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2/28/2022

Ag Lending in the 2022 Marketplace

By Dr. David M. Kohl

Agricultural lending in the 2022 marketplace will be a tall order with the likelihood of margin compression and less government support for agriculture producers. Loan portfolios in the agriculture sector are very strong, buoyed by high prices, lower pre-inflation input costs, and generous government checks. Now, the tough part of the economic cycle lies before us. The future will require intensity and proactive actions to maintain order with customers and portfolio financials.

Focus on the financials

What are the key areas on the financial statements to focus on?

In the last three to five years, what percentage of net earnings were a result of government checks? You can use the "stoplight assessment" to benchmark the portfolio:

- Green light - Less than 25 percent
- Yellow light or caution - 25 to 50 percent
- Red light - Greater than 50 percent

If more than 50 percent of net income resulted from government checks, what will be the producer's strategy to adjust moving forward? Next in the analysis, determine if government payments are recurring or nonrecurring. Remember, the most recent government checks came with little or no cost of production. These windfall payments will require some crucial conversations.

Profitability analysis

Now is the time to dig deeper into how profits in recent years were generated. As an analysis of FINBIN data from the University of Minnesota would suggest, a large percentage of net income in 2020 was derived from government payments. For crop farms, 62 percent of net farm income resulted from a government check. Analysis of dairy farms finds that 72 percent of net farm income was from government support payments. Over 100 percent of net farm income for the hog and beef farms in the analysis were a result of government payments. Were profits generated by speculative marketing practices or by following a systematic marketing and risk management program? Included in the analysis would be the impact weather has on the business

plan, production, marketing, finance, and risk management with a focus on operational efficiency.

Profit distribution and working capital

When one examines the direction of land values in 2021, it appears that stimulus checks were invested into farm and ranch land. Did this investment deplete working capital and cash? What were the additional debt service commitments, and will there be any recurring net income to meet those debt service and overhead cost obligations? Careful attention needs to be placed on working capital levels. Did the profits flow over to the balance sheet to build the necessary resources? In a potential recession, compressed, or negative margin environment, a burn rate on working capital may need to be conducted. For example, if working capital is $500,000 and losses are $200,000, then the working capital burn rate is 2.5 years. Working capital is the second line of defense when adversity occurs in profits and cash flow. Maintaining enough reserves to have a burn rate of at least two years would be suggested, but four years or more would be ideal. Any financial crisis, whether it is agriculture, housing, manufacturing, or high-tech firms, finds the choke point often centers on financial liquidity. Negative margins and high rates of inflation will magnify any deficiencies.

Household budgets

Lending in the agricultural marketplace will require a close examination of living costs. Remember, if there are losses or inadequate profits, living costs will often be withdrawn from lines of credit. If this occurs over multiple years, the solution is often a term out or refinance of the line of credit which results in a loss of equity. Family living costs can be expected to increase five to ten percent as a result of inflation. A global analysis of the business may find multiple families living out of the business. The question becomes, is this sustainable in a compressed margin environment over multiple years?

Net worth analysis

Whether it is an individual customer or a total portfolio, a candid analysis of net worth gains needs to be conducted. Break this analysis into three profiles. The strongest segment would have 75 percent of net worth gains over a three-to-five-year period resulting from retained earnings and 25 percent as a result of capital appreciation. The middle of the road group would have 50 percent earned net worth and 50 percent appreciated net worth. The third segment would have 25 percent of net worth gains from retained earnings and 75 percent of net worth gains from appreciation. This net worth analysis is vital for your customer’s growth and preservation of wealth.

Business management practices

Lending in the agricultural marketplace in this margin compressed era will require a customer to step up their business acumen. The ability to develop a projected cash flow and monitor it line by line at least quarterly will be a requirement.

The same could be said for the balance sheet and respective schedules that provide further documentation of assets and liabilities. For many of you reading this column, a Schedule F tax statement is used for the income statement. In an inflationary

environment, relying solely on the cash basis statement rather than an accrual adjusted statement can quickly put you behind the curve for potential risk.

If you receive none of the above from your customers you now have become a five “C’s” lender: collateral, collateral, collateral, collateral, and collateral. If this is the case, you will need producers to have a debt to asset ratio under 25 percent to minimize potential risk and compensate for their lack of financial acumen. You also need to inform your customers with a low business IQ that the loan collateral, often land, will be required and could be taken if problems occur over an extended period of time.

In conclusion, lending in the marketplace in 2022 will require the producer to step up their finance, marketing, and operational efficiencies. This will proactively prepare them to navigate the economic white waters that potentially lie ahead.

False Prosperity

The Spring of 2022 is now revealing the unintended consequences of government stimulus and accommodative central bank action in recent years. The title of this section says it all. Whether it is the U.S. or around the globe, the rise of asset values such as real estate and stocks has created a situation with tremendous gains in paper wealth. In many regions, farmland has been 'hotter than a pepper sprout' with values becoming more distant from economic returns based on projected incomes, including green payments and net returns through flipping. The rise in asset values leads to the notion of the wealth effect, which is the theory that an increase in perceived wealth is accompanied by changes in spending habits. For example, for every one dollar increase in stock valuation, consumer spending may increase by as much as 3.8 cents. Every one dollar increase in real estate values equates to $0.08 to $0.10 more in consumer spending. This paper wealth has fueled inflation with $1.23 of money chasing $0.93 of goods based on an analysis in a *Wall Street Journal* opinion section article.

What is concerning is that asset values are starting to correct, first in the stock and equity markets and cryptocurrency. Will this correction ripple to the housing, real estate, and farmland markets? Future interest rate increases and geopolitical military action along with consumer confidence in major economies in the United States, Europe, Japan, and China could be telling in the future months. Could the roller coaster of paper prosperity, which reached the apex in 2021, now start a downward direction which could hamper economic growth? A recent article in *The Economist* magazine focused on equity market corrections, which is a must read for those of you that follow this column or listen to my seminars and speeches.

Now, let's move to the leading and lagging economic indicators.

The Leading Economic Index (LEI)

After several months of increases, the Leading Economic Index (LEI) is now down three-tenths of one percent, and the diffusion index has declined to 60. If the LEI continues to decline in this manner, by the next column it could be foretelling a possible recession later this year. Of course, it is a dynamic economic environment with many moving parts; however, this is the first crack in the economic armor.

Oil

Oil prices have reached $100 per barrel and could go to $120 per barrel very quickly. This is a determining factor for consumer spending. However, the impact will be felt in the agriculture sector where up to 80 percent of the expenditures are linked to oil. It will be interesting to see whether the disincentives to invest in fossil fuels versus green energy in recent years will be lifted.

Purchasing Manager Index (PMI)

The Purchasing Manager Index (PMI) is still north of 50 in the United States, which is indicative of a growing economy. However, one must observe this metric in China and Europe where recent indicators are near 50, suggesting dimmer prospects for economic growth.

Unemployment
Most sectors are experiencing a shortage of workers. My interaction with large companies finds automation and simplification of the work processes are well underway to reduce the emphasis on labor. However, the issue of labor shortages and wage increases is starting to strain small businesses and ripple over to agriculture business margins, many of whom are not in the position to automate.

Housing starts
Housing starts continue to remain strong above 1.5 million units annually. Demographic shifts from high cost of living areas in the United States to lower cost of living areas are creating regional booms. At a recent seminar in Nashville, participants were discussing the influx of New Yorkers, New Jerseyans, and Californians with cash from the sale of high-priced properties in those states. This has brought challenges for infrastructure and local, cultural habits.

Factory utilization
Factory utilization remains quite strong despite the supply chain challenges and inflation pressures. Over the next few years, the movement of supply chains back to North America or in the U.S. could impact this number.

Index of Consumer Sentiment
The Index of Consumer Sentiment is just plain ugly, in the range of the Great Recession and other downturns ranging all the way back to the 1970s. With 70 percent of the U.S. economy dependent on consumer spending and services, any threat to the wealth effect, an increase in interest rates, or a slowdown in the economy could quickly lead to a recession.

Inflation
The “I” word, or inflation, is alive and well and appears not to be in a position to dissipate anytime soon. Headline inflation is 7.5 percent, followed by core inflation at 6 percent. The Producer Price Index (PPI) is at 9.7 percent, increasing over the last 12 months. The inflation rates have been high for a year, and it appears they may be there for another year.

Oil price increase dynamics
When oil prices increase $10 per barrel, core inflation will increase 0.035%, headline inflation by 0.2% and the GDP will fall by 0.1%.

Get ready for a walk on the wild side for equity markets and the economy in general!

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	119.6		✓	
LEI Diffusion Index	60%		✓	
Purchasing Manager Index - PMI	57.6	✓		
Housing Starts (millions)	1.638	✓		
Factory Capacity Utilization	77.6		✓	
Unemployment Rate	4.0%	✓		
Core Inflation	6.0%			✓
Headline Inflation	7.5%			✓
Oil Price ($/barrel)	$90.14		✓	
Yield Curve	1.60		✓	

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