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<u>Renewal Season Readiness Kit</u>

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The cold winds descending from the North are a sign of the changing seasons. For agricultural lenders, this marks the beginning of the renewal and request season. And in some cases, the lack of communication or avoidance of issues by the customer may foretell refinancing or loan extension requests to come.

The economic reset is entering its fifth year, which likely means some candid and crucial conversations will take place this renewal season. There is no magical cure for commodity prices and even short-term optimism for a rebound is low. While there are some similarities to the 1980s farm crisis, today's economic reset is different because of its elongated nature. Of course, as it persists, more challenges will be presented.

Approximately 40 percent of producers are making changes and in a position to be selective in growth opportunities. Another group has zeroed-out their working capital, and carried over their lines of credit; while businesses in the lower end of the spectrum are riding on their equity, particularly in land. Of course, each group hopes for the return of higher prices and profits, but some are experiencing significant deterioration on the balance sheet while they wait. With customers in a wide range of financial conditions, let's examine some of the focus areas and tools that should be included in a readiness kit for the 2018 renewal season.

First, conduct a three to five year analysis of profits and cash flows. And while accrual analysis may be an intimidating process for some, it is important to focus on the answers to the following questions before turning to the numbers. The answers to these questions will spur the critical thinking needed to organize discussions with the customer and form the basis from which the numbers should be examined.

1. What is happening to inventory numbers? Are they up or down?
2. Is there a marketing and risk management plan on the inventory?
3. How much of the inventory is stored? And how much must be sold at what point in time in order to meet cash flow?

4. What is the change in the level of accounts receivable and are they collectible?
5. How much cash is present on the balance sheet that has not already been committed?
6. What is the direction of accounts payable or vendor financing? Are these creditors a temporary bridge for shortfalls in cash flow or profits?
7. Have accrual expenses changed? If so, in a positive or negative direction? And has the strategy of prepaid expenses shifted in a way that denotes further financial stress?
8. Are the current assets sufficient to offset the operating lines of credit? And will there be a deferred tax liability when current assets are sold that may have already been counted as an expense?

With this background information, the next focus area needs to be family living withdrawals. Remember, there is no average or normal based upon numbers because there is a $40,000 to $70,000 variation in family living withdrawals between businesses of similar size and scope. The best tool in the readiness kit for this discussion is an example of family living budgets found in various farm record systems. Many of these databases break down family living budgets into individual components that can be useful for customer benchmarking. Recently, some lenders have indicated that up to 50 percent of refinancing requests of operating monies are not necessarily for business losses, but rather for lifestyle and personal spending habits. Other producers are facing the challenges created by their past tax strategies where tax payments were minimized instead of managed. Now, tax payments are due when the customer can least afford them, which necessitates the sale of assets to meet cash flow needs.

Another tool in the readiness kit is the burn rate on working capital and core equity. To calculate the burn rate, divide cash flow losses into excess working capital (including unencumbered land equity). This tool interjects a logical, reality-based approach to the future of the business. Further, when examining the burn rate, spouses and partners should be included in the process. This bolsters transparency in conversations, conveys the reality of business losses, and provides a time frame in which to work. In addition, the burn rate also draws attention to the preservation of wealth for long term needs. Especially if the burn rate indicates urgency, it is important to be proactive in developing liquidation strategies (partial or total) early when demand for assets remains strong, and there is still time to manage tax strategies for the overall obligation.

Whether dealing with an adverse or opportune situation, the next tool in the readiness kit is the customer's plan of action. This plan should be in writing and include goals with projected cash flows including price, cost, production, and interest rate scenarios. A schedule for monitoring should also be outlined (monthly or quarterly) so all parties are clear on responsibilities and obligations from the beginning. The majority of plans are most effective if kept to three or less action items, which then need to be monitored closely. Lastly, it is wise to include follow-up actions or ramifications if the plan is not implemented.

Finally, one of the more important tools in the lender readiness kit is an assessment of character, as measured through actions. Are the borrowed monies being used as agreed upon? Is vendor financing consistent with what was reported? Are assets and liabilities reported accurately and do inspections confirm the numbers? Of course, mistakes can happen, but outside of 10 percent variation, one may need to ask if the inconsistency was an oversight or an issue of character.

An additional sign of character can also be the customer's openness to suggestions and changes. Is the customer willing to take advantage of educational opportunities and implement the needed adjustments? Complacency and resistance to change can make a difficult situation much worse.

In summary, the lender readiness kit includes asking questions regarding the top half the balance sheet, initiating crucial conversations concerning lifestyle choices, calculating burn rates on working capital and core equity, and requiring a written plan of action from the customer. Of course, the fifth tool of character assessment requires careful and subtle observation, but is the one tool that provides balance and perspective in a lender's readiness kit for this year's renewal and request season.

Management Tip: Observe credit card balances. Horror stories are emerging both on the business and personal sides of finances related to high credit card debt.

Global Economy

The global economy is showing signs of growth. According to *The Economist*, growth will be in the 3 1/2 to 4 percent range in 2018. In Europe, the reelection of Chancellor Merkel brought with it economic and political stability for this region of the world. However, one issue to continue monitoring is the success of populist parties in European elections.

A long-term trend to observe in France and Germany is a movement toward electric vehicles (EV). Their goal is to minimize the use of internal combustion engines for transportation by 2040. Of course, this could have lasting implications for the energy sectors across the globe, but also presents challenges in acquiring sufficient natural resources for production.

Similarly, China is following France and Germany's lead on the increased incorporation of EVs. By 2025, China's goal is have up to 25 percent of their vehicles be EVs. For the world's most populated country, and the second largest economy, this initiative will be a game-changer for the world.

Another trend in China is the movement away from standard currency or cash. Over 50 percent of transactions in the country are now digital; and many consumer transactions, such as those at McDonald's and other fast food chains, are moving away from cash transactions completely. Of course, China faces significant debt issues in the consumer, corporate, and real estate sectors. This necessitates close monitoring as disruptions in these areas of China's economy could ripple throughout the world economy.

Nations such as Brazil, Russia, and South Africa are struggling both economically and politically. The wildcard in geopolitical risk is North Korea; not only because of the nuclear threat, but also from possible cyber-attacks.

Domestic Economy

Inside the borders of the U.S., economic expansion is on the cusp of the 100th consecutive month with no sign of abating. And analysis of the economic indicators finds a forecast for continued growth.

The September Leading Economic Indicator (LEI) fell by 0.2, which may in part be due to recent hurricanes. However, in spite of the decrease the trend is still consistent with economic growth. The diffusion index is at 60 percent, which shows that six out of the ten indicators that comprise the LEI also remain positive for growth. Continue to monitor the LEI going forward to determine whether a trend is forming, or this indicator simply experienced a temporary bump in the road.

Oil prices have remained quite resilient despite recent, major hurricanes and OPEC's reduction of oil production. In the high $40 to low $50 range, current oil price illustrates the independence of the U.S. from foreign oil. This is a result of a domestic increase in oil production, alternative sources of energy, reduced demand due to increased usage of public transportation, and overall improved fuel efficiency in vehicles.

The Purchasing Managers Index (PMI) is strong and above 60 for the first time in a number of years. In addition, the PMI in major economies around the world are following this lead, registering in above 50, favorable for worldwide economic growth.

Unemployment hit a record low of 4.2 percent (U3) and 8.3 percent (U6). These numbers would foretell wage pressure; however, the movement toward automation, robotics, asset lite strategies, and systems efficiencies in major companies throughout the U.S. are driving down the possibility of wage inflation.

Housing starts are still in the modest range of 1.1 to 1.2 million annual starts. This is reflective of the Millennial Generation with large amounts of school debt and conservative attitudes towards investments, including home ownership.

Factory capacity utilization appears to be quite strong in the high 70 range. From discussions with various manufacturers throughout the country, orders are strong both domestically and globally. This may in part be due to the weakening of the dollar, which makes U.S. goods and some services more economically attractive in overseas markets.

Consumer sentiment remains quite strong despite the hurricanes, flooding and fires that continue to plague major population regions of the country. Well above 90, the strength of this indicator is partly due to stock market performance which stimulates the wealth effect, or the feeling of wealth for consumers. Of course, this feeling spurs spending. Interestingly, consumer sentiment recently hit 101.1, going above 100 for the first time since 2004. However, one needs to ask if this number too high.

Finally, inflation bears watching. The Producer Price Index (PPI) was up 0.4, indicative of inflation. Headline inflation rose due to increases in energy prices. The question now becomes whether core and headline inflation will continue to sustain their current levels over the long run.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	128.6		✓	
LEI Diffusion Index	60%		✓	
Purchasing Manager Index - PMI	60.8	✓		
Housing Starts (millions)	1.127		✓	
Factory Capacity Utilization	76.0		✓	
Unemployment Rate	4.2%	✓		
Core Inflation	1.7%	✓		
Headline Inflation	2.2%	✓		
Oil Price ($/barrel)	$55.59		✓	
Yield Curve	1.27	✓		

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