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Priorities of Credit and Risk

By Dr. David M. Kohl

In the days of lockdowns, social distancing, and other restrictions, virtual meetings are a common mode of action. During a recent webcast, two well respected agricultural lenders and longtime friends had some thought-provoking perspectives on credit and risk. The fundamentals of credit and risk have not changed, but the priorities have been rearranged. Let's examine this statement and expand on the traditional five C's of credit. In this discussion, the seven “C’s” of credit and risk will be discussed in the context of the current and future black swan events.

Supply and Marketing **C**hains:

One of the first “C's” of credit that has emerged is supply and marketing chain certainty. The consolidation of processing in the protein complex has been a major disruptor of profits and cash flows. Producers have experienced much of the burden, while the processors have profited. The challenges in the supply chain have caused consumers to experience food shortages and inflation. Regardless of a producer’s size, market access and supply chain evaluation will be important now and in the future for credit and risk analysis.

The same challenges are relevant for the supply chains of critical inputs. In a world of tight margins, just-in-time management, and extreme volatility, a hiccup in the input supply chain can result in multi-thousand-dollar losses.

Counterbalance:

The next “C” is counterbalance. Never before has the importance of a marketing and risk management program been more relevant for both revenue and costs. Counterbalance is applicable to commodity and value-added businesses. Discussions in loan committees may center around optimization and efficiency versus diversification and resiliency concerning markets and revenue and cost protection programs. The ability to plan, execute, and monitor results will be a high priority in economic cycles with extreme volatility and short profit windows.

Cash Flow:

The next “C” is an “oldie, but a goodie.” The importance of cash flow scenario planning with the mentality of "quarterly sprints" that are monitored by both the producer and lender will be critical. The level of working capital to expenses and quickness to cash will be part of the cash flow and liquidity timing analysis. If the lender conducts a debt restructuring, monitoring working capital reserves and burn rates will need to be part of a servicing strategy.

Cash Reserve:

The backup to cash flow is working capital and equity. In this analysis, the quickness to cash of working capital and the type of equity need to be examined at various advance rates to ascertain borrowing capacity reserves. If losses are to occur, the burn rate on core equity, such as land or other noncurrent assets, needs to be conducted and discussed with the borrower.

Competitiveness:

The next "C," competitiveness, will be particularly important for every business to determine viability in a national and global context and to determine whether cash flow needs to be supplemented with nonfarm income. The importance of knowing the cost of production metrics and benchmarking using year-over-year trend analysis will be critical. The cost of production metrics and break-even points can then be benchmarked to the industry for all overall competitiveness and sustainability.

Cranium:

The next "C" is one that was coined by Denny Everson of First Dakota State Bank. The cranium or business IQ is important for assessing the capabilities and commitments of the borrowers and management teams in the short and long-run. Post black swan, the business IQ of the owners and key managers will increase in importance as the decade evolves. The business IQ, measured by a chart presented in previous columns with 15 questions that create crucial conversations, can be an excellent tool for logically working through plans and priorities for improvement with the customer.

Character:

The seventh "C" is one that is often overlooked in the "go-go" years. Character often divulges itself in the good times in terms of prioritization of uses for profits or remaining true to a plan. However, difficult times like the current environment can expose true character flaws in customers, lenders, and other stakeholders. On the lender side, being conservative in the good times and courageous in the tough times, allows us to be more consistent all of the time. For the borrower, having Plans A, B, C, and possible D scenarios and maintaining open communication is imperative. It has been impressive during discussions with both lenders and borrowers in these times of uncertainty how patience and working together to find solutions has emerged. Hopefully, this will be a longer-term trend. In the seven "C's" of credit. A balanced approach to credit and risk analysis and long-term viability for both the borrower and lender will be critical.

Domestic Economy

Let's depart for a moment from the economic indicators to answer one of the most common questions from recent webcasts, "What will be the shape of this recession?"

Many economists are indicating a V-shaped recession similar to the Great Recession of 2008 to 2009. The sudden impact, along with the breadth and future uncertainty changes the shape to a Nike swoosh symbol. The question then becomes, is it a size six, size 14 to 18, or larger? From my vantage point, the recession appears to be setting up for a long, choppy recovery with uneven economic growth here in the United States and around the globe. Of course, only time will tell.

The Leading Economic Index (LEI) has declined by over 12 points since January 2020. This large decline is a record and may be the foreteller of the depth of the recession. The diffusion index measures whether the factors comprising the LEI are trending positive or negative. This index bottomed out at 10 percent in March but rebounded to 70 percent in May.

Oil prices bottomed out at just over $14 per barrel in April and now have increased to the high $20 to low $30 per barrel range.

The Purchasing Manager Index (PMI) is near recession levels in the low 40s. This decline in the PMI was expected as manufacturing ground to a halt here in the United States.

As of this writing, the unemployment rate is at 13.3 percent for U-3 and 21.2 percent for U-6. The unemployment rate is most likely understated as numbers are very volatile in the monthly reports. These figures will need to be closely monitored and watched later in the summer as businesses permanently lay off individuals as a result of closures or operating at 50 to 75 percent capacity.

Housing starts are at nearly 900,000 units annually, which is a solid number given the economic uncertainty and financial situation of many businesses and households.

Factory utilization fell to 64.9 percent of capacity, which is a level not seen since the Great Recession. In the months ahead, watch overall demand for manufactured goods and the speed at which production ramps up.

On the inflation forefront, both producer and consumer indexes showed 0.2 percent deflation, or near zero inflation. This is a result of demand destruction created by COVID-19 here in the United States and around the world.

Surprisingly, the Index of Consumer Sentiment jumped up to 78.9 from a low of 71.8. Was this increase in consumer confidence a result of government stimulus and unemployment compensation providing a boost or "sugar high" to the economy?

Overall, at the time of publication there appears to be a dichotomy between the stock market prices and the economic performance in the U.S. and global economies.

Global Economy

The global economic analysis starts with China. China's Purchasing Manager Index (PMI) is now back above 50, which reflects expanding manufacturing activity. The question remains whether demand for Chinese goods will exist around the globe, specifically in the rich nations of the world. On a side note, China imports many agricultural products from the U.S. and may become our largest trading partner of agricultural imports. However, China’s current imports of U.S agricultural products is much less than the Phase One trade deal expectations. This number one spot could be the result of a slowdown of agricultural trade between the U.S., Canada, and Mexico, which historically have been large trading partners ranking first and third. One will have to observe trade tensions between Australia and China for agricultural goods as a prelude to possible outcomes in the rest of the year relating to global trade with the United States.

Both the Brazilian and Indian economies are in the crosshairs of the COVID-19 outbreak. The pandemic is stalling economic activity around the globe. From a health standpoint, the progression of the virus in other countries must be monitored very closely for indicators of what may occur in the U.S. in the fall and winter months.

Moving to Europe, the economy is slowly picking up pace as more businesses and government activities are allowed to occur. The question for later in the year is whether northern Europe's economies will continue to support southern Europe. As we go to press with this article, the global economy appears to be headed towards a negative three to five percent growth rate with the exception of China, which may remain slightly positive.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	99.8			✓
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	43.1		✓	
Housing Starts (millions)	0.974			✓
Factory Capacity Utilization	64.8			✓
Unemployment Rate	13.3%			✓
Core Inflation	1.2%	✓		
Headline Inflation	0.1%	✓		
Oil Price ($/barrel)	$29.03	✓		
Yield Curve	0.50		✓	

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