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<u>Lending Risks with Large, Complex Credit</u>

By Dr. David M. Kohl

Each agricultural lender has some accounts that require special attention. One example is an account with large, complex credit. Often, only a handful of customers fall into this category, but they represent a large percentage of the portfolio. Occasionally, these types of accounts present so much risk in the portfolio that parts of the loans must be sold to other institutions to reduce exposure. Across the nation, this segment of agriculture raises a particular concern, and one not observed in the 1980s farm crisis. At that time, debt was much more evenly dispersed over a broader segment of customers. Today, approximately 260,000 customers encompass over 60 percent of the total debt in the agricultural portfolio nationwide. In the stronger part of the economic cycle customers with large, complex credit can quickly and efficiently grow your portfolio. In fact, these accounts may even result in bonuses or other incentives for account officers in environments where growth is sought. However, these customers can be a double-edged sword. If they are not astute managers, these customers can present considerable credit and portfolio risk when the economic cycle is down, as it is today.

The current economic reset continues to illustrate this risk. Covering a 12-state area, the 2015 data from University of Minnesota's FINBIN Farm Financial Database verifies the double-edge assertion. For both the crop and livestock sectors, data is segmented into the highest 20 percent of business profitability, the lowest 20 percent, as well as the overall average profitability of farms. For the farms $100,000 to less than $1 million in gross revenue, the difference between the high and low ends of net profits is less than $100,000. However, for those operations beyond $1 million in gross revenue and particularly, over $2 million, there is a widening gap in profitability. For example, the top 20 percent of farms above $2 million in revenue generated over $570,000 in net farm profits, but the bottom 20 percent lost over $300,000. This variance is near $900,000 from positive to negative. This large net income difference first impacts the coverage ratio and the ability to service debt. Second, those with a negative profit range can deplete working capital and equity rapidly. Thus, these accounts require strict enforcement of covenants as well as close supervision and monitoring.

Another prudent practice is to require timely and accurate financial statements. Monthly and quarterly variance reports that compare projected incomes and cash flow to actual numbers can quickly identify any issues. This also helps determine topics for any crucial conversations that may need to take place with the customer. Year-end statements such as balance sheets, income statements, and cash flow statements are insufficient for proactive planning and corrective action as losses can quickly mount throughout the year.

Accounts with large, complex credit often have other pending credit risks as well. Many owners and managers of larger operations are in a growth mindset. Often profits are funneled into land acquisitions, rents and leases, or growth of the business structure. Profits are leveraged to the maximum level without regard to working capital and cash reserves. While this strategy may work well in the positive part of the economic cycle, it often becomes a downfall when adverse economic times occur. Many times, this entails selling off assets or business segments to provide liquidity and cash for the operation. Unfortunately, when these assets are sold in a down market, it represents a steep discount in value of your collateral.

Another dangerous risk with large, complex credit is the customer's level of knowledge of all the business entities, including income and cash flows. While a global analysis of all enterprises is critical, individual business entities must be examined for viability and profitability as well as sustainability. In particular, the practice of supplementing a financially struggling enterprise with income from another is cause for concern. As the old adage says, this is "robbing Peter to pay Paul" within the business structure.

Next, some larger producers have formal or informal business relationships with other producers and agribusinesses. Lenders must conduct careful examination of any outside contracts or agreements, which hopefully are in writing. Thorough examination of total exposure for interconnected, third-party or counterparty risk will be extremely important on all large, complex credit accounts.

Especially during an economic reset, it is important to follow the money. For example, consider a hypothetical situation where Farm "A" borrows from Farm "B's" operating line of credit as part of an informal business relationship. In this example, Farm "A" was most likely not able to secure an operating line of credit. As a second example, Farm "B" may purchase inputs for Farm "A's" planting season with the hope and trust that Farm "A" will be able to reimburse Farm "B" by the end of the year. While these are just examples, similar concerning situations are occurring across the nation.

When assessing credit risk, consider the intangible aspects of a business' management as well as manager skills. The management of large entities requires a systematic approach to production, marketing and risk management, and finance. There must be confidence in the middle level of management as well as the employee team. The 6th "C" or the cranium in the evolution of management often requires probing questions. As an example, does the producer know the cost of production for each enterprise? Is there a marketing and risk management plan in place? A written business plan with clarity in goals and objectives is not an option but a requirement for large, complex operations. A business transition plan for owners and management must be carefully scrutinized as well. In addition, training and education for owners, management and employees can be the difference between success and failure. Another necessary element in managing risk is insurance coverage on key individuals in the business. Often, large businesses can be targets for environmental compliance, animal welfare and even legal action, each of which increases risk. In short, a thorough and objective assessment of management is often an indication of whether the loan will perform.

Finally, large businesses too often outgrow their management acumen. Getting caught up in the economies of scale, some producers believe they can overcome any economic cycle through increased production. Unfortunately, if not carefully managed, a large, complex account can quickly spiral out of control, magnifying the customer's risk as well as overall portfolio risk to a lending institution.

Management Tip:
If you have not already, sign up now for the National Agricultural Bankers Conference in Indiana this November, sponsored by the American Bankers Association. Come early on Sunday for a special program sponsored by Farmer Mac and FINPACK to gain timely, valuable information. See you there!

Global Economics

In the words of Marvin Gaye, “What’s going on?” The BREXIT and equity markets crash was a dip that recovered very quickly. However, Europe will continue to struggle with ramifications of the BREXIT vote for some time to come. In fact, Great Britain just recently lowered its interest rates by 25 basis points. New leadership in Great Britain along with immigration and regulation reforms throughout Europe will be important for this section of the world economy; however, resolution will likely take several years.

Shifting to Asia, this part of the world tends to be very cautious and continues to struggle economically. Of course, much depends on China’s economy as their government adjusts economic, political and social policies. In addition, $5.8 trillion of the $78 trillion world economy runs through the South China Sea. This fact alone elevates the importance of any tensions over the region’s islands. Clearly, access to this area is critical to the future of international trade traffic.

The economies of both Russia and Brazil continue to struggle with dependence on oil sales. Of course, Brazil also faces post-Olympic issues in addition to the probable impeachment of their political leader. As the major economic power in the Southern Hemisphere, changes in this region should be monitored.

In summary, the overall global economy exhibits suppressed growth which directly impacts agriculture and manufacturing in rural areas of the U.S. and North America, in general. In the future, we will investigate why “slow orbit” may be the growth speed of the domestic and global economies into the next decade.

Domestic Economics

Wow! The U.S. economy has me confused. Maybe it is all the negative election rhetoric, or the grumpiness of air travel, or perhaps, just the end of a hot summer. The economy feels sluggish and possibly recessionary, but the dashboard numbers say otherwise. For an accurate assessment, let’s put emotions aside and examine the numbers.

The Leading Economic Index (LEI) has been very positive this summer increasing a full point since April. The diffusion index has been 80 or above, meaning that 80 percent of the factors making up the LEI are moving in a positive direction. Both metrics indicate a positive, strong economy over the next six months.

Another forward-looking indicator is the PMI or Purchasing Managers Index. The PMI registered in at 52.6, which is positive. Any measure above 50 generally indicates a growing economy.

Unemployment numbers are strong. Unemployment is at 4.9 percent and job numbers increased more than 250,000 in July. U-6 unemployment numbers which include those underemployed in the workforce held steady at 9.7 percent over the summer.

As a pleasant surprise, annual housing starts continue in the 1.2 million range. While not at the idealistic metric of 1.5 million, this range shows solid and steady growth and a resilient sector.

Factory capacity utilization is not stellar, but is in the 75 percent range with slight increases in the positive direction. This is a good sign, despite the strong dollar which inhibits exports of manufactured goods.

Core and headline inflation have been held in check at 2.2 and 0.8 percent respectively. Oil price moderation along with slow growth in retail sales continues to maintain a lid on inflation.

So far this year, consumer sentiment has been above 90 for seven out of the eight months. This indicates strong consumer behavior. Overall, the U.S. economy is not ablaze going into the fall of 2016, but does appear to be performing above the negative sentiment of much of the nation.

Throughout my summer travels, I frequently encountered individuals asking why the stock market was performing so well in the midst of such strong negativity in America. Well, maybe the answer is in the indicators outlined above. More likely, it is a combination of factors. The U.S. Federal Reserve and global Central Banks continue to keep rates low. Additionally, eight countries around the world have negative interest rates. Low interest rates and inflation are usually positive for equity markets, both domestically and internationally. Only time will reveal all the reasons.

Lender and Business Dashboard Economic Indicator Assessment **08/23/16**

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	124.3	✓		
LEI Diffusion Index	80%	✓		
Purchasing Manager Index - PMI	52.6	✓		
Housing Starts (millions)	1.211		✓	
Factory Capacity Utilization	75.9		✓	
Unemployment Rate	4.9%	✓		
Core Inflation	2.2		✓	
Headline Inflation	0.8	✓		
Oil Price ($/barrel)	$39.79	✓		
Yield Curve	1.18		✓	

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