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<u>Refinancing: Bridge or Pier?</u>

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The current agriculture economic cycle has some similarities to the post-commodity super cycle period from 2007 to 2012. In that era, commodity prices declined but inflated costs and interest rates did not occur. The result was seven years of reduced profit margins, known by some as the “grinder years" or wandering in the “profit desert.” During that period, zero-bond interest rates and returns on comparable investments allowed land and asset values to increase. As a result, the net worth on many balance sheets increased due to inflated asset values, or paper wealth, which brought some sense of financial prosperity.

Fast-forward to today's environment, a post-mini super cycle that was a result of the pandemic. Initially, profits were spurred by high prices before inflated expenses and interest rates reduced margins. Next, record levels of government stimulus paid to producers with zero cost of production resulted in land value increases and strong working capital and cash positions.

The economic era we are approaching at the quarter-century mark appears to be one with margin compression as a result of moderating commodity prices and stubborn inflation in the agricultural sector, along with higher interest rates that are resilient to lower adjustments. In this economic cycle, the number of requests to restructure losses to longer-term debt as a result of financial adversity in the business and household will naturally increase. Some of the requests will come from existing customers, while others will be the result of other lenders’ customers attempting to find a new home for their financing. At the lending schools, we jokingly call these “stray dog” credit requests. One must be very careful with these credits as sometimes stray dogs will bite you!

When refinancing debt, one has to quickly determine if the loan restructuring has a high degree of success. Is the restructuring building a bridge for successful business continuity? Or is it providing an additional debt load that moves the business toward the end of a pier, where the options for success are fewer and the water, or in this case the debt, is deeper, resulting in a higher probability of adverse outcomes?

The Call

One must first assess what caused the refinancing request. Often, multiple adverse weather events or sudden changes in the marketplace are the culprit. Historically, growth plans that went awry as a result of cost overruns or market production expectations not meeting projections are also observed. Of course, mismanagement of the business, particularly in the areas of finance and marketing, is often the culprit. Inflated family living withdrawals or investments in nonproductive assets, better known as “killer toys,” can also result in financial stress.

Business transition is now becoming an issue as the baby boomer generation ages out. Of course, the deadly D's (death, disease, divorce, and disability) and other life events can often disrupt and drain energy from business and financial operations.

The Bridge

Usually, a debt refinance is a two-way street. First, the borrower must pledge more assets as security or provide a cash call to shore up operations. The lender will often term out the operating monies to provide financial liquidity for ongoing operations. The longer-term debt payments are generally higher, particularly in today's higher interest rate environment. This is why a debt restructuring can influence the cost of production and breakeven points for a long time. The lender must monitor the preservation of working capital through a debt restructuring. If one is not careful and adjustments are not made to the business spending or financial habits, another refinancing request can quickly arise.

Based on my experiences, turning this two-way street into a solid bridge requires focus, intensity, commitment, monitoring, and communication. From the lender’s perspective, a problem account will require four times the amount of time, money, and effort than a performing account. Similarly, the borrower must devote considerable time and resources and have a sound financial system to be successful.

The parties involved in building a bridge must outline short- and long-term goals in writing. Often, this happens during the discovery process, and one will quickly find out the commitment of the parties involved. Sometimes, a partial or total liquidation in this stage can reduce the losses on both sides.

Next, up-to-date inspections and financial statements, including the balance sheet schedules of inventories and debts, are critical. A monthly or quarterly cash flow, developed by the borrower, can be a powerful tool. In some cases, the borrower may require some assistance from others, but it is important that the borrower take the lead on the cash flow to create buy-in. The cash flow is 80 percent of a business plan because one has to think through operations, marketing, risk management, and finances on paper. Monitoring these financials monthly and quarterly can quickly determine whether the business and management have the capability of executing a turnaround.

The cash flow must include best-, average-, and worst-case scenarios to provide the financial guardrails for outcomes. In many cases, positive cash flow outcomes can be a motivational tool for both the borrower and lender. Scheduled meetings between the borrower and lender with cash flow outcomes can be a great communication moment critical for success.

Another important component of a successful bridge is monitoring the family's living expenses, particularly if they have been an issue in the past. This sometimes requires a personal cash flow along with the business cash flow in the credit workout. In some cases, a defined family living withdrawal is determined so that the borrower lives within the budget. Lenders must be careful to monitor credit card usage and other sources of credit, including relatives and friends, to determine whether abuses are occurring.

Finally, the business IQ assessment that I have developed and presented at numerous lending schools and conferences is an excellent tool to assess the bridge versus peer concept. My experience in working with distressed credits finds a score above 32 is usually required for success. A score under 25 often finds that a refinance is moving the borrower toward the end of the pier, which often leads to higher debt, fewer options, and adverse outcomes. In conclusion: hopefully, this article can stimulate some thought on distressed credits as the current economic environment evolves.

Global Economy

Economic stress would be the overall theme for the global economy outside of the United States. Japan recently went into recession mode with consecutive quarters of negative growth. Japan's economy slipped to the fourth largest economy behind Germany on a global basis. Despite this, the Nikkei 225, a Japanese stock market index, has been climbing to the high 30,000-point range not seen since the 1989 peak level.

China's economy is in an accelerating trend resulting in cuts in interest rates and capital requirements at banks to loosen credit. Recent data from China finds that the one-child policy, in place from 1980-to 2016, has resulted in declining population numbers, which, of course, hinders economic growth. If they were segmented into one population, individuals over 60 years old in China would comprise the fifth largest population in the world, which places pressure on the Chinese health system and social programs.

Deflation and a reduction in paper wealth are impeding economic growth in China. Both commercial and residential real estate are down more than 35 percent, very similar to the financial crisis here in the United States in 2008 and 2009. Eighty percent of Chinese citizens' wealth is in real estate compared to 30 percent in the United States, which is deterring spending.

The stock market exchanges in China are down 35 to 40 percent. In China, eight percent of the individuals own approximately 60 to 65 percent of total equities. Many of these individuals were born in the decades of the 1960s, 1970s, and early 1980s and were the beneficiaries of pro-economic growth policy in recent decades. Many of these Chinese investors are observing their paper wealth, achieved through asset appreciation, suddenly disappear. In China, people often call an investment that has gone bad a “landmine explosion,” which is predominant in the financial landscape there. The question becomes: Is this the beginning of a trend that could occur worldwide where paper wealth gains, which were fueled by loose fiscal and monetary policy and low-interest rates, shrink?

Moving to Europe, Great Britain, Germany, and the major economies on the global front are in recession. The remainder of the euro sector has generated enough growth to have an overall growth rate of 0.10% for the whole region. Europe will continue to be challenged by the wars while attempting to maintain support and unity. From an agricultural perspective, monitor the “greenlash” movement that started in the Netherlands and is now expanding to Germany, France, Spain, and Italy. The support for agriculture by the general public versus negative political stances on agriculture by politicians will be interesting to observe, including whether it spreads worldwide.

Over the next few months, watch the results of the elections in India and Mexico. These elections could impact trade including export and import restrictions and sanctions.

Overall, the get-rich schemes as a result of government spending and strategies and the resulting impact on paper wealth are definitely in a correction mode. Will it spread to the United States?

Domestic Economy

In my travels this winter, my observations would suggest a booming economy. Hotels and airports are full of vacationers and families traveling with youth sports teams. It appears people are spending money like "drunken sailors with no end in sight." Examination of some of the leading economic indicators would suggest similar trends, while others forecast a bleaker picture.

The Leading Economic Index (LEI) has been in a recessionary stance for over a year, declining each month. The Index of Consumer Sentiment, reported by the University of Michigan, indicated two months with readings above 75 for the first time since 2022. This is a positive sign because consumer spending drives two-thirds of the U.S. economy. However, if one analyzes the Purchasing Manager Index (PMI), it is still below the 50 mark indicating a contracting economy, but above recessionary levels.

Unemployment numbers are very strong, at 3.7 and 7.2 percent for the U-3 and U-6 unemployment rates, respectively. However, storm clouds may be on the horizon. One thing that we are seeing is that white-collar and tech sector layoffs are accelerating as companies shed middle management. Businesses are investigating artificial intelligence to thin the workforce as a strategy for possible difficult economic times.

The headline inflation rate is at 3.1 percent, below the established goal of 4.0 percent. However, core inflation remains stubbornly high at 3.9 percent, well above the ideal metric of 2 percent. This is the result of high housing and medical costs, which are a large percentage of the core inflation rate.

Another factor to keep in mind is the contraction of the money supply and the rate of deficits and federal debt increases. This could have some long-term implications for the U.S. economy. Overall, the U.S. economy may be walking a tightrope. The Federal Reserve is likely to be very measured about interest rate increases or decreases.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	102.7			✓
LEI Diffusion Index	35%			✓
Purchasing Manager Index - PMI	49.1		✓	
Housing Starts (millions)	1.331		✓	
Factory Capacity Utilization	78.5%	✓		
Unemployment Rate	3.7%	✓		
Core Inflation	3.9%		✓	
Headline Inflation	3.1%	✓		
Oil Price ($/barrel)	$82.94		✓	
Yield Curve	-1.41			✓

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