FARMER MAC

DAVE'S GPS

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<u>Spectrum of Performance Possibilities</u>

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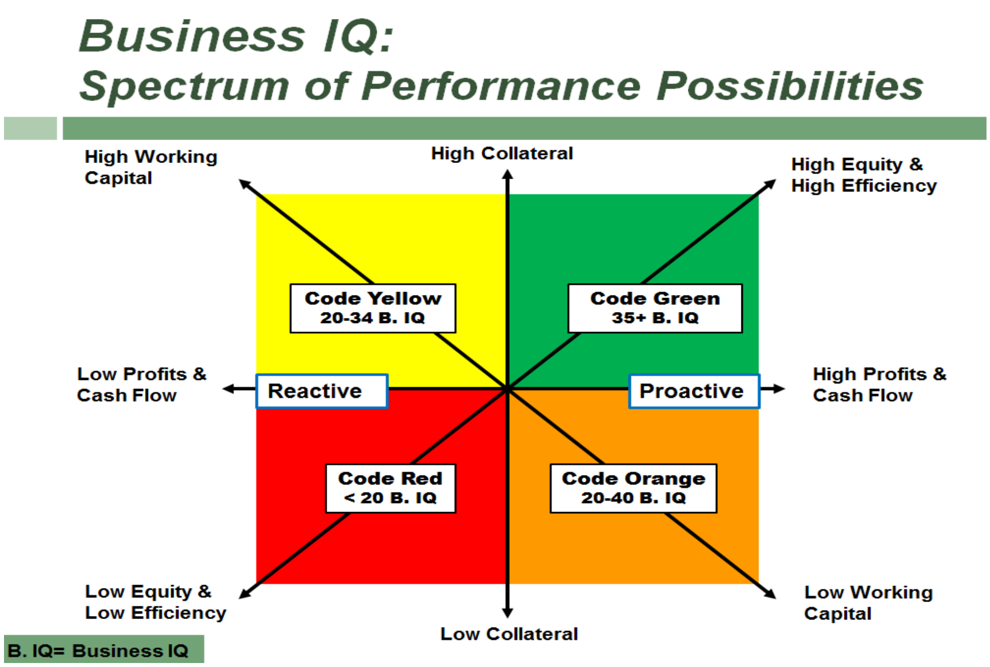
It is an honor to work with Farmer Mac and the FINPACK team from the University of Minnesota’s Center for Farm Financial Management during the pre-conference seminar each year at the American Bankers Association's Agricultural Bankers Conference. This year in Dallas, Bob Craven and his FINPACK team set the stage by segmenting customers within an agricultural lender’s typical portfolio. In the spectrum of possibilities, they are either paddling, moving forward, treading water, or bailing water and ready to sink. Classifying the portfolio was a challenge and after considerable thought, a matrix was developed with four quadrants (Figure 1). Let's examine a few characteristics of each category, which will stimulate some thought as you evaluate your portfolio this winter.

The north half of the spectrum contains producers with both strong equity and collateral. Conversely, producers in the south end have low equity and collateral. The eastern, or right half, represents producers with high profits and strong cash flow. Finally, producers with low profits and weak cash flow are in the western half.

Figure 1:



Green Quadrant
The northeast quadrant, color coded green, represents producers in the position to grow the business and the agricultural lender must wear the business development hat. Some of the financial characteristics of this group include 60 percent or greater equity and working capital to expenses greater than 30 percent. Next, the operating expense to revenue ratio, excluding interest and depreciation expenses, is generally under 75 percent over a three-year accrual adjusted average. The term debt to EBITDA ratio is under 2.5 to 1. Concerning management, this segment is very proactive and has a strong business IQ score above 35. Please see previous articles for more information about evaluating business IQ. Another characteristic of this group is discipline and growth. When it comes to marketing and risk management, this group strives for “base hits” rather than home runs.

Yellow Quadrant
The next group is in the northwest quadrant of the performance possibilities. This can be a frustrating segment as equity in land and other assets is present. However, these producers lack profits and cash flow. Working capital will range from high, just after a refinance, to low a few years after a debt restructure. This is a result of very little improvement of net farm income or other earnings. However, equity reserves are still strong, which makes this quadrant attractive to agricultural lenders. Specifically, this segment will exhibit high equity above 70 percent when considering appreciated versus earned net worth. Working capital to expenses will often be above 20 percent as the lender replenishes this important variable. The culprit lies in the operating expense to revenue ratio, excluding interest and depreciation expenses. The ratio is often above 80 to 85 percent. The business IQ of this group is frequently in the 25 to 28 range and some producers will have competitive issues within the industry. This group has another Achilles' heel. If a son, daughter, or other younger partner enters the business, clashes often occur in transition management. The older generation is set in their ways, while the youth want to move forward with innovation and adaptation. This clash can be very gut-wrenching for lenders to observe and can often be the biggest financial risk.

Orange Quadrant
Next, let's move to the orange segment. This group is where the very young, beginning, and growing farmers and ranchers reside. The southeast group can either be bailing water toward red or paddling toward green. This segment of producers has some of the biggest risk, but also some of the greatest opportunity.

The financial characteristics of the orange group that are paddling forward toward the green group include a high business IQ, often above 38. They are profitable with a return on assets (ROA) above six percent. This is achieved through operating profit margins, asset turnover utilization, and efficiency of capital assets. Other characteristics of this group are modesty and sacrifice in family living withdrawals and a multi-dimensional stream of revenue. Sometimes the diversified revenue comes from outside the business and can include contract labor, W-2 income, or side “gig” businesses. The percent equity is often under 50 percent, which creates fear for many collateral lenders.

Within the orange group, there is a segment bailing toward red. This group of producers will often exhibit a low business IQ score of less than 28. Financial characteristics of this group include profit issues because of a lack of "earns and turns," or net farm income and asset turnover. In some cases, specialized assets or revenue streams in this group places them in the high-risk category. Another characteristic that sets them apart is higher than normal living costs coupled with less than 50 percent equity. Frequently, agricultural lenders will utilize Farm Service Agency (FSA) guarantees to mitigate the risk and closely monitor business activities. The southeast corner on the spectrum of performance possibilities is where the lender has to rely on more than a credit score and be a relationship-based lender.

Code Red!

The southwest corner of the financial spectrum is the dreaded area. Low business IQs and reactive management are often characteristics of the group. Equity is limited and working capital is frequently negative. The operating efficiencies are often lacking with an operating ratio consistently over 90 percent. Excessive living costs above what off-farm income can cover can also be a culprit. The attitude of this segment also factors into the equation. The "victim" always plays the blame game, including blaming the lender. The "know it all" is the alpha producer who always seems to have the next big thing or home run that is going to solve all of the financial issues. A characteristic of this group is that they often will seek other lenders as last resort financing. This is happening more often in the agricultural lending field, particularly during this extended downturn. Remember, up to 50 to 60 percent of your time can be spent on this group, to the detriment of other producers.

Practical Exercise

How can the spectrum of performance possibilities be utilized? First, have business development and risk mining exercises with all of the staff. Individually allow them to place customers' names and businesses in each area. Next, examine prospects in the exercise. This can be a useful tool to prioritize business development opportunities and to identify and quantify risk.

Next, what are the strategies and actions that could move your customers into other segments? This can be useful in developing pathways to monitor customers throughout the year or year-over-year. One of the keys to success will be the business IQ, which will be a difference maker for your customers in a low margin, high volatility industry.

Domestic Economy

The U.S. economy has kicked off the new decade with a robust start. The economic expansion is in record territory with 129 consecutive months of growth and counting. The economy appears to be picking up momentum. Let's examine the economic indicators to gauge the health of the economy.

The Leading Economic Index (LEI) is showing very few signs of a recession in the next six months. In recent months, the indicators have been flat with both positive and negative deviations. However, there is no definitive trend. The diffusion index has been above 50, which means that over half the indicators making up the LEI are in positive territory.

Moving to the Purchasing Manager Index (PMI), this indicator was below 50 for five months, indicating a constricting manufacturing sector. However, the PMI increased slightly in January to above 50. It will be interesting to see how the United States-Mexico-Canada Agreement (USMCA) and recent trade deal with China will affect this metric both in the U.S. and globally. Disruption in supply chain management, reduced global demand in the manufacturing sector, and a cut in capital investment have all combined to make a rough stretch for the manufacturing industry in the U.S. and abroad. While many economists say the manufacturing industry is small, keep a close eye on the PMI because it can ripple through other parts of the economy.

Moving to oil, stability is the keyword despite military offenses by both the United States and Iran in recent months. This is indicative of the strength of supplies being generated in the U.S., Canada, and Mexico. Stable oil prices bode well for both agriculture and non-agriculture interests and the general economy.

Housing starts increased in December to over 1.6 million units annually, the strongest number reported in over 12 years. Despite withdrawing slightly in January, housing starts have finally reached the magic number of 1.5 million units annually following the Great Recession of 2009. Low interest rates and the millennial generation moving into home ownership may give this metric some strength for 2020. In addition, record low levels of unemployment for an extended period of time has been a contributing factor to stronger housing starts.

Speaking of unemployment, recent numbers are very similar to the past five or six months. The U-3 and U-6 unemployment figures are very positive. Despite job numbers being down in recent reports, finding and retaining qualified workers for both agriculture non-agriculture interests is a real challenge.

Moving to factory utilization, the numbers are in the range expected for a sector that has been struggling. New, post-trade deals will need to be closely watched for this sector to rebound.

Inflation and interest rates appear to be very benign despite some rise in headline inflation due to oil price increases. If oil prices continue to increase, expect very little change in interest rates, particularly given it is an election year.

The Index of Consumer Sentiment, measured by the University of Michigan, remains high at above 90. Low unemployment, along with low inflation and robust stock and real estate markets, are resulting in “all systems go” in consumer spending.

Global Economy

The passage of the USMCA and a trade deal between the U.S. and China should provide more free flow of goods and services globally. China's recent economic growth was reported at 6 percent. This is solid growth given the trade sanctions with the U.S., a large purchaser of Chinese goods and services. The U.S. taking China off of the currency manipulation list should also be positive for the second largest economy in the world. It will be interesting to see if China continues to aggressively invest in the Belt and Road Initiative in 2020 and whether a second trade deal will be in the works with the U.S. Another factor to consider is the relationship between China and Russia for export and import opportunities and resources. It will be interesting to see the impact of both Russia and China’s relationship with various European economies.

Currently, the European economy is in a slow growth mode as we move into 2020. The German elections and the Brexit process must be closely watched to determine the economic health of this region of the world.

Southeast Asian and Japan will need to be observed to determine whether the economy will continue to ascend similar to 2019. At the beginning of 2020, the U.S. appeared to be the stellar economy uplifting the global economy. The key question is, will this continue?

P.S.
It is too early to determine how the coronavirus outbreak will impact the global economy. More updates on this situation will be forthcoming.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	112.1		✓	
LEI Diffusion Index	85%	✓		
Purchasing Manager Index - PMI	50.9	✓		
Housing Starts (millions)	1.567	✓		
Factory Capacity Utilization	76.8		✓	
Unemployment Rate	3.6%	✓		
Core Inflation	2.3%		✓	
Headline Inflation	2.5%	✓		
Oil Price ($/barrel)	58.80		✓	
Yield Curve	-		✓	

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