FARMER MAC

DAVE'S GPS

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<u>Mom, My Mentor</u>

By: Dr. David M. Kohl and Samantha Dunn, Intern, Farm Credit University

The agricultural lending transition is in full force as responsibilities shift from the baby boomer generation to the millennials and Generation Z. This has been evident at lending schools, conferences, and in the online educational training of Farm Credit University. Our intern, Samantha, who is a graduate student at Virginia Tech and received her Bachelor's in Agribusiness Management, is enrolled in the FCU Commercial Ag Lender course. This mentor-based educational experience requires guidance, often from an experienced agricultural lender. In this case, her mentor is her mother, an experienced agriculture lender and a former student in the farm management and agricultural financial courses at Virginia Tech during the farm crisis years of the 1980s. Through a series of questions, Samantha was able to glean knowledge and perspectives that were not only useful to her education, but valuable to any newbie in the agricultural lending field. Let's probe some of the nuggets gleaned from her mentor.

What are the liabilities most often left off the balance sheet?

Liabilities most often omitted from the balance sheet are money owed to suppliers and notes cosigned for children. This response is particularly true in today's agricultural lending environment as supplier credit for operating expenses has ballooned in recent years. These amounts are often rolled over into a refinance or restructure of debt using land equity as collateral to buffer the risk. Furthermore, cosigned notes with children can often balloon into additional obligations for co-obligors should an issue occur financially or personally.

An old saying from the Reagan administration is very appropriate in this area: "Trust but verify." Request year-end financial statements and crosscheck expenses, such as interest expense compared to the amount of debt, to determine if the numbers are reasonable given the total liabilities.

What are some tricks of the trade to get accurate financial information?

Mom's response was very appropriate regarding how to obtain accurate financial information for the balance sheet, income statement, or accrual income statement. Send out reminders to customers containing the previous year's statements prior to the current year-end. Educate the producer on why the information is important and take time to go over the information together, providing benchmarks and metrics useful for business operations.

Do customers really fill out cash flow budgets?

Yes, but many producers are very optimistic. She compares the producer's projected numbers to their historical performance and makes appropriate adjustments. Getting producers to complete accurate cash flow budgets is an ongoing, educational process as farm economic conditions continuously change. She also noted that typically cash flow budgets are completed on an annual basis with very few monthly or quarterly statements.

What are the top five nonfinancial risk factors?

Over the years, nonfinancial factors become second nature, otherwise referred to as a "gut feeling." The character of each individual is very important. Do they provide accurate information upfront, or do you have to drag out the information? In the recent years, marketing plans and environmental assessments are becoming a bigger portion of the risk equation. Again, trust and verify. Observe the operation and determine how the producer cares for their equipment, livestock, land assets, and their people.

What are some examples of "train wrecks" you have experienced?

A common train wreck is growing the business too fast or growing by large leaps all at once. She mentioned that a producer trying to grow quickly rented too much high-priced farmland. On top of the additional rented land, the producer acquired a considerable amount of debt to purchase equipment through outside machinery financing, used multiple suppliers for crop inputs, and purchased supplies outside the area. The issue was that no one knew what was going on, including the lenders and suppliers. A poor crop year coupled with the additional debt required refinancing, but no one took the bait. Overall, the producer's ego resulted in the "too big for his britches" syndrome.

Conducting due diligence with constant monitoring is an educational lesson for all. This was also a reminder that split lines of credit, or financing from more than five to seven sources, is a sign that a business could possibly be headed south. This was a concept she learned at Cornell in graduate school decades ago that is still very applicable today.

What are the biggest issues in debt structure?

Providing a producer with a revolving line of credit that does not get paid down each year, otherwise known as an evergreen credit line, is a debt structure issue. If the credit line is maxed out and carried over from year-to-year, providing more money in addition to the original credit line can be an accident waiting to happen. Another interesting point she made was regarding when the loan is secured by real estate and the producer thinks everything is okay, even if the current assets to pay off the credit line are not available. This is known as the old concept, "If you've got the dirt you can't get hurt!"

Unfortunately, this thought process is very prevalent in today's agricultural lending environment.

Mom provided some helpful mentorship and wisdom that would be a good primer for any new agricultural lender. The agricultural lending field is full of potholes and washouts. However, gleaning some of the wisdom from those that have come before us, such as the aforementioned points and perspectives, can be invaluable for both lenders and for producers.

Global Economy

Trade and political issues are dominating the discussion on the global economy. Since the last article, the Asian economy is in a slowdown, but still showing positive growth for most of the region. The trade war has resulted in the Chinese economy slowing growth by 1.2 to 1.6 percent. However, their total growth is still above six percent. The ongoing trade negotiations will most likely only present deals in the short run as the U.S. economy moves toward the 2020 presidential elections.

The European economy has been uplifted by the central bank and policy stimulus of China. Europe is a major trading partner for China and the Asian region. To quickly size up the global economy, it would be modest and moderating growth with fairly strong equity markets. The trade and political uncertainty will continue to result in volatility in all segments of the U.S. economy, including the agriculture, manufacturing, and technology sectors.

Domestic Economy

The all-time record for consecutive economic expansion in the U.S. is over 120 months and counting with no end in sight. Who would have known at the height of the Great Recession one decade ago what would follow? Until recent years, the elongated expansion was not much to write home about. Gross domestic product (GDP) was in the modest two percent range at best. However, low inflation, strong gains in the stock market, and low interest rates on real estate brought the wealth effect to many.

How much longer will this economic streak last and what will be the factors causing its demise? The senior level class enrolled in Interpreting Economic Change at the Graduate School of Banking at Louisiana State University provided some insight regarding the future direction of the economy. Utilizing clicker technology, anonymous responses from the class of over 150 students provided some thought-provoking data.

Seventy four percent of the students polled indicated that the next recession would begin either in early 2020 or the last half of 2020. In order of response, the leading probable causes of a recession are as follows:

- 33 percent of the students cited federal, personal, corporate, and student debt as obligations that would choke the growth and start the next recession.
- Approximately 20 percent cited the outcome of the 2020 presidential election.
- One in five students stated that the cause would be on the ongoing global trade wars.
- An asset price bubble in the equity markets and real estate were mentioned by one in seven participants.

Now moving to the economic indicators, let's see if there are any storm clouds on the horizon.

The Leading Economic Index (LEI) and its diffusion index were unchanged in May, following three consecutive increases.

The Purchasing Manager Index (PMI) is the lowest that it has been in the past six months at 52.1. However, the metric is still above 50, which is a sign of a growing economy. Surprisingly, factory utilization is in the high 70s, a bullish number for the manufacturing sector.

The U-3 and U-6 unemployment rates remain in record low territory at 3.6 percent and 7.1 percent, respectively. The unemployment rate is considered to be a lagging indicator of the economy.

The Index of Consumer Sentiment, measured by the University of Michigan, remains very strong in the high 90s. This metric is closely watched by the Federal Reserve because consumer spending drives about 70 percent of the U.S. economy.

Preliminary GDP reports were quite strong at approximately 3 percent growth. Both the Producer Price Index (PPI) and the Consumer Price Index (CPI) indicate that inflation is modest at approximately two percent.

Commodity prices such as oil and copper have been bearish in the past month, possibly indicating a slowdown in the economy. The storm cloud on the horizon is the yield curve, which is tipping toward negative. One must watch this variable over the next few months to determine if a negative trend across all rates develops.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	111.8	✓		
LEI Diffusion Index	60%	✓		
Purchasing Manager Index - PMI	52.1	✓		
Housing Starts (millions)	1.269		✓	
Factory Capacity Utilization	78.1		✓	
Unemployment Rate	3.6%	✓		
Core Inflation	2.0%		✓	
Headline Inflation	1.8%	✓		
Oil Price ($/barrel)	$67.10		✓	
Yield Curve	-0.23			✓

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