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<u>The Management Factor</u>

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The economic reset is now passing the half way mark of the decade. For five years, reduced margins and in some cases, compounding of losses have plagued most agricultural sectors. And with little hope of a fast turnaround, some lending institutions are being forced to re-examine their systems of risk analysis in extending credit.

Recently, one institution I started worked with many years ago, indicated they were increasing the management factor in their risk-rating system, but were struggling to objectively evaluate it. This institution, in particular, was struggling with the objective because of the barbell effect in their lending staff. That is, their tenured staff with institutional memory are retiring, as the younger and less experienced staff continue to enter the industry, leaving just a few in the middle. Thus, in order to objectively quantify, define, and evaluate the management factor, let's draw from some recent research and real-world observations.

While struggling to define it, this institution is astute to include the management factor in its analysis because management practices are undoubtedly dividing the producers who are performing economically from those that are not. Of course, there are spectrums on both sides of the profitability scale, but many of those that are struggling are also losing dramatic amounts of equity. This trend is confirmed by farm record databases, which clearly outline this division regardless of size, enterprise, or geographic location.

First, the management factor is largely defined by the intellectual capital of the business. In fact, in the next few years, intellectual capital versus financial capital will not only be a barrier to entry into agriculture, but also to the ability to perform throughout economic cycles, market shifts, and structural adjustments that can occur rapidly in the industry. In particular, the importance of intellectual capital increases as the business grows in revenue and the complexity of management. This is true not only for family members, but for nonfamily parties as well.

Conceptually, there are four cornerstones of management: planning, strategizing, executing, and monitoring. Often, the better performing farms and ranches have the resources to formally plan, whether it is production, marketing, finances, labor, or the systems approach. Next, those that exhibit these four steps are more strategic in approach than tactical. They also tend to be proactive instead of reactive. These managers recognize the priority of the $10,000 decision over the $100 decision. They also execute their strategies through people and technology, accepting any consequences from their executed plan. Finally, they have in place a system to monitor performance. This includes production, marketing, finance, and overall efficiency, which often equate to bottom line results.

With this overview of management basics, what are some of the objective factors agricultural lenders can use to evaluate the management component and the risk it presents in credit analysis?

One of my favorite qualifiers for the management factor is knowing the cost of production. And if multiple enterprises exist, or multiple sources of income, an idea of how much comes from each is critical. In a recent nonscientific study, over 400 producers used anonymous, individual response pads to answer the question of whether they knew their cost of production for each enterprise. Only 23 percent had a good idea of their production cost. Without the knowledge of production cost, producers may need to refinance their lines of credit, perhaps every two to three years. Others will compile multiple losses, while others will attempt to produce their way out of their financial issues by boosting yields, and cost.

The next objective evaluator of the management factor is goals. Does the producer, have written goals for the business, family, and individual, both for one and five years out? Among the producer group of 400, only 14 percent of the business owners and managers had well-defined goals, regardless of size. Yet, this step often tends to bring focus and efficiency, which is critical in periods of suppressed economic margins, or equity erosion.

Another factor to include in the evaluation is the record-keeping system for the business. As seasoned agricultural lenders will attest, quality records and their application to the business strategy is usually a differentiating point for positive profits and cash flow. In addition to the record-keeping, does your customer review and utilize the information regularly? Those producers that do a financial drive-by review every year before turning their books over to an accountant are forfeiting a valuable opportunity to impact their bottom line. And often, these producers instruct their accountant to minimize taxes instead of managing them. It is also important to determine if the producer manages from the Schedule F, or if accrual analysis is performed. Of the 400, approximately 14 percent actually completed accrual income statements. While this accounting approach is a good idea for all businesses, it is a necessary requirement for the larger and more complex businesses.

Next, when evaluating the management factor, one should consider whether there is a projected cash flow, and perhaps more importantly, what is the attitude towards completing a projected cash flow. In most cases, a projected cash flow is 80 percent of the overall business plan because it forces one to think through production schedules, marketing schematics, revenue, cost, finances, debt service obligations, family living, taxes, capital expenditures, and maintenance. Of this same group, only 19 percent had completed a cash flow projection.

Along with the cash flow projection, another sign of good management is the sensitivity analysis conducted on the projections. In a book I wrote years ago, *Weighing the Variables,* I suggest including a 5 percent drop in revenue, a 5 percent increase in expenses, and a 3 percent increase in interest rates as many loans are structured on variable rate terms. A good owner or manager will shock levels in production, cost, prices, and interest rates in order to find the limits of the business as well as those levels that could derail the ability to service debt and meet expenses.

Inside the management factor, lenders should also assess whether the overall management team has an understanding of key ratios or the breakeven point of the business. Is there an understanding of working capital to expenses, operating expense to revenue, as well as debt service coverage ratios and debt levels? This type of knowledge usually sets a customer apart from others.

Whether it is financial ratios, cash flow, or profitability, part of the management factor is the customer's willingness to accept counsel. Is there an advisory team in place to help monitor performance? A willingness to continually assess the business, accept guidance, and benchmark against others in the business are critical components of the management factor.

One significant indicator of good (or poor) management is the marketing and risk management plan. Whether it is commodity pricing, a value-added market, or and overall risk management, determine the customer's approach. In baseball terms, is the customer a base hitter or a home run hitter? A solid marketing and risk management plan is about knowing the risks and mitigating exposure. In analysis of the management factor, lenders want to see a customer that develops and executes a solid plan. In other words, as the old saying goes, does the customer talk the talk, or walk the talk?

Of course, lifestyle habits are another component of the management factor, particularly in good economic times. Increasingly, younger producers are realizing the importance of family living budgets and how that expense impacts their growth strategy. Budgets also help determine whether the business is large enough to accommodate draws from multiple family members, which is a common drain on today's farms and ranches.

When including the management factor in credit analysis, lenders need to consider whether a customer facing adversity developed a written plan of improvement, and executed that plan. This initiative is often makes the difference in a turnaround situation. While the ability to follow constructive coaching is indicative of good management, it is critical when trying to reverse margins.

Another sign of good management is a transition plan for the business. Are the right skills being transferred in a timely manner? Are the talent and resources available to take the business to the next level or would an unexpected transition put the business in a tailspin of financial ruin? Believe it or not, the lack of transition plans is one of the largest potential risks to credit performance.

Finally, when objectifying the management factor, one should observe the priority of education. Does the customer attend educational events? And at educational events, lenders should pay attention to who attends and engages. This can foreshadow the future status of the business as well as credit performance.

Of course, there are always additional ways to objectively define the management factor. Yet, the aforementioned components gave the lending institution I recently worked with a good start in quantifying this important factor in analysis. For ways to evaluate and quantify the management factor, the following guide may offer additional help.

Management Tip: In assessing the management style of a customer, consider his or her attitude. Is the customer proactive, reactive, or perhaps toxic in relationships? Observe the customer's relationships with labor, other management, suppliers, and stakeholders. Remember a good attitude can get one a long way in life.

Management Factor Guide

Customer Checklist	Green	Yellow	Red
1. Knows cost of production	Written	In head	No idea
2. Knows cost of production by enterprise	Written	In head	No idea
3. Goals- business, family & personal	Written	In head	No idea
4. Record keeping system	Accrual	Schedule F (one & done)	No idea
5. Projected cash flow	Written	In head	No idea
6. Sensitivity analysis	Written	In head	No idea
7. Understand financial ratios, break evens	Written	In head	No idea
8. Work with advisory team and lender	Yes	Sometimes	Never
9. Marketing plan written and executed	Yes	Sometimes	Never
10. Risk management plan	Yes	Sometimes	Never
11. Modest lifestyle habits, family living budget	Yes	Sometimes	Non existent
12. Written plan for improvement	Yes	Sometimes	Non existent
13. Transition plan	Yes	Working on plan	Non existent/ controversy
14. Educational seminars/courses	Yes	Sometimes attend	Never attend
15. Attitude	Proactive	Reactive	Toxic

Scoring	Overall Analysis
Majority of greens and yellows, few reds	Strong management rating
Some greens, mostly yellows, and few reds	Moderate to high risk, will most likely show previous refinancing
Few greens, majority of yellows and reds	High risk, use a de-marketing strategy

Global Economy

The synchronized global growth that has taken place over the past 18 months is now threatened by potential trade disputes and escalating military and geopolitical tensions.

The growth of the Euro sector economy is at approximately 2.5 percent with an unemployment rate of 8.5 percent. These numbers are fueled by the large economies of Germany and France, but also the smaller economies in southern Europe such as Italy and Spain, each projecting GDP growth at 1.5 and 2.8 percent, respectively. A cloud on the horizon for the Euro sector is its amount of household debt, which is approximately 160 percent of the region's GDP. This is above the U.S. at 152 percent of GDP. Of course, trade negotiations with the U.S. and other major economic partners will be critical to watch in the coming months.

In Asia, all eyes are on the trade spats between the U.S. and China. Sitting at the forefront, agriculture will feel the initial shots. Even as the first tariffs are just going into effect, the real impact is yet to be seen, and other industries such as manufacturing and technology are already feeling the strain. From investors to farmers, there is much concern over a potential trade dispute.

In recent months, growth in manufacturing and in the price of certain commodities has slowed. There has been a decline in the price of copper as well as other precious metals, as a result of the slowing economy in the Asian region. Of course, declining copper prices are one watch sign for a possible global slowdown. Is this a foreteller of the global economic slowdown, or is it fallout from the tweets and the war of words between trading partners? As a reminder, maintain a close eye on the Belt and Road Initiative in China for long-term implications on global competitiveness.

Domestic Economy

The leading economic indicators, the LEI (Leading Economic Index) and the PMI (Purchasing Managers Index), still show signs of a strong economy heading into the spring and summer. Both indicators are running strong, and well above critical resistance levels that would forecast a negative economy or looming recession.

Oil prices have increased in recent months due to the tensions in the regions of the world that produce energy. Supplies in the U.S. are lessening, which could result in a bump at the pump. Yet, because North America is still the world's largest energy producer, we have not seen that spike.

Unemployment is still in the low four percent range (U3) and right at eight percent (U6). This is a sign of a robust economy with a tight job market.

Housing starts are the strongest they have been in years, at approximately 1.3 million annual starts. Will higher interest rates place this important area of the economy in a slower mode? Only time will tell.

Factory capacity utilization is very strong compared to the five and ten years ago. However, this sector could be included in the fallout of possible trade issues, which could have a sweeping impact especially in rural America.

Both the producer and the consumer price indices point to modest inflation in the current economy. Of course, GDP growth was revised up to 2.9 percent in the fourth quarter of 2017. The aforementioned metrics will need to continually be monitored, and particularly if the GDP growth is sustained above 3 percent. This could lead to higher inflation, which is a major factor in determining interest rates.

Finally, consumer sentiment is still very strong in the high 90 percent range. This is linked to an increase in credit card debt and a lower savings rate. The question to ask is whether sentiment can sustain a decline in the stock market, and the geopolitical and trade disruptions.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	108.7 (Feb.)	✓		
LEI Diffusion Index	80% (Feb.)	✓		
Purchasing Manager Index - PMI	59.3	✓		
Housing Starts (millions)	1.319		✓	
Factory Capacity Utilization	78.0		✓	
Unemployment Rate	4.1%	✓		
Core Inflation	2.1%		✓	
Headline Inflation	2.4%	✓		
Oil Price ($/barrel)	$66.05		✓	
Yield Curve	1.02	✓		

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