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Credit Analysis Killers

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During the great commodity super cycle of 2008 to 2013, a prevailing mindset in agricultural lending was to grow the portfolio. Because of the economic environment, producers were flush with cash, and assets, like land, were appreciating. Credit scoring limits were extended, and documentation reviews were less rigorous due to the intense competition. Now, in the fourth year of the economic reset, profits and cash flow are weakening, burn rates are being applied to any remaining working capital, and appreciated net worth in land is flattening or declining in many regions of the country. As the billionaire Warren Buffet once said, “When the tide goes out, you find out who’s naked.” And if a customer is exposed financially, a lender experienced with a cyclical downturn can be extremely useful. Unfortunately, much of that experience in agricultural lending is transitioning out of the industry and into retirement, or other endeavors. For these reasons, let’s examine some of today’s most pertinent “killers” of credit analysis.

Schedule F Lending

Over the years, the mantra of some lenders has been “All I need are three years of tax records and a balance sheet.” Well, Schedule F tax records can be useful in documenting revenue and expenses, but one can be quickly be fooled. In actuality, Schedule F analysis can often disguise credit issues for up to two years. The absence of accrual adjustments in areas such as accounts payable and receivables, changes in inventory, drawdowns in grain and livestock, crops in the field, and prepaid expenses, can be disastrous for true business profitability.

In my winter travels, lenders and producers spoke about growing, unpaid bills like feed, or the veterinarian. Others talked about selling stored grain at a low price just to meet cash flow demand, which of course, liquidates a valuable asset. Each of these instances creates credit risk and exposure. Further, if the account is large, the credit risk is only magnified. There may have been a time when lenders did not investigate this type of potential exposure, but overlooking such details today could place both the institution as well as the customer in jeopardy.

Operating Lines

The short-term health of any business operation depends on the status of operating lines of credit. In recent lender programs, some indicated that up to 50 percent of their customers are unable to pay down lines of credit, and have requested refinancing of the loan. In some of these cases, there was abuse of the credit line. Specifically, operating loans were used to make down payments on land, equipment purchases, or to obtain breeding livestock. Others have abused lines of credit for family living, and yes, even for the “killer toy.” No matter the reason, neglecting to monitor these lines of credit can quickly place both the credit and the customer in a dire situation.

Cookie-cutter Lending

Credit scoring in agriculture is a great tool; however, it is not a replacement for due diligence. In other words, a little common sense, and a bit of interpretation of the score can prevent future problems. In addition, benchmarks and ratios, the use of which I strongly support, are only guidelines. Factors like the stage of the economic cycle, the position of the business, and even the business enterprise, can alter interpretations. I have heard objections that use of financial ratios are not valid anymore. The green, yellow, and red lights that I place on indicators like coverage ratio, working capital, equity, profits, financial efficiency, oil, inflation, unemployment, and others will vary just as they did during more profitable times. But remember that these ratios are like credit scoring; a good tool only if used properly. Too much reliance on credit scoring can result in lazy practices.

Outside the Numbers

Depending on numbers alone is definitely a credit analysis “killer.” It is important to remember that problems often start outside the numbers. In fact, problems may take years to show up in the numbers, which is some cases, may be too late for correction. For example, one of the top reasons for business bankruptcy is medical expenses, followed by divorce. Lenders that are networked into their communities, and who spend time on the ground with their customers greatly improve their chances of negating potential problems.

Relationship Officer vs. Credit Analyst

The great commodity super cycle made it easy to segment the roles of the relationship officers and the credit analysts. The relationship officer sought out customers and accounts while the credit analyst determined whether they were viable. Today, however, the absence of either of these roles can be another credit “killer.” If either the officer or the analyst leaves, institutional memory on that account or customer is lost. Furthermore, any account that is under duress often requires a team approach and is largely based on the numbers. While this objective approach is necessary, it may neglect the human side of the equation. Today’s stage of the credit cycle does require a team approach, but in the sense that numbers and relationship building are both required to resolve issues and maintain goodwill.

Family Living Expense

Another “killer” in credit analysis is using one number for all customers. Family living expenses are a great example. First, this number will change depending on each customer and family. Second, this number will change for all customers over time. In recent years there has been a wide disparity in living costs and finding an appropriate, representative average is almost impossible. In fact, “average” may not exist anymore in this category. In general, there are two categories for family living: high maintenance, often $100,000 or above; and lower maintenance, generally in the $40-$70,000 range. One point to consider is that family living expense is an after-tax withdrawal, which makes a huge difference to the bottom line. One common mistake in credit analysis is overlooking personal and family credit. Personal credit cards of the producer, spouse, and other immediate family members need to be analyzed and monitored. An age-tested strategy is to request a monthly family living estimate and add 25 percent. It may also be advisable to conduct an earned net worth analysis as this will often catch profit drains and equity changes being diverted to support lifestyle.

Lender Liability

In today’s economic environment, lender liability cases should be expected. Yes, customers depend on lenders to provide solutions and alternatives. However, when detailing options, lay them out, and then, let the customer choose. Even if a plan is required by the lender, it is still the customer’s responsibility to develop it. For example, a good marketing plan is vital to a profitable business. While both the lender and producer have a vested interest in the business’ success, the lender can only make suggestions. Exercise caution in all forms of communication including texts and emails. Financial stress can be emotional and if tempers flare, make sure there are no grounds for legal action.

Side Note

What percentage of your portfolio has been refinanced in the last two years? Surveys done at recent lender seminars show some results above 50 percent. This is likely to catch up to the customer eventually. Plus, it is worth considering whether the regulator will continue to allow it.

As the economic reset trolls on, lenders and producers alike are increasingly becoming creative and proactive to improve finances. Yet, both lenders and producers, along with numerous other people, are dependent on the overall integrity of our financial system. On the front lines, lenders must be careful, detailed, and skillful in assessing credit risk. Otherwise, recovering from an economic reset may not be agriculture’s largest future challenge.

Global Economics

Agricultural trade and exports are the lifeblood of profits and balance sheet values, specifically, in land. Approximately $1 in every $5 of net farm income is the result of global trade. Several, if not all commodities ranging from cotton to tree fruit, wheat to vegetables, poultry to pork, and even forest products are dependent on trade. Rapid capital expenditures in the poultry and dairy industries could result in profit disasters if markets in Mexico, Asia, or Europe are disrupted. Of course, this means agriculture and an agricultural lending portfolio can both be quickly impacted by political, military, or social action. Agricultural lenders need to stay apprised on policy changes concerning trade including changes to existing trade agreements like NAFTA.

History is another factor to keep in mind as one of the precursors of the 1980s economic downturn in agriculture was disruption in international markets. An increase in interest rates followed almost immediately which aligned for a prolonged economic downturn. Is this déjà vu? Well, we will just have to watch for the same possible scenarios aligning again.

Some global economies such as Europe and Asia are beginning to experience green shoots of hope and growth in their economies. The European elections as well as the resolution of issues with North Korea could foretell global economics, growth or recession. Current developed countries and emerging nations are growing modestly at best, much less than the go-go years of the super cycle.

Domestic Economics

The current administration has stated its goal for economic growth is between 3% and 4%. Is this achievable? Regulation in areas including banking and environment will be an important element. Yet, the key to growth will be the level of confidence baby boomer investors and corporate businesses have in the economy and domestic infrastructure. In reality, economic growth hinges on their ability to invest cash into productive, long-term investments. Execution of this game plan could provide the bump Mr. Trump is looking for. Otherwise, the bump could quickly turn into a thump which would likely ripple through the world economy.

The Leading Economic Index (LEI) continues to demonstrate increasing strength with a strong Diffusion Index well above 75 percent. Both are very positive indications looking forward for the U.S. economy. Oil prices are settling to a range that is good both for agriculture and the consumer. However, agricultural lenders that have portfolios dependent on supplemental cash flow from oil production should stay alert to changes.

The Purchasing Manager Index (PMI) demonstrates growth, registering in the high 50s. While factory capacity utilization is still modest at 76%, low unemployment (4.5% U-3, 8.9% U-6) suggests a strong employment sector. Core and headline inflation are 2.0% and 2.4% respectively. This suggests minimal inflation on the horizon. Consumer sentiment, a driver of the U.S. economy, finds a red-hot sector well above the mid-90s.

Even housing starts, the old staple of the domestic economy, is in the 1.2 million annual range, which is the strongest since the great recession of 2007-2008.

In summary, the U.S. economy is motoring along as a whole. The population centers on both Coasts as well as in the South are growing. The flyover states, dependent on agriculture, energy, and manufacturing, are not crashing, but rather are in a long-term readjustment after the super cycle.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	126.2 (Feb.)	✓		
LEI Diffusion Index	90% (Feb.)	✓		
Purchasing Manager Index - PMI	57.2	✓		
Housing Starts (millions)	1.215		✓	
Factory Capacity Utilization	76.1		✓	
Unemployment Rate	4.5%	✓		
Core Inflation	2.0%	✓		
Headline Inflation	2.4%	✓		
Oil Price ($/barrel)	$50.20		✓	
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