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Refinance Screening Guide

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The renewal season for agricultural loans is now over. This first round of refinancing included equity restructuring. Specifically, some producers utilized equity on the bottom half the balance sheet, usually land, as a basis to provide financial liquidity in the current asset section of the balance sheet. Others stretched term debt over a longer amortization to reduce cash flow pressure. Of course, the good old-fashioned refinance of operating debt and accounts payable on five to seven year notes was another form of adding financial liquidity. In informal discussions, many lenders expressed concern that while the 2016 renewal season was challenging, they fear that financial conditions will worsen next year and beyond if economic conditions in agriculture and rural areas do not improve. In this environment, it is important to ask critical questions and interject objectivity into the challenge of refinancing. To aid in this process, we will examine a method by which to measure risk, or a screening guide for negative margins.

Right now, negative profit margins are a fact of life in agriculture. This is due, in part, to the cyclical nature of the industry. One of the first questions a lender must ask is whether the business profitable in the positive part of the economic cycle. Of course, one should not measure profits based off Schedule F tax records. Often, producers utilize capital expenditures as well as other expense and income options to minimize taxes. In order to accurately assess business profitability, an accrual adjusted analysis is needed. In the analysis, it is important to conduct a trend analysis rather than relying on one year.

Next, examine changes in equity on the balance sheet. Was a change the result of appreciation perhaps in land, livestock or machinery values, or true earned net worth or retained earnings? A change in net worth can be the vehicle to start open, direct discussions with the borrower concerning the business' long-term sustainability. During the great commodity super cycle, many individuals discussed the concept of building working capital as a financial shock absorber. However, an important factor was whether the stored grain, livestock, and crops in the field each had a risk management plan to mitigate market volatility.

A crucial conversation needed for many borrowers concerns family living expense. In recent years, family living cost has nearly doubled, according to many of the farm record systems nationwide. Often, family living costs are withdrawals taken after taxes are

paid. Thus, a discerning business can calculate a dollar for dollar reduction in cost by cutting this expense category.

Another critical strategy is to remove or sell unproductive assets. This is often most difficult for those producers in a growth mode. Reducing acreage and livestock numbers was a strategy that worked in the farm crisis days of the 1980s. Already a proven strategy, perhaps downsizing and a focus on profit centers will work in these challenging times as well.

Often, lending requires observation of factors outside the financial numbers and the study of human behavior. Examine the producer's history concerning marketing and risk management practices. Did the producer "shoot from the hip" or wait for the home run in regards to prices? On the other hand, was the producer disciplined enough to seek smaller profits when they occurred throughout the year? Following and executing a marketing and risk management program will not be an option, but a requirement during this economic reset.

As a result of the commodity super cycle, variable and fixed costs of production spiked. Today's economic reset will require discipline and a calculated series of cost reductions. This means careful negotiations on cash rents, as well as reductions in crop and feed costs. Many producers are beginning to experience a decline in input costs. Over the next few years, a 10 to 30 percent reduction is feasible for those with the discipline, strategy and execution to monitor cost.

All assets, including human assets, should be thoroughly examined and assessed. Difficult decisions on land, machinery, livestock and even an unproductive family member may be necessary. Sometimes the philosophy of "better is better before bigger is better" is more appealing to the bottom line.

Finally, it will be important to monitor two financial metrics during the refinance cycle. First, know the burn rate on working capital. Specifically, that is losses divided into net working capital. For example, if the losses were projected to be $100,000 and working capital $250,000, the burn rate is 2.5 or two and one-half years. If the burn rate is above 2.5 years, the business has more flexibility and time to make adjustments. Any rate under one year significantly limits options and applies a great deal of pressure to the business.

If you refinance operating money to term debt, monitor the term debt to EBITDA ratio. To calculate EBITDA, start with net income and add interest and depreciation paid before taxes. Simply put, if term debt is $1 million and EBITDA is $200,000, the ratio is 5 to 1. Rates that exceed this ratio place the long-term business sustainability in jeopardy; particularly if the financial downturn prolongs.

After completing the screening guide, tally the answers. More than eight "yes" answers indicates the refinance is probably solid. A tally under four denotes questionable long-term viability of the business and a potential credit problem. This quick guide can be

used as a tool in working with producers to objectively examine refinancing and its impact on long-term viability.

Management Tip:

For any lender refinancing an account, suggest the business develop a one-page plan of how the business will adjust and maintain its long-term viability. This plan must follow the S.M.A.R.T. principle, which includes specific, measurable, achievable, rewarding and timely goals.

Screening Guide for Negative Margins

Historically has the producer/entity:	Yes	No
Been profitable above interest rates and rate of inflation?		
Shown growth of balance sheet which is earned vs. appreciated net worth?		
Has built and protected working capital in positive cycle?		
Been able to cut living expenses if needed?		
Been able to sell unproductive assets?		
Followed and executed a marketing risk management program?		
Have the ability to cut 10 to 30% of costs?		
Been able to shed unprofitable land, machinery, livestock, & human assets if necessary?		
Had a burn rate for working capital 2.5 years or more?		
Had a term debt/EBITDA ratio <5 to 1?		

Scoring Key:
>8 Yes boxes checked = strong case for sustainability
5-8 Yes boxes checked = modest case for sustainability
<5 Yes boxes checked = very questionable for sustainability

Global Economics

The global economy is in a slow growth mode. In Europe, the “Brexit” or the British exit of the European sector has behavioral consequences on investments and consumers in this area of the world, which represents one- quarter of the world economy. In addition, immigration issues along with long-term economic issues with Greece and others slowed growth in this region of the world. In most countries, the Purchasing Manager Index (PMI) is either just below or slightly above 50 which represents a struggling economy.

China, on the other hand, continues to experience a slowdown of exports to many of its trade partners. China has repeatedly devalued its currency to gain the competitive edge in world markets. The latest PMI out of China suggests that future growth will be tepid at best. This may impact the demand for commodities and other products produced by American agriculture and in rural areas.

Brazil is moving forward with impeachment proceedings against Brazilian President, Dilma Rousseff. In addition, Rio de Janeiro will host the 2016 Summer Olympics in less than two months as fears regarding the mosquito-carried, Zika virus continue to mount. As the world’s sixth largest economy, Brazil’s impact on world economic growth must be carefully watched.

Domestic Economy

An interest rate increase in June or July was probable until the recent jobs report was released, shocking many experts. The unemployment rate declined to 4.7 percent; however, monthly job gains were only at 38,000, which was far below expectations. To compound matters, the previous two months were downgraded due to questions concerning long-term viability of the U.S. economy from the job market standpoint. The U-6 rates remained at 9.7 percent. However, job participation rate declined to 62.6 percent which means 458,000 individuals left the workforce during the time period. While one report is not overly significant, it does indicate that the next few months must be closely analyzed to determine whether this is a trend. Undoubtedly, this analysis will be a high priority for the Federal Reserve. In June, the Federal Reserve indicated that the British vote or “Brexit” impacted decisions on rates. Either way, the vote will have widespread implications.

Looking at the rest of the U.S. economy, other indicators are quite good. The Leading Economic Index (LEI) was strong increasing dramatically, almost 8/10 of 1 percent in April. Additionally, the diffusion index, positive and negative variables of the LEI, registered in positively at 90 percent.

The Purchasing Managers Index (PMI) number was above 51.3 indicating a positive economy moving forward. Of course, any number above 50 indicates an expanding economy.

Oil prices returned to the high $40 range per barrel again which provides some relief to the energy sectors, both domestically and abroad. Best estimates suggest oil prices should settle in the $50 to $60 per barrel range, unless an unusual event causes a supply or demand imbalance.

Housing starts bring a glimmer of hope for the U.S. economy as they inch toward 1.2 million starts annually. While this still is under the ideal metric of 1.5 million, steady growth above 1 million is a positive sign for the economy as the housing industry employs one out of every seven people in the U.S.

Factory capacity utilization registered in around 75 for recent months, illustrating difficulty in this sector of the economy. The strong dollar hindering exports as well as the slowing global economies do not bode well for this sector.

On inflation, core inflation, not including food and energy, registered in at 2.2 percent, within the Federal Reserve's ideal range of 2 percent. However, headline inflation, which includes food and energy, is still at 1.0 percent. Additionally, growth of the economy registered in under 1 percent for the first quarter. Inflation along with growth of the economy are variables to watch closely as predictors of Federal Reserve action.

Finally, with 70 percent of the U.S. economy in services, consumer sentiment must be carefully monitored. The most recent number was above 90, indicating strong consumer behavior in the U.S. economy.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	123.9 (April)	✓		
LEI Diffusion Index	90%	✓		
Purchasing Manager Index - PMI	51.3	✓		
Housing Starts (millions)	1.164		✓	
Factory Capacity Utilization	74.9		✓	
Unemployment Rate	4.7%	✓		
Core Inflation	2.2	✓		
Headline Inflation	1.0	✓		
Oil Price ($/barrel)	$44.80		✓	
Yield Curve	1.55		✓	

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