FARMER MAC

DAVE'S GPS

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<u>One Page Recovery Plan</u>

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The sixth year of the economic downturn has turned the tables of expectations for both producers and lenders. Negative profits and cash flow frequently lead to requests for debt restructuring. This is particularly true for operating loans that are carried over from the previous year, also known as carryover debt. This requires both the lender and borrower to work side-by-side to develop potential solutions. Over the past several years, I have suggested that borrowers should develop a one-page written recovery plan.

I was asked during a recent webcast for Farmer Mac to provide an example of a one-page recovery plan. In this example, the livestock and crop producers, who operated a third-generation family business, were seeking to refinance operating losses for the second time. They requested to refinance their accounts payable and carryover operating debt for a seven-year term utilizing land equity as collateral. The business had 65 percent equity with a strong, productive land base that provided a 3:1 land equity to farm debt collateral ratio.

The following was part of their recovery plan.

The producers, in this case, a husband, wife, and son, were asked to express their short and long-term goals for the family, business, and personally. They were asked to write them separately and then combine the goals to determine areas of similar focus as well as outliers.

The senior owner's short-term goal was to reduce feed and labor costs by 5 percent to improve cash flow. For the longer term, he wanted to position the business for the fourth-generation so that it was profitable and had a productive asset base. His personal and family goals were to spend more time with the children and take a one-week vacation.

His wife was willing to provide labor in the livestock operation to improve cash flow. She also agreed to develop a personal family living budget within 30 days with the objective to reduce living expenses by 20 percent. In the long run, her goals were consistent with her husband's goals to balance time between the family and the farm and to integrate the son into the family business.

The son's short-term goals were to work with a crop and livestock consultant to reduce costs for each crop by 10 percent and to reduce feed costs within 24 months. In the long run, he expressed an interest in becoming the fourth-generation to operate the family farm. Personally, he wanted to volunteer as a coach for the local high school basketball team.

Next, the family developed a monthly cash flow with the assistance of the farm business management consultant. The cash flow included their assumptions for production, price, costs, and marketing expectations. Specific metrics for production costs were based on the last three years of tax records that were adjusted for accrual changes in payables, inventories, and investment in growing crops. The new family living budget and proposed debt structure were also included in the monthly cash flow.

It is critical to develop best, average, and worst-case scenarios for production, price, and costs in the plan. Within these scenarios, break-even calculations can be developed to provide parameters for expectations to guide both the producer and lender when working side-by-side.

The recovery plan should detail the rules of engagement and roles for the individuals involved. The borrowers and their lender should agree on the frequency of meetings to review the progress of the plan. At these meetings, the lender and borrower can work side-by-side to review the actual financials as compared to the projected financials, also known as variance analysis. With the increasing size of many agricultural operations, the financials can quickly get out of control if not monitored on either a monthly or quarterly basis.

The farm owners should designate an advisory team within the recovery plan. This team can help guide the direction of the operation, identify areas of opportunities and weaknesses, and ultimately aid in the business' recovery. Individuals such as lenders, other farmers, extension agents, agronomists, and veterinarians often serve on advisory teams. In this case, the crop and livestock farm management consultant and the family stakeholders were involved in the advisory team meetings.

The business owners also mapped out alternative plans if the results were not achieved. Addressing the "soft" issues of the recovery plan are critical to ensure successful execution.

The plan also needs to include other sources of income. In this case, the spouses were willing to generate off-farm income to supplement cash flow. The family also identified parcels of land that could be sold either for development or to neighbors seeking expansion.

The family members agree that by going through this process that they are more financially literate for both the business and personal side of the equation. In this case, their lender was more confident with a written plan considering the time and the commitment the owners put forth in the process. It also was much easier to discuss this credit with the credit analyst and loan committee with a one-page summary and the supplemental projected cash flows and financials in the appendix.

Management Tips

If you do a debt restructure without a written plan developed by the business owners, be prepared for another refinance in two to three years. Refinancing debt is only a Band-Aid unless there is commitment from the other side.

Components of a One-Page Recovery Plan:

- Goals
  - One and five year
  - Business, family, and personal
- Cash flow
  - Production: plan, strategize, and metrics
  - Marketing: plan, strategize, and metrics
  - Systems: plan, strategize, and metrics
- Break-evens: production, price, and cost
- Sensitivity analysis: production, price, and cost
- Plan for monitoring: monthly, quarterly
- Advisory team
- Sources of other income: Equity, recurring, and non-recurring
- People’s roles, rules of engagement, checkpoints, and communications
- Alternative plans

Global Economy

Tariffs and trade are front and center in the direction of the world economy. The Euro sector is generating modest economic growth despite issues in Italy. France and Germany, the large engines of growth, are in an economic growth range of two percent. Like historical standards, Northern Europe is outperforming growth in Southern Europe by approximately a two to one ratio. The rise in interest rates and the curtailment of economic stimulus in the Euro sector and Great Britain will need to be closely watched for the future direction of the economy.

The 800-pound gorilla regarding the global economy is the direction of the Chinese economy. The Chinese stock market is down approximately 18 percent since its recent peak. The growth of the economy is slowing to the mid-six percent range with construction and manufacturing bearing the brunt of the moderating economy. An indicator to closely watch is copper prices, which have declined recently. This decline is partially because of the slowdown of the Chinese manufacturing economy.

On the other hand, the Japanese economy is showing its largest growth in recent years. This is a positive sign for one of the United States' largest trading partners and the third largest economy in the world.

For the U.S. agricultural sector, it will be necessary to keep a close eye on Brazil and Argentina. This area of the globe is moving into spring when the crop planting decisions will be made based upon ongoing trade negotiations. Weather patterns, along with planting decisions, could result in major changes in commodity prices in the Northern Hemisphere.

Argentina's new leadership is shifting the past administration's stance on taxing agriculture with internal tariffs. Their beef herd is expected to triple within the next three years, which could be serious competition to the U.S. and global markets.

The drought in Australia is also impacting both wheat and beef markets, which may be felt in the U.S. over the next six months.

Domestic Economy

The U.S. economy is full steam ahead and backed by the economic indicators. The LEI, or the Leading Economic Index, measures the future direction of the economy. Economic growth is robust and increasing at an accelerated rate. The diffusion index measures the indicators that are positive or negative and is at a record high of 95 percent.

The PMI, or Purchasing Manager Index, is at a stellar 58.1. Any number above 50 illustrates economic growth, which has been the case for nearly 30 consecutive months.

Oil prices have moderated back into the high $60 per barrel range despite threats from oil-producing areas such as Iran and Venezuela.

Unemployment (U3) is back below four percent and the U6 unemployment is into the 7.5 percent range. Despite this low rate, wage inflation has been under control because of advancements in technology, automation, and innovation.

Housing starts have taken the largest drop back to 1.1 million units annually. Higher costs for building supplies as a result of terrorist threats and higher interest rates are headwinds for this important sector of the economy. Another factor is the sharp drop in the number of homebuilders from 98,000 a decade ago to 48,000 currently. This results in less competition and builders having more power in home pricing decisions.

Factory capacity utilization is in the high 70 percent range, which indicates that factories are near capacity. The impact of tariffs and trade deals on this sector will need to be closely monitored.

The Index of Consumer Sentiment is at 95.3. Although the index is down from previous months, it is still strong. The rise of consumer debt, credit cards, and household debt along with declining savings rates will test the sustainability of this metric.

Gross domestic product is above four percent, but is this growth sustainable? Inflation has risen in recent months. Core inflation has increased from 1.8 percent to 2.4 percent since the beginning of the year. Headline inflation, which includes food and energy, has increased from 2.1 percent to 2.9 percent this year. Most of this increase has been energy-related rather than food related.

With the record for the longest economic expansion in the history of the United States within reach, it will be interesting to determine what could place the economy in a negative growth mode.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	110.7	✓		
LEI Diffusion Index	95%	✓		
Purchasing Manager Index - PMI	58.1	✓		
Housing Starts (millions)	1.168		✓	
Factory Capacity Utilization	78.1		✓	
Unemployment Rate	3.9%	✓		
Core Inflation	2.4%		✓	
Headline Inflation	2.9%	✓		
Oil Price ($/barrel)	$73.53		✓	
Yield Curve	0.94	✓		

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