FARMER MAC

DAVE'S GPS

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<u>Frontline Boot Camp</u>

By Dr. David M. Kohl

In agriculture, economics shifted dramatically in the past three years, presenting challenges as well as opportunities for both producers and lenders. It appears that the 2008 to 2013 agricultural economic super cycle was indeed an aberration of profitability. Now, producers and lenders alike must face a moderating agricultural economy. This means asking tough questions and committing to even more difficult actions. From my travels and discussions with lenders, producers and agribusiness owners, agriculture's frontlines seem analogous to some type of boot camp. Let's examine some of the challenging situations as well as recommendations and best actions.

<u>How far do we go?</u>

At a recent lender training program, one of the lenders presented me with an interesting situation. A couple in their mid-60s reported $2 million in land value on their most current balance sheet. The bank's internal policy dictated a maximum loan to value ratio of 70 percent. The couple had $700,000 in debt against the land, which left $700,000 in available equity or core value reserve. After deducting living expenses and taxes from the past two years, the couple presented a loss of $150,000; which of course, changes the situation. With a recurring medical issue among other high living costs, this couple was in a troubling situation regarding working capital. In addition, they had already refinanced their operating losses once and now, were requesting refinancing again. As longtime customers, the lender knew this couple had previously been profitable and were well-respected, active individuals in the community. The lender also added that this couple had no next generation onto which they would pass the business. Clearly, this business is struggling and the lender's question was, "How far do we go?"

In this case, the best approach is to stick to the numbers, at least initially. The overall reserve of $700,000 is in land equity. At this rate of loss, the couple would burn through their equity reserve in a little over 4.5 years ($700,000÷$150,000 = 4.67). Second, the lender must review the numbers with both spouses present in order to circumvent any possible miscommunications. Sticking to the numbers will present a clear illustration of the situation for everyone and most importantly, will keep emotions balanced with objectivity.

Another factor to consider is the land equity. This farm is in an area susceptible to a possible 20 percent decline in land value. If this were to occur, using the variables outlined above, the land would decline from $2 million in value to $1.6 million. According to the bank's lending policy, that reduces borrowing capacity by $320,000 for a maximum total of $1.12 million. Now, starting with the new maximum borrowing capacity of $1,120,000, subtract the existing debt of $700,000 which calculates to an excess reserve of $420,000. This allows less than three years to burn through their core equity if land values drop. Of course, this is before any capital gains or other taxes are paid on land sales. Unfortunately, this case and similar ones will be played out many times during the upcoming winter renewal season where operating losses are present with considerable land equity and a possible decline in the land market.

Large Accounts and growth-oriented producers

If you will, imagine this scenario. An agricultural lender has a customer with a large credit account of approximately $15 million that comprised a significant portion of the lending portfolio. With an appetite for growth, this customer's account expanded quickly and performed quite well during the great commodity super cycle. However, practices such as using operating money to make a down payment on land, or to purchase equipment were problematic. Clearly, this growth-oriented producer did not like dealing with rules or financials, so he hired a Chief Financial Officer (CFO) for the business. Well, over time this CFO either ignored or misunderstood the magnitude of mounting operating losses, which caused concern for the lender. When the lender approached the situation, the producer became visibly and vocally displeased, refusing to work with the lender on corrective actions. In response, the producer went directly to the lending institution's CEO to garner a deal.

While this scenario may seem extreme, it is likely to occur in many situations over the next several months. When faced with such a situation it is important to maintain a systematic approach and deal with the numbers. First, regardless if this producer deals with the lender or the CEO, institution policies remain the same. Next, the lender must conduct due diligence on the balance sheet and income statement information. Fraudulent activities are on the rise with disappearing livestock, mysterious equipment serial numbers, bushels missing from the grain bin, and marketing plans that may not be secured. In addition, when a customer does not understand the financials of the business, or the terms of a loan there is cause for concern.

The next step in the above example may be threats from the customer to leave the institution for financing with a competitor. Well, many lenders are likely to see this occur in the current stage of the economic reset. In fact, an applicable name for this action may be the "greater fool theory." According to the theory, this producer may believe that another institution will welcome his account, despite the losses. The customer may claim that a competitor is willing to re-finance operating losses from the past three years on a 20-year, interest-only note. Well, if the customer leaves, the existing lender will take a hit on the losses of the $15 million account. However, according to the theory, this lender most likely saves considerable future problems and headaches as compared to the competing lender. With the misuse of operating money and an uncooperative attitude, this customer presents significant risk, regardless of the account size. It would be interesting to know how long the competitor lending institution can support this account if losses persist. Sometimes it is better not to fight the battle and allow a customer to learn about business finances the hard way!

In cases of negative margins and mounting losses, there are ways to help the customer return to profitability, if the lender chooses that course. Requesting a one page plan of adjustments in writing is one way to start on the return road to profitability. The adjustment plan should follow the S.M.A.R.T principles, which are specific, measurable, attainable, realistic and timely. Along with a corrective plan, require monthly and quarterly financial statements. This type of monitoring allows for adjustments as needed and prevents the business from getting too far into another problematic situation. Of course, finances for any business, but especially large and complex operations, can spiral out of control quickly. If these terms are not agreeable to a customer seeking refinancing, perhaps it is better to suggest another lending option.

In our alpha-dog example, three lessons should stand out. First, a customer who is unwilling to negotiate and goes straight to the institution's CEO may also be a customer unwilling to implement important business changes. Second, a CEO or CFO that ignores, minimizes or just does not understand the business' finances will continue to be problematic. Lastly, never compromise on your credit principles. A customer that uses threats or manipulation could be trying to deceive you, or perhaps may have some character flaws that will prove them a difficult customer.

The cost-cutting challenge!

In today's economic environment, cost-cutting is a necessary part of reality. So, how does a farm cut family living costs or business costs in general? Well, over the next few years in agriculture, the most successful producers will be proactive in strategically cutting costs. This includes identifying both fixed and variable costs, along with family living costs, that have grown to be excessive, or simply can be reduced without sacrificing productivity.

Let's begin with family living costs. First, involve the entire family and develop a budget. Many times, the first question a producer asks is what should go into the family living budget. The state record systems in Nebraska, Illinois, Kansas and Kentucky along with the FINBIN data out of Minnesota all provide excellent formats for categorizing cost. Next, place family living estimates on a monthly basis, and add 25 percent. Watch for the commingling of business and personal expenses. Remember that credit card expenses and debt must be included and monitored as part of the family living budget. Especially when involving the entire family, this process may seem daunting; but in actuality, it could be an extremely valuable lesson as children will one day need to budget in their own lives.

Moving to the business costs, when possible develop cost budgets. Remember not to use Schedule F tax records for budgeting purposes. Accrual adjusted analysis identifies year-to-year changes in areas such as inventory, accounts receivable and paid expenses. Accrual accounting is the best, most accurate tool to use both for the entire business as well as the individual enterprises. In the coming year, cost reductions should continue. Specifically, items such as fertilizer, cash rents, equipment and hopefully, living costs should each decrease providing some relief for stressed margins.

On the revenue side, the execution of a marketing and risk management plan will be the differentiator between profit and loss. Will the customer take the time to plan and strategize both short term as well as long term? After the strategy is set, execution is the most important step. While day to day market swings can be emotional and difficult, executing the strategized plan will reward those that are disciplined. Then, monitor the results. Make adjustments as needed and keep moving forward.

These steps will require a side-by-side relationship with the lender and producer. In fact, these steps may require an entire team to develop, implement and review. The frontlines of agriculture today may seem like some sort of boot camp, both for producers and lenders. Surprises and even shocks may happen. However, working together and systematically formulating a strategy can sustain a profitable business no matter the economic cycle.

Management Tip: Increased monitoring of the financials on large accounts will be a foremost priority. This winter's renewal season may hold some big surprises regarding losses accrued since the last financial review.

Global Economics

A "slow growth orbit" is a good description of today's world economy, post the Great Recession of 2008. Since World War II, the post-recovery expansion rate has been in the 3 percent to 6 percent range. In recent days, expansions have ranged 1 percent to 2 percent.

So, why the slow growth? The short answer is debt, debt and more debt! The U.S. federal debt is over $19 trillion at approximately 104 percent of the national GDP. Japan's national debt is nearly 250 percent of their GDP and the Euro area reported Government debt to be approximately 91 percent of GDP. Although China's debt percentage to GDP is approximately 44 percent, their government debt is $28 trillion, far past that of the U.S. At these high levels, current and future obligations are definitely a strong headwind to growth. Low interest rates have moderated debt service, however, investors and the general public know this level of debt is a ticking bomb.

Next, growth suppression also stems from rapidly increasing regulations. With the advent of new technologies, big data, hypersensitive media and social media, additional regulation is needed to provide structure and guidance for society as a whole. Nevertheless, legislative action, legal action and rule-making inside government agencies each continue to increase the scope and expense of regulations exponentially. This trend will continue to suppress growth as well as create inefficiencies in many small businesses, both domestically and abroad.

The 50-year to 70-year cycle of political and governmental dysfunction is well underway. The time periods of 1870s to1880s, 1920s to 1930s, and 1970s to 1980s each demonstrated similar situations in the U.S., Europe and other places around the world. Innovation, technology, population and demographic changes are major disruptors to political systems across the globe. Political and social discontent will continue to deter economic growth.

Finally, demographics play a major role in the suppression of economic growth. Baby boomers or the "Pig and the Python" generation continue to trend more conservatively in investment patterns as they age. Specifically, insufficient retirement funds seem to be a looming worry among this demographic.

Thus, the macro factors of slow growth, mounting debt, increasing regulations and changing demographic patterns all combine as major headwinds to economic growth in the U.S. and across the globe.

Domestic Economy

The current U.S. economy is full of mixed signals concerning the future. The Leading Economic Index (LEI) was up three-tenths 1 percent and the LEI Diffusion Index registered at 55 percent indicating a lackluster future economy.

The Purchasing Managers Index (PMI) is above 50, which indicates an expanding economy. The unemployment rate (U-3) registered in at 5.0 percent and with U-6 numbers included it remained steady at 9.7 percent. Recent numbers of jobs created did increase but are still under the important benchmark of 200,000.

Housing starts seem to be stuck just above 1 million annually which once again is not in the ideal range of 1.5 million. Next, factory capacity utilization is in the mid-70s. Housing starts and factory utilization numbers coupled with the late stages of economic and business expansion, combine to create slow growth.

Speaking of domestic economic growth, the U.S. GDP growth is still under 2 percent despite the strong consumer sentiment, which is 87.9. Overall, the U.S. economy continues to move along, but at a slow speed. This pace should keep interest rate increases to a minimum and inflation in the low range of 2.2 percent. Slow growth should also keep core inflation, currently at 2.2 percent, and headline inflation, at 1.5 percent, relatively stable as well.

Surprisingly, the equity markets and non-farm real estate still maintain strength in many markets. However, any change in Central Bank policies could alter returns in these areas very quickly.

Lender and Business Dashboard Economic Indicator Assessment — 10/25/16

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	124.4	✓		
LEI Diffusion Index	55%		✓	
Purchasing Manager Index - PMI	51.5	✓		
Housing Starts (millions)	1.047		✓	
Factory Capacity Utilization	75.4		✓	
Unemployment Rate	5.0%	✓		
Core Inflation	2.2		✓	
Headline Inflation	1.5	✓		
Oil Price ($/barrel)	$43.44	✓		
Yield Curve	1.32		✓	

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