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04/26/2021

Credit Downgrade: The Sour Sixteen

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Tenured agricultural lenders have all experienced the following situation sometime in their careers. The performing, stellar credit with a solid risk rating suddenly has a hiccup. The loan relationship is now being scrutinized by the chief credit officer, loan committee, and internal review. They are recommending that the credit be downgraded, which will require more oversight, additional covenants, inspections, all sorts of additional costs, and even create possible reputational risk. In certain situations, when the credit moves into a questionable risk rating, the special assets or distressed credit team will be involved. During a recent webcast, a group of new agricultural lenders asked an interesting question, "With your decades of experience conducting training and schools in the agricultural lending field, what are some of the commonalities of credits with sudden downgrades?" The "sour sixteen," a compilation of natural and man-made events, can deteriorate a credit very quickly. Let's address this question from a proactive approach to stay in front of potential problems.

1. Economic cycles

It is interesting that before the pandemic, much of the agriculture industry had been in an extended margin crunch, which was nicknamed the "financial grinder." Profit margins were thin or slightly negative and working capital was eroding. However, equity in land was resilient, which allowed for debt restructures. Fast-forward 12 to 18 months and the same credits that were possibly being downgraded have gotten renewed vigor from higher grain prices and government stimulus checks. These windfalls have shored up profits, regenerated working capital, and resulted in improved risk ratings. Economic cycles can move a portfolio of credits in an adverse direction. It is important to point out that not all credits in the agriculture industry are adversely affected by an economic cycle and some have performed quite well due to strong management.

2. Weather and natural disasters

According to Eric Snodgrass, also known as "Eric the Weather Guy", extreme weather will be the new normal. Extreme weather events can vary by farm, county, or region. A series of adverse weather events can even result in the top one-third of managers moving very quickly to the lower third of profitability. Similar results can occur when disease outbreaks befall livestock, crops, or other segments of the agriculture industry. The initial result is the loss of working capital, followed by a reduction in equity, and

finally a downgraded credit. This is why risk management products, programs, and preventative measures are critical.

3. Fraudulent activities

The fact of life is that fraudulent activities are increasing, regardless of the credit size. Examples include livestock that may be missing during an inspection and grain that is gone when inventory is counted.

4. Third-party counterparty risk

Fraudulent activities can also filter out to other performing credits who have business arrangements or agreements with the suspect parties. Due to the interconnected nature of the agriculture industry, third-party counterparty risk comes into play with many of the “sour sixteen.” The business arrangements and informal partnerships related to downgraded credits need to be examined to determine the full impact on the loan portfolio.

5. Inventory and receivables management

Inventory and receivables management is a critical aspect in stressed credits. Inventory can quickly become outdated or not in demand. Accounts receivable concentration with collection issues can result in profit, cash flow, and financial liquidity issues.

6. Supply and marketing chain disruptions

The Achilles’ heel of many industries during the pandemic has been too much concentration in supply and marketing chains. Many were left without markets, thereby hindering profits and cash flow. The inability to garner supplies at a reasonable price has squeezed profits and resulted in credit downgrades. Moving forward, this area of risk must be a high priority.

7. Competition

Whether it is global, regional, or local, competition can creep up slowly on a customer or loan portfolio. However, sometimes it seems that it can occur overnight. This is why industry assessments and benchmarking one customer to another is a critical task in proactively analyzing credit risk.

8. The 4 P’s: Policy, people, priorities, and philosophy of the lender

Over the decades, “fair-weather” agricultural lenders and the “new kids on the block” can be a credit downgrade waiting to happen. The 4 P's could be a sudden shift in policy, people, priorities, or philosophy that can leave a customer “high and dry” for financing. Many producers have split lines of financing and a change in one or all of the 4 P's can result in a possible downgrade. If this affects working capital lines, the impact

can be immediate with subsequent downgrades.

9. Misallocation of profits

Strong economic cycles can result in many credit issues including the purchase of killer toys, an increase in family living expenses, or investments in sideline financial opportunities. These expenditures and investments are often sold at cents on the dollar and yield little to nothing for the financial statements.

10. Adversity after capital expansion

Adversity can often occur following major capital expansions. This can be a result of unexpected events such as economic cycles, adverse weather conditions, or a disease strike during the transition or expansion phase. In some cases, business owners mistakenly believe they can grow out of their problems. Unfortunately, growth often exacerbates problems.

11. 25 Percent Rule of expansion

When embarking on an expansion project or other capital expenditure plan, many customers fail to accurately estimate the required capital and time to profitability. This can result in draining working capital and ultimately equity when costs are over budget and markets fail to materialize on a timely basis. Overestimating the investment of time and money for a project by 25 percent is a proactive way to plan for potential adversity.

12. Management transition

Failing to increase business acumen to operate the business in an ever-changing environment can result in unfavorable results. The right skill sets must be transitioned in a timely manner to avoid a credit downgrade.

13. Integration of new players

The successful integration of the new players into the management team is an important part of managing a business. This could involve a family member, non-family member, or investor. Failure to plan a proactive integration of new players can result in short- and long-term cash flow issues.

14. Decline in asset values

One of the major causes of the 1980s farm crisis was the decline of asset values, specifically land. Fortunately, this has not happened recently with the exception of land in transition during the Great Recession in 2008 and 2009. Farm land values have provided much of the resilience in agricultural loan portfolios. However, if and when farm land values decline, agricultural credits can be downgraded very quickly; the effects of which can be widespread.

15. Deadly D’s

We all know the traditional deadly D's: disability, death, and divorce. They are each a major contributor to a credit downgrade. However, in recent years, many issues are being caused by drugs, depression, and a general disinterest in the business. This list is not comprehensive and needs to be on your radar screen.

16. Other

Many other issues can also contribute to increased credit risk, ranging from a black swan unexpected event to a compilation of micro adverse events happening to the business. We will leave this up to you as the reader.

The sour sixteen list needs to be discussed with the new generation of agricultural lenders. This list, along with proactive strategies and experience, is important in the ever-changing agricultural lending environment.

Domestic Economy

The oldies song "Shake, Rattle and Roll" is a good way to describe the U.S. economy moving forward. With between $3 and $4 trillion of extra savings accumulated over the past year, pent up demand, and stimulus checks, the American consumer is ready to hit the ground running as we *roll* forward. However, any new medical issues in addition to supply and marketing chain challenges could be the *rattle* and *shake* that impact spending habits. These factors will be ever present on the horizon. The next 12 months will be analogous to an economy, workforce, and social behavior pendulum, making it difficult to predict the long-term implications of the pandemic. Let's examine some of the leading and lagging indicators to provide credence for the U.S. economy to grow at an estimated six percent in 2021.

Both the Leading Economic Index (LEI) and the diffusion index over the last six to nine months would suggest strong growth. The diffusion index, which measures whether the factors comprising the LEI are trending positive or negative, is quite positive registering above 65 in recent months, and up to 100 in March.

Oil prices, which have increased over 30 percent in recent months, have started to level off. The adverse weather in Texas and the threatened cuts in oil production by OPEC and Russia will require close attention on how these events ultimately will impact the consumer and the agriculture industry.

Copper prices are a leading indicator of the U.S. and global economic growth. The price per pound of copper has nearly doubled over the past year. Is this price increase a result of China stockpiling its pantry or true demand in the worldwide manufacturing sector?

The Purchasing Manager Index (PMI) is a robust 64.7, a level not seen since the height of the recent prolonged economic expansion.

The unemployment rate has been steadily moving downward and is currently registering at 6 percent and 10.7 percent for U-3 and U-6, respectively. However, the generous unemployment benefits and stimulus payments may hinder the ability to move forward to full employment, along with the mismatch of job openings and skill sets.

Housing starts increased from 1.4 million units annually in February to 1.7 million units annually in March. Rapidly rising construction costs combined with other high input costs will put pressure on the housing sector. If interest rates stay low and millennials maintain strong demand, this segment of the economy should remain strong.

Factory utilization is quite strong, although this sector is struggling with supply chain issues ranging from electronic component availability to distribution issues such as the situation that occurred recently in the Suez Canal.

Core and headline inflation rates have increased, but are tame at 1.6 and 2.6 percent,

respectively. However, the basket of goods used to measure inflation for various sectors including agriculture and construction are measuring an inflation rate between 5 percent and 10 percent. These changes can be observed in the Producer Price Index (PPI) jumping over one full point in one month.

The Index of Consumer Sentiment, published by the University of Michigan, is bouncing back at 84.9, but is still under the 90 level that would be indicative of a confident consumer.

The stock market just keeps growing. The gains have been fueled by stimulus checks, accommodative monetary policy, and investors lacking other alternatives. The Dow Jones Industrial Average has gained more than double since its low last spring. Only time will tell how much more steam the market has!

Global Economy

The $80 to $90 trillion global economy is uneven, but overall it is going full steam ahead. It appears that China's 8.5 percent growth rate estimate has a high chance of becoming reality. Interestingly enough, India's economic growth rate is in double digits. It will remain to be seen if India’s growth can be sustained over a longer period of time.

Even Japan’s economy, mired in slow growth for decades, is projected to grow by three percent.

Moving to Europe, the growth rates for the major European economies are between 3 percent and 5 percent. One must maintain an eye on continued trade growth between Europe and China. In the long run, this could be competition for the United States and North America in general.

Over the next six months, maintain a close watch on the following items on the global radar screen.

- Climate change policy and which countries take the first steps
- Demand for on consumer goods in major economies, specifically China
- Human rights issues in North America, Europe, and China.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	111.6	✔		
LEI Diffusion Index	100%	✔		
Purchasing Manager Index - PMI	64.7	✔		
Housing Starts (millions)	1.739	✔		
Factory Capacity Utilization	74.4		✔	
Unemployment Rate	6.0%		✔	
Core Inflation	1.6%	✔		
Headline Inflation	2.6%	✔		
Oil Price ($/barrel)	$63.37		✔	
Yield Curve	1.73		✔	

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