FARMER MAC

DAVE'S GPS

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Questions and Answers with the Doctor
By Dr. David M. Kohl

Last month, we kicked off the year with a Farmer Mac webcast that boasted record attendance. The participants were active with numerous questions both during and after the webcast. As promised, this column is devoted to providing perspectives and insights on those questions. Special thanks to the over 665 lenders from 36 states that tuned in to the webcast! Great questions!

Stress testing!

Regulators are asking lenders to "stress test" individual customers and their overall agricultural portfolio. Do you have any suggestions?

Concerning individual customers, "stress testing" starts with testing a 5 to 10 percent decrease in revenue, 5 to 10 percent increase in expenses, and a possible 1 percent increase in interest rates on variable rate loans. Isolate each component and determine how it influences the coverage ratio.

Next, assess the burn rate on working capital. Specifically, divide negative margins (actual or projected) into the net working capital amount. For example, if a farm has $500,000 in working capital, and $200,000 in actual or projected losses, the burn rate would be 2.5 or 2 ½ years to burn through the working capital reserve. Less than one year or a negative burn rate is a red flag for future cash flow issues.

Concerning the overall agricultural portfolio, examine it for debt concentration. An element that is different than the 1980s farm crisis is today's tremendous concentration of debt. In fact, 63 percent of agricultural loans are distributed amongst 10 to 15 percent of the agricultural customers. Stress testing must take into account more than just enterprise or size of business. Risk from a third-party or counterparty must also be included because they could represent significant potential difficulties, especially, in regards to concentrated debt.

Finally, shock test values of equipment, livestock, and land. Look at varying rates of reduction; 10 percent, 25 percent, and 40 percent to ascertain how those reductions would impact collateral positions. This can be valuable in creating thresholds to avoid any overreaction by regulators or those individuals in charge of oversight.

Working capital

The working capital to revenue (or expense) ratio is becoming a more popular metric in measuring financial liquidity. What's included? The benchmark of 40 to 50 percent seems high based upon my portfolio.

First, the working capital to expense ratio uses total expenses including straight-line, not accelerated, depreciation as a conservative metric. If one has a producer in a stressful financial situation, depreciation could be subtracted realizing that eventually assets must be replaced. Concerning the 40 to 50 percent mark, yes, it is quite high. However, if one examines farm record data from FINBIN and state farm record systems, it will confirm that the top one-quarter of managers will exhibit this percentage rate while the bottom 25 percent of producers have metrics now, under 10 percent or in some cases, in the negative.

Working capital metrics are a must for dairy, hog, and other livestock businesses as a result of more price and cost volatility. These types of operations require a good financial shock absorber, which is working capital.

Costs

Do you have any tips on working with producers to cut cost?

There is no doubt that commodity prices are in reset. Actually, they are very similar to the revenue structure of the 2005 to 2009 time period. Producers need to determine what their cost structure was during that timeframe and start making incremental adjustments towards those levels. As lenders, if you refinance a customer's operating debt to long-term debt, the producer must develop a plan for improvement in writing using the S.M.A.R.T. standards. Specifically, that means a goal that is specific, measurable, attainable, reasonable, and timely. This strategy reduces the probability of lender liability, specifically, if the producer develops a plan. Be sure to retain a copy of the plan in the customer's file.

Concerning cost-cutting, fuel and energy costs will be down approximately 50 percent as compared to recent years. Next, fertilizer and crop input costs will also require a plan. Some reduction of input costs may occur this year, but will continue to accelerate over the next two years. One of the larger, looming issues is cash rents on leased ground. Tough negotiations may be necessary. Producers should use enterprise budgets to allocate resources to crop and livestock enterprises based upon the bottom line. In many cases, family living costs have a huge potential for reduction. Motivate producers to develop a personal family living budget and then, monitor the progress. Some lenders will stipulate that producers take a specific personal withdrawal from the business for living expenses and also, monitor credit card debt. Cutting costs is not easy or immediate. It requires planning, execution, and in some cases, scaling back the size or scope of the operation.

Risk management

What should lenders look for in a producer's risk management programs?

Your role as a lender is to ask questions and then verify that the producer not only strategizes but executes their plan. Sometimes, a producer may "talk the talk but not walk the walk." First, does the producer have the mental and emotional capacity to develop and execute the plan? Can they work with a qualified advisor? If a producer knows his or her cost of production as well as the profit thresholds, often there is already an effective marketing and risk management plan in place. Further, one must ensure that plan meshes with the cash flow obligations. Examine a customer's insurance programs including crop, livestock, and attitude towards risk. As outlined, developing a checklist of questions can be an important component of the lender-producer relationship.

Beginning farmers

What are your recommendations for working with new producers, or young and beginning farmers?

The reality of the economic reset has hit for many new and young producers. Some experienced the economic benefits of the commodity super cycle, while others did not. In working with this segment of your portfolio, it is critical to go back to the basics and work closely side by side. Education and feedback will be critical for this group. Producers open to guidance should develop a basic business plan. This includes annually updating one, three and five year goals, in writing, for their business, family and personal life. This process opens the lines of communication which is vital for initial as well as long-term success. Second, an updated balance sheet, and close monitoring of open accounts, lines of credit, and credit card debt are all essential. Young producers who develop a projected cash flow and utilize it as a monitoring device throughout the year will have a much higher probability of success. Completing the cash flow requires a producer to think through their production, marketing, and finances on paper. The big question is whether that producer can execute. Yes, there will be some attrition, but those who are proactive in planning and execution have a greater chance of long-term sustainability.

Management tip:

Throughout the year, education should be a high priority not only for your lending team, but also for your customers as well. Attending educational conferences with your customers can be extremely valuable. Often, different points and perspectives are presented that can stimulate interesting conversations to help you both better navigate the economic reset.

Global Economy

The main question for 2016 will be whether fallout from global economic turbulence will result in economic recession for the U.S.

A walk around the globe finds many oil-producing countries in a game of chicken amidst declining oil prices. Who will slow production first? Well, Saudi Arabia and the OPEC nations have approximately five years of financial reserves for a burn rate. The power struggle between OPEC nations, Russia, traditional oil-producing countries, and the new oil reserves in shale in North America and other regions of the world will be interesting to watch in 2016. Additionally, this could create more volatility in commodity markets in general.

In Europe, the moderation of economic growth will continue. Watch for the European Central Bank (ECB) to continue stimulus, which in turn may strengthen the U.S. dollar. In addition, slowing global markets could directly impact Germany's export-driven economy. The European stock market is a "bear" market, at 20 percent down for the most part, which may spill over into consumer sentiment.

Speaking of equity markets, China's exchange is a "double bear" at more than 40 percent down. China continues to struggle to convert its economy from an agriculture and manufacturing base to a consumer-based economy. One point to monitor is the tremendous amount of government and consumer debt accumulated in recent years in China. The official growth rate of the economy is measured at 6.9 percent; however, many feel this is overstated by 2 to 4 percent. Any country or industry, including agriculture, linked to China will feel considerable pressure from the slowing demand in most sectors. This pressure may also include energy and manufacturing, which directly impacts the heartland of the U.S. Additionally, Japan surprised the world with a negative interest rate. This was designed to encourage lending and stimulate investment in the economy.

Throughout the emerging markets of the world, slowing economic fortunes will ripple into the developed and rich nations. Accomodative central bank strategies across the globe can only extend but so much and eventually, the structural issues must be addressed and corrected.

Domestic Economy

The Leading Economic Index (LEI) exhibited a decline with the diffusion index registering in under 55 percent. This may indicate the start of a longer-term trend towards a slowing U.S. economy. The Purchasing Managers Index (PMI) now has been under 50 for three consecutive months, which confirms the manufacturing sector is in recession. Factory capacity utilization is in the mid-70's as compared to the high-70's one year ago. Indicatively, this important segment of the economy is in decline. Remember, these lead economic indicators predict future economic direction often three to six months before official numbers register a slowdown.

The oil industry continues to struggle. If prices drop into the teens or even into the low-20's level, the pendulum effect will most likely cause prices to exceed $100 per barrel. Despite low gasoline prices, any consumer benefit is offset due to increased medical, education, and other consumer costs.

Housing starts are steady at approximately 1.1 million annually. Low wage growth, demographics, student debt and increased regulation on lending institutions are all headwinds for this sector, despite low interest rates.

Surprisingly, consumer sentiment is above 90, which is positive. The question to ask is how long this will continue with the stock market corrections, labor force layoffs and continuation of restructuring issues.

Speaking of the stock market, U.S. equities are headed towards a 20 percent correction. This has a negative "wealth effect" on households. Specifically, when stocks rise one dollar, the consumer spends four cents more. When the opposite occurs, as it is now, the consumer spends four cents less.

For the early part of 2016, economic growth will be in the one to two percent range. However, the economic jury is still out in the latter part the year. Furthermore, the U-6 unemployment rate is at 9.9 percent which includes under-employed individuals as well as those in transition. The workforce participation rate is anemically low, dampening the positives of the unemployment rate.

With inflation near or under two percent, the growth of the economy at modest levels, and global uncertainty, four interest rate increases in 2016 are highly unlikely. The Federal Reserve should have raised interest rates two years earlier but perhaps the latest rise in interest rates may have been a buffer strategy used to provide flexibility in case of an economic slowdown or unusual event. Surprisingly, in recent U.S. Congressional testimony, Dr. Yellen, Chair of the Federal Reserve, discussed the possibility of negative interest rates. This bears close monitoring because if employed, this action could ripple through domestic and global markets and economies.

Finally, as the economy slows in the core of the country, will that extend to the coastal and southern economies? Only time will tell!

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	123.2		✓	
LEI Diffusion Index	55%		✓	
Purchasing Manager Index - PMI	48.2		✓	
Housing Starts (millions)	1.099		✓	
Factory Capacity Utilization	77.1		✓	
Unemployment Rate	4.9%			✓
Core Inflation	2.2		✓	
Headline Inflation	1.4	✓		
Oil Price ($/barrel)	$28.28	✓		
Yield Curve	1.60	✓		

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