DAVE'S GPS

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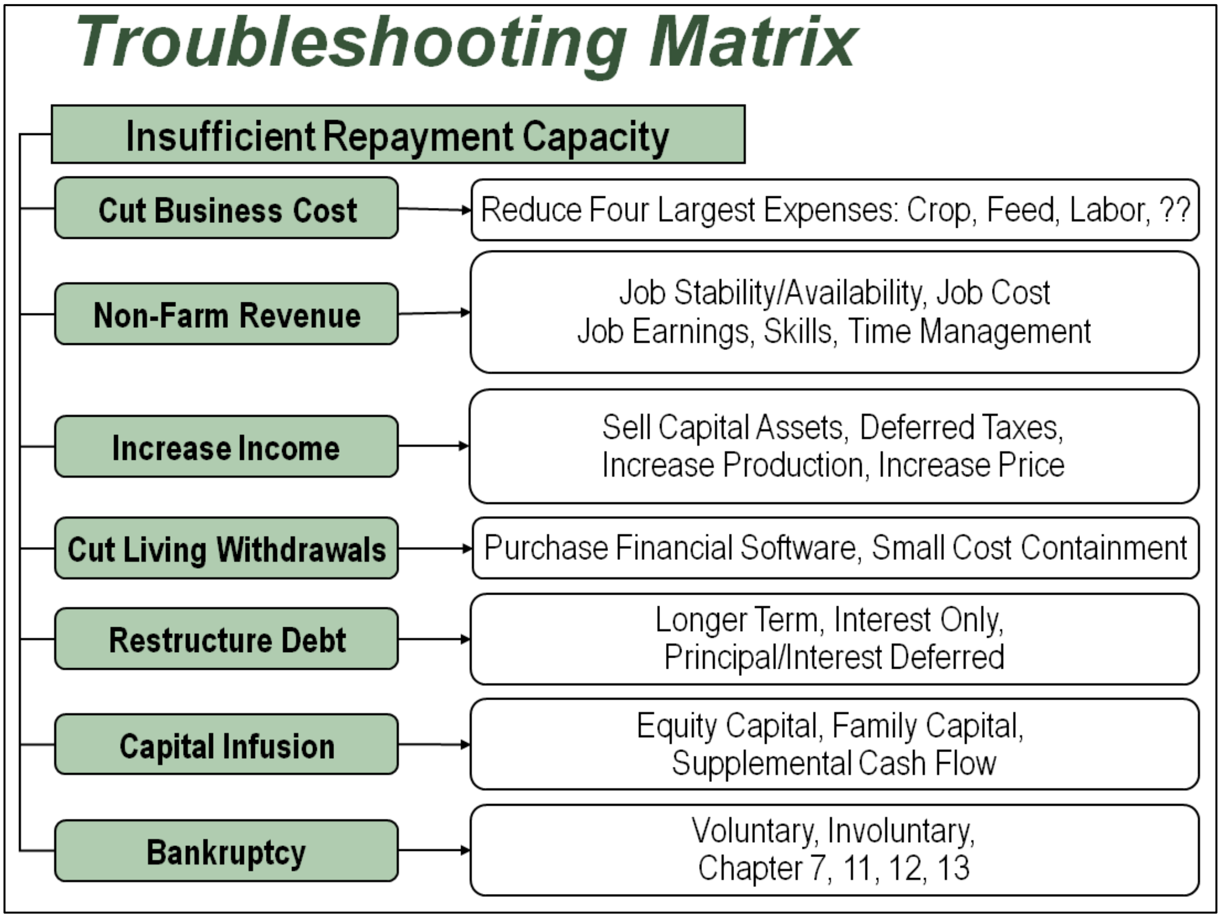
A Tool for the Times
By Dr. David M. Kohl

Many agricultural lenders are spending more time and money with producers who are struggling to generate sufficient profit and cash flow. Some producers who built up working capital during the super cycle have spent their funds filling financial performance gaps. Other producers are using their land equity as a buffer to rebalance their balance sheets by refinancing or restructuring operating losses into term debt. In each situation, critical questions must be answered, and crucial conversations must occur for both a short and long-term solution. A tool from the toolbox of the 1980s farm crisis called the "troubleshooting matrix" may be relevant given the elongated economic reset.

The genesis of this troubleshooting matrix occurred in the 1980s when I served as a third-party troubleshooter between borrowers, lenders, and agribusiness firms. Often, the borrower only sees one solution: what can my lender do to alleviate the financial stress in the form of a debt restructure? While this is an obvious strategy, the troubleshooting matrix requires other strategies to be explored before focusing on the debt restructure. In other words, if no financial improvement is made by the customer, usually another refinance request will loom in the future with the bottom line equity being reduced or encumbered by more risk. If insufficient repayment capacity is exhibited, expressed by the term debt and lease coverage ratio being less than 100 percent, what are some of the strategies to employ? The term debt and lease coverage ratio can act as a breakeven calculation to gauge the level of expenses, debt service, taxes, living expenses, or dividend withdrawals.



Cut Business Cost
When troubleshooting, a good area to start is a line by line expense analysis. This process can be very valuable to identify what can be done to reduce the top four or five largest expenses without compromising revenue or net income. The key is to cut the right costs. For example, one livestock producer cut costs by eliminating vaccinations of his animals, only to have five percent of his herd die of blackleg. In recent years, some producers have cut crop insurance only to experience bad weather situations such as hail, a hurricane, or an early winter snowstorm. The bottom line is to be judicious on cost-cutting without hindering long-term sustainability.

Non-Farm Revenue
A standby strategy from the 1980s farm crisis is to seek off-farm income. These jobs not only provide extra cash, but in many cases fringe benefits such as health insurance. Now, “gigs” or outside revenue generating is *en vogue*. This ranges from towing services, hosting weddings, and trucking companies to selling seed. However, when evaluating alternative income sources, one must consider time management and the resources employed to carry out the diversification of income streams.

Increase Income
In recent years, some producers have been lucky enough to produce their way to prosperity or profitability. However, improvement of net income usually requires an increase in production while holding costs in line and utilizing a sound marketing and risk management program. The additional production, combined with higher prices, can be a powerful tool to increase the bottom line.

Other producers are taking one or two steps backwards to go three steps forward. One producer recently sold some high-priced land to improve working capital. This strategy allowed him the ability to take cash discounts and have increased flexibility in the marketing program. When combined, the producer added $200,000 to the bottom line. Yes, there are deferred tax liability considerations with this strategy; however, the net benefit was really determined when this producer bought the same land back seven years later at 30 percent less than when it was originally sold.

Cut Living Withdrawals
Turning to expenses, the family living budget is a great tool for financial self-improvement. Recently, a lender indicated that the family living budget is just as important as the farm budget. Use budget guidance from state or national farm record systems for assistance on categories to include in a budget. Do not forget income taxes and Social Security payments as these items can be cash flow killers. Other budget busters such as healthcare and vehicle maintenance also need to be considered. I recommend budgeting for family living costs on a monthly basis as opposed to annually. Also, examining family living expenses on a daily basis can be an eye opener. Analysis of the farm record databases that include family living costs finds that daily living expenses range from $140 to $277 a day, not including income taxes and Social Security. This is quite a range and can be a good area for both borrowers and lenders to monitor.

Restructure Debt
The restructure of debt also needs to be considered as a strategy. Keep in mind that restructuring operating losses takes one or two years of operating expenses and often converts them into a 10 to 20-year burden to the business. A debt refinance or restructure may impact the next generation of operators in their business cycle.

Capital Infusion
Some producers may seek an equity/capital infusion or other sources of supplemental cash flow. If this occurs, transparency and documentation must be considered even if capital is being provided by a family member.

Bankruptcy
A final option is bankruptcy. When all other strategies are considered, some producers may opt for voluntary or involuntary bankruptcy when insufficient repayment capacity exists. This decision should not be taken lightly, as a bankruptcy filing can follow a producer for quite a while. It may, however, provide the tools needed to restructure and improve the long-term situation.

The troubleshooting matrix is most valuable when the customer documents their top two or three strategies, actions, and monitoring procedures. This process requires buy-in from the customer and also circumvents lender liability issues by providing alternatives for the turnaround of the situation. In summary, the economic reset can be challenging, but it also can be a catalyst for business improvement if a producer takes a proactive stance.

Global Economy

In my last column, it appeared that the world economy was in a synchronized slowdown. Fast-forward a few months and the Chinese and European numbers have improved, but are still not stellar.

In China, the recently released GDP finds growth in the mid-six percent range. The PMI, or Purchasing Manager Index, is hovering around 50 which indicates neither expansion nor contraction. Central bank stimulus in China with an accommodative central government policy is a means of maintaining steady growth as China works its way from a production to a consumption-based economy. Another factor stemming growth is the uncertainty surrounding trade discussions with the U.S. and other trade partners. However, the Chinese leader has traveled to numerous countries to promote infrastructure building in the Belt and Road Initiative. A recent visit to Italy by Chinese President Xi Jinping got the Europeans' attention.

While issues are complex in South America, specifically Venezuela, and other areas of the globe, it has not yet brought a case for a global recession.

Domestic Economy

It appears that the U.S. economy will establish the all-time record for economic expansion this summer. A read on the Leading Economic Index (LEI) finds evidence of this statement. The LEI has been strong since the last column and is up by 0.5 since January. The diffusion index measures the movement of the ten indicators that make up the LEI, and it is very strong at 95 percent. These indicators provide no evidence of economic storm clouds on the horizon.

The PMI, or Purchasing Manager Index, is strong at 55.3. A number above 50 is a sign of economic growth. The LEI, diffusion index, and PMI are each suggesting that U.S. economic growth should continue into the summer.

Oil prices have been higher, resulting in higher gasoline and diesel fuel prices. This was a result of world tensions in oil producing areas, such as Venezuela, and OPEC cutting production. Another factor influencing petroleum prices is the change of grade and refining process for summer-time travel.

U-3 and U-6 unemployment rates both suggest tight labor markets. Labor shortages are being observed in many industries and sectors. The conversion to technology to replace labor has maintained some competitive pressures on wage increases.

Housing starts and factory utilization are steady and remain in a comfortable range for economists analyzing these numbers.

Some inflation is being observed in the Producer Price Index (PPI) and the Consumer Price Index (CPI), but they are both still in acceptable ranges for any possible interest rate increases. The Index of Consumer Sentiment, measured by the University of Michigan, remains very strong in the mid-90s.

The next column should be ushering in the record-breaking U.S. economic expansion. See you then!

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	111.9	✓		
LEI Diffusion Index	95%	✓		
Purchasing Manager Index - PMI	55.3	✓		
Housing Starts (millions)	1.139		✓	
Factory Capacity Utilization	78.8		✓	
Unemployment Rate	3.8%	✓		
Core Inflation	2.0%		✓	
Headline Inflation	1.9%	✓		
Oil Price ($/barrel)	$66.38		✓	
Yield Curve	0.01		✓	

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	<6%	6%-8%	>8%
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