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Refinance and Restructure: The Filter

By Dr. David M. Kohl

The fifth year of the current economic reset places both financial and emotional pressure on agricultural producers and lenders. And when preceded by a six year economic supercycle that brought record profits, this reset can seem even harsher. In contrast, the farm crisis of the 1980s was a sharp, five year drop in farm fortunes that ended with a slow return to profitability. Today's economic downturn continues to be slow, methodical and one that I have nicknamed "the grinder." Initially, the grinder stressed profits and cash flow. Now, working capital and core equity in land are being used to cover shortfalls. As some producers face compounding losses, they are turning to their lender for relief.

Increasingly, the most common request for agricultural lenders is the refinancing of operating loans into long term debt, or what is often called "loss carried forward." Others are seeking financial liquidity by utilizing their equity. This may help provide some financial flexibility in the top half of the balance sheet, and balance current assets against the current liabilities. Because of these requests, several lenders have asked for a filter or type of guide to help differentiate those borrowers who bear the most risk for credit performance and overall portfolios, from those who simply need a bridge while adjustments are made in the business. Thus, the following checklist of questions may prove very useful in assessing the refinancing and restructuring requests of individual customers.

The first major question to ask is whether the restructure or refinancing of operating losses is the result of lifestyle habits (family living or consumption). Is the producer living within the means of the business and the nonfarm income, if present? Many lenders have commented that up to 50 percent of their current loan requests are partially or totally due to inflated living costs. Of course, the recent commodity supercycle boosted income levels, which increased draws (both in number and amount) for many farm businesses. Now, with suppressed prices and little upside, these additional draws are placing a real strain on cash flow. For many, this shows up as an increase in accounts payable, extensions in operating lines of credit, and refinancing requests.

In assessing requests, it is often necessary for the lender to engage the customer in some crucial conversations, which can be emotionally taxing on both sides. Some lenders are requesting a family living budget along with the projected cash flows. Other lenders are requiring the customer to set a withdrawal amount from the business for family living expenses. Additionally, lenders are monitoring credit cards and other short-term credit accounts. In some cases, these measures are needed to determine if adjusted practices are being followed or curtailed.

According to data from some of the farm record systems, family living expense, as a percentage of net farm income, was up to 20 and 30 percent during the supercycle. Today, the same cost categories are ranging between 40 and 60 percent of net income, particularly for the businesses in the lower margins of profitability. Especially for those with thin or negative margins, off farm income and the use of equity to refinance debt are both popular solutions.

The next item on the checklist is management habits. Is the restructuring or refinancing request a result of poor management, marketing, or financial decisions? Recently, one lender summed up this approach calling it the “lend and pretend” solution. In other words, a customer wants the lender to stretch operating losses into 20 or 30 years of financing. And the customer pretends that this is the solution for the long run viability of the business. This lender also noted that this type of approach seems more common among those with high amounts of equity.

A successful restructure or refinance almost always requires producer commitment. Specifically, customers need to develop a written plan of how they will rectify the situation. Most often this includes changes in production and costs, as well as financial and marketing habits. Along with its record profits, the recent supercyle also brought complacency in many of the basic management, finance, and marketing principles. For others, a strong balance sheet and land equity have covered for their lax practices. Yet, regardless of why the management has slipped, mounting losses require corrective action. And many times, the lender must work side-by-side with the customer to highlight factors like the burn rates on working capital and land equity. One lender shared that his largest customer was persistent in the goal to rent or lease over half of the surrounding farmland. However, much of the land was marginal and quickly eroding his financial situation. In this case, it may be necessary for the lender to acknowledge the customer’s fear about losing farm ground, while also pointing out the high-stakes result. Land competition and pride can easily and quickly deliver unfavorable outcomes for the entire business as well as a lender’s portfolio.

Another item for the checklist is the number of times a business has refinanced or made similar requests of the lender. If multiple refinancing requests persist over time, a lender must determine the cause. For example, uncontrollable events such as weather or personal tragedy can be accepted. However, if there is a pattern of refinancing or restructuring two to three times over a five to seven year period, one needs to question the future viability of that customer’s operation.

One financial practice that should also be part of the filter is working capital. Specifically, did the customer build sufficient working capital during the last positive economic cycle? If so, lenders need to assess the quality and liquidity of assets including stored grain, livestock, and crops in the field. In addition, the quality of longer term assets like land and equipment must also be regularly assessed. Remember that the value of collateral can deteriorate, which presents financial difficulty if partial or total liquidation occurs.

While many will suggest additional factors to include in this checklist or the filter questions, the aforementioned items are a good start for a solid assessment. The days of easy profits and easy credit are behind us, but this checklist of questions represents a valuable opportunity for both the lender and producer to secure sustainable profits and credit.

Lender Tip: The following questions can be used as a guide in the process of determining which accounts are viable for refinancing or restructuring. In your candid assessment, more than five “yes” answers serve as a red light, indicating high risk. One or two “yes” answers are a green light, indicating low risk; and of course, numbers in between indicate a yellow light, or caution. Remember that each situation is unique with different variables, options, and challenges. Dedicate individualized analysis and thought to each customer and business.

Refinancing and Restructuring Filter Questions	Yes	No
Are there poor lifestyle habits (family living, killer toys, etc.)?		
Are there poor management habits?		
Are there poor marketing and financial habits?		
Was there failure to build working capital during positive economic times?		
Have there been uncontrollable events (weather or personal tragedy)?		
Have there been multiple requests for refinancing or restructuring?		
Are collateral assets (land, equipment, and livestock) in poor quality?		

Global Economy

The global economy is in a synchronized growth pattern, and over 90 percent of the equity markets have been in a positive territory over the past 12 to 15 months. This, of course, stimulates the wealth effect. That is, when paper wealth in the stock market increases, consumer spending is stimulated. This is often called behavioral economics, which is becoming more and more mainstream in the profession of economics.

Concerning global economic trade agreements, specifically CPTPP and NAFTA, attention is warranted. For all those involved and interested in agriculture, trade is front and center on the radar screen. And agricultural trade is being commingled with the manufacturing and technology negotiations, which only heightens the importance of the deals and their potential impact on agriculture. Many do not understand that the outcomes of negotiations with Canada and Mexico may go well beyond agriculture, but are nevertheless undeniably tied.

Another negotiation to watch closely is the small grains deal with China as it relates to possible U.S. sanctions on steel and other Chinese goods. This deal may serve as a bellwether for future outcomes in similar deals. Actually, U.S. trade agreements with Asian countries and others must be examined carefully as 20 percent of net farm incomes depend on agricultural export and trade.

In an accelerating trend, Central Africa may become the new Saudi Arabia as more countries move away from internal combustion engines to electric and alternative sources of power. Many of the various components of these batteries such as cobalt, lithium, magnesium, and others, are mined in Central Africa. Yet, many major mining projects are in areas that are unstable politically, militarily, and socially. In addition, China also has sources from which to supply these specialized inputs, which may well place the U.S. at a strategic disadvantage. And as agriculture becomes more dependent on technology, it increases its exposure to the availability of these minerals and metals.

Domestic Economy

The U.S. stock market has been a wild ride that has everybody watching for the next move. Is it a new trend of increased volatility? How high and how fast will new U.S. Federal Reserve Chairman Powell raise rates? Let’s examine what the economic indicators can show us.

The LEI (Leading Economic Index), the bellwether of future economic growth, is still in a positive mode. Confirmed by the diffusion index, this is a good sign for the short term status of our economy. Of course, the U.S. is now going into record territory, possibly exceeding 106 months of expansion over the next few months, which is the second longest economic expansion in the history of this country.

The Purchasing Managers Index (PMI) remains well above 50, indicative of an expanding economy in the manufacturing sector. Actually, the PMI has been above 50 for the majority of the past two years, which shows that factories are gearing up to be a major part of the domestic economic growth.

While it did temporarily spike to above $60 per barrel, oil is now back into the $40 to $60 per barrel range, as previously predicted. The movements toward alternative energy, electric vehicles, and urbanization place resistance on rising oil prices. And the oil fields in the U.S. are quite competitive, producing oil in the $50-$60 per barrel range, making the U.S. the largest oil producer in the world.

Unemployment is still in the low 4 percent range with the possibility of dropping into the high 3 percent range, which is record territory. Throughout business and industry, one easily notices wage inflation creeping in, which can lead the way for inflation. For instance, Disney just implemented a 9 percent rise in ticket prices after a one-time raise for all their employees. Will other companies follow?

In recent months, housing starts has exhibited strength rising into the 1.2 to 1.3 million annual range. The most recent recording was well over 1.3 million annual housing starts. However, the rise of long-term interest rates could be a headwind to this important sector of the economy.

Of course a new tax bill and emphasis on the manufacturing sector has placed factory capacity utilization in a bullish range in the high 70s. Moving forward, it will be very interesting to see whether international trade deals assist or hinder this sector.

Recent reports on Consumer Price Index (CPI) and Producer Price Index (PPI) point toward an increase in inflation. This component of the economy should be closely monitored over the next few months as a possible indicator of interest rate hikes.

The fourth quarter GDP (gross domestic product) was under the projected 3 percent, which temporarily slowed the steady rise of interest rates by the U.S. Federal Reserve. And consumer sentiment is still well above 90, illustrating a confident consumer. However, this same consumer confidence is closely correlated with future economic growth, as well as stock market earnings. Over the next few months, watch the direction of the stock markets, both domestically and abroad. Will there be a permanent correction? What will happen with international trade negotiations, and will they back the market? Of course, there are still several key positions in the U.S. Federal Reserve to be filled. In short, there is much that is yet to be determined, so stay tuned!

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	94.9*	✓		
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	54.1	✓		
Housing Starts (millions)	0.699			✓
Factory Capacity Utilization	78.5%		✓	
Unemployment Rate	8.3%			✓
Core Inflation	2.3%		✓	
Headline Inflation	2.9%	✓		
Oil Price ($/barrel)	$111.11			✓
Yield Curve	1.74		✓	

*The LEI underwent comprehensive benchmark revisions at year-end, so regardless of the apparent decrease in the index value from the previous article, the LEI actually increased 0.5 in December and 0.4 in January. For details, see the press release at this link: http://www.conference-board.org/data/bcicountry.cfm?cid=1

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