute this plan could result in your next problem loan.
- Many ask whether credit scoring works anymore. My answer is yes, but don't check your brain at the door. Many lending problems in recent years resulted because lenders failed to know the customer and industry. Knowing your customers and the industries you lend to will be even more imperative as new lending staff comes on board and work force transition occurs.
- Finally, agriculture and rural America are laden with opportunity. There will be more opportunity for success for both customers and lenders who use sound debt and credit principles and keep an eye on domestic and global economic

trends. For those that do not, speed bumps, financial road blocks, and failure will be the destination.