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<u>Preparing for a Rocky Renewal Season</u>

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Fall is in the air and the days are getting shorter, a telltale sign to an agricultural lender that the renewal season is just around the corner. After six years of the agriculture economic reset following the commodity super cycle, a fork in the road is coming for some producers as a result of financial deterioration.

Bumps in the financial road will be the result of financial disruptors ranging from trade, consumer trends, weather, and competitive forces around the globe. Low margins and extreme volatility are the realities both short and long-term for the agriculture industry. Now, let's discuss preparing for the rocky road of renewal season, not the favorite ice cream flavor.

Stray dogs

This fall and winter, many lenders may be asking some of their customers to find a new lender. This may occur when the customer is in a situation where multiple refinances of operating loans, losses, and loss carryforwards have occurred. In many of these situations, the equity on the balance sheet appears to be strong due to inflated asset values. However, if an accrual analysis of income statements and a line by line examination of cash flow is completed, the results show a different outcome with ballooned losses.

One has to keep in mind that profits and cash flow pay expenses and service debts, not equity on the balance sheet. Customers that are turned away from one lender will seek other sources of credit. The bridge is often a nontraditional source of credit such as cooperatives or captive finance firms. Once these sources of credit have been exhausted, then the fork in the road is often partial or total liquidation of assets.

In this part of the economic cycle, it is time to build a fence around your sound portfolio and serve it well. Conduct due diligence on any new customers seeking financing or refinancing. Remember the old adage that it takes five times the amount of time, money, and effort to obtain a new customer, but they are twice as likely to be a credit problem. Another point of wisdom is that it takes four times the amount of time and money to work out a problem account versus a performing credit. A desperate customer is analogous to a stray dog. Yes, they can be lovable, but they can bite if you are not careful.

Financial statements: Answers versus questions

An experienced agricultural lender mentioned that financial statements do not necessarily have the numbers for all of the answers, but they can give you the information needed to ask the right questions. Questions and active listening will be critical on all accounts this renewal season. First and foremost, do your producers know their cost of production? If multiple enterprises exist, do they know the cost of production via enterprise? Do not accept the excuse that cost, price, weather, and the global trade situation are too uncertain. This is why spreadsheets and scenario analysis are critical to outline the parameters of the rocky road to prevent the business from ending up in the financial ditch.

The producer needs to develop a projected cash flow for business outcomes that can be monitored throughout the year. The key is that the producer, with the assistance of a farm management instructor, extension agent, or financial counselor, develop these cash flow statements to encourage buy-in and distance a lender from lender liability. Short and long-term goals need to be articulated in writing by the owners, partners, and spouses to ensure that everyone is on board and traveling the rocky road together. If the producer or business owners are unwilling to define goals and complete a projected cash flow, then they should receive a negative check for business character. The past three years of financial statements and cash flow projections are good documents for solving questions about the business' direction.

Asset-based lenders

Let's be candid, some lenders are asset-based lenders in this part of the economic cycle. How much longer can operating losses be placed against equity without eventually eroding the wealth of the customer? Calculating the burn rates on core equity by dividing the losses into equity will be a critical component of this renewal season if losses have occurred. Conducting burn rates with scenario analysis, such as a 20 percent decline in land values, need to be articulated to provide a customer perspective on how quickly wealth can erode. Loss of equity is particularly true if the business has needed multiple refinances over the past few years.

Family living expenses

Withdrawals and family living budgets are of equal importance to farm budgets. Some anecdotal evidence suggests that up to 50 percent of operating loan refinances can be attributed to excessive family living withdrawals. Customers may question the level of family living costs used in a lender's analysis. If they do, conduct an earned net worth analysis to back into family living withdrawals. The customer's response will often be, "It cannot be this much!" Conduct due diligence on credit cards with the owners, spouses, and children. Due diligence is often the path of least resistance down the rocky road of no return.

Finally, this renewal season will be about emotion, objectivity, and attitude. This renewal season, more than any other, will require side-by-side work with producers, lenders, and others. The goal is to maintain objectivity, which results in less emotional business decision-making.

Domestic Economy

The U.S. economy enters the fall season with economic storm clouds on the horizon. Let's examine some of the key indicators to get a glimpse of how strongly some of the headwinds are blowing.

Leading Economic Index (LEI)

Since the spring, the Leading Economic Index (LEI) has been relatively flat. This metric must be closely monitored for any negative movements, as a reduction in LEI is often a precursor to a recession. The diffusion index measures either the positive or negative movements of the ten indicators that make up the LEI. The diffusion index is still above 50 percent, registering in at 55 percent. However, even this measurement is much softer than earlier in the year.

Purchasing Manager Index (PMI)

The global and U.S. economies are in a manufacturing recession. For the last two months, the Purchasing Manager Index (PMI) has been under 50 in the United States, indicating a contracting manufacturing sector. This metric is down sharply from the robust numbers in the mid-50s posted in the spring of the year. The trade wars and tariffs have disrupted supply chain management, which in turn has reduced capital spending in the manufacturing sector both in the U.S. and globally. Some manufacturing sectors are shedding jobs and building efficiencies, given the expected deeper downturn.

Oil

Oil prices increased approximately $10 a barrel due to the Iranian crisis and issues in the Saudi oil fields. Slower demand worldwide has maintained supply and demand balances. With the U.S. as the number one energy producer, followed by Canada in fourth and Mexico in eighth, the stability of the energy sector can be expected unless a major black swan or unusual event occurs.

Housing starts

Housing starts reached the highest number since the Great Recession of 2009, registering in at 1.364 million units annually in August. However, this indicator is still under the ideal level of 1.5 million units annually and dropped to 1.256 million units in September. Low interest rates and strong employment numbers are spurring the incremental increase in the housing sector.

Factory utilization

Factory utilization is softening. However, numbers are still above average in the high 70s. Expect factory utilization to decline as the global manufacturing recession intensifies.

Unemployment rates

When unemployment rates increased above 10 percent in the Great Recession about a decade ago, one could not imagine the U-3 and U-6 unemployment rates dropping to 3.5 percent and 6.9 percent, respectively. This is the lowest unemployment rates since the Vietnam War. Remember, the unemployment rate is a lagging and some rumblings on the road indicate the softening of hiring in some regions of the country.

Consumer sentiment

Seventy percent of the U.S. economy is driven by the consumer. A strong job market, along with wealth increases in the stock market and real estate, have boosted this metric. However, consumer sentiment has declined below 90 for the first time in over three years. Watch this variable as the U.S. economy moves into the holiday season.

Consumer and producer inflation still remain very tame. If any of these aforementioned metrics move towards a negative direction, expect the Federal Reserve to provide accommodative action either through quantitative easing or lowering of interest rates.

<u>Global Economy</u>
The global economy continues an incremental decline in the major rich nations of the world. Large European economies, which are manufacturing-based, are still growing despite tariff and trade issues around the world. The Brexit movement is moving forward with a slow pace as more individuals are thinking through the unintended consequences of an exit.

To the north, watch for the outcomes of the Canadian elections. Mr. Trudeau, the liberal incumbent, is in a fight with the conservatives for his political leadership. This could be a foreteller for numerous other countries' directions concerning economic philosophy.

China and Asia

The Asian Rim economies are in a slowdown, but not quite in a recession. A new trend called "decoupling" versus globalization is emerging in the region and appears to be spreading globally. Countries are reassessing trade relationships due to the tariffs and trade issues. Critical industries are now being moved backed into mother countries or other nations that can be trusted. This decoupling, along with populism, will need to be monitored for unintended consequences and the effect on global growth.

In upcoming columns, a deep dive into decoupling will be outlined and what could happen to agriculture, energy, manufacturing, and social movements in countries around the world.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	111.9	✓		
LEI Diffusion Index	55%		✓	
Purchasing Manager Index - PMI	47.8		✓	
Housing Starts (millions)	1.256		✓	
Factory Capacity Utilization	77.5		✓	
Unemployment Rate	3.5%	✓		
Core Inflation	2.4%		✓	
Headline Inflation	1.7%	✓		
Oil Price ($/barrel)	$62.51		✓	
Yield Curve	-0.16			✓

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