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04/19/16

The Most Dangerous Customer

By Dr. David M. Kohl

This winter's seminar season with agricultural lenders, producers, and young farmers had a distinct atmosphere. Many lenders and producers face for the first time the realities of negative cash flows and margins, as well as the stress of how quickly financial fortunes can change. Throughout my winter travels to producer and agribusiness meetings, I encountered emotional situations including the occasional outbursts of frustration. In fact, some say these mood shifts are reminiscent of the 1980s, during the farm crisis. Using this is as a backdrop, it is important to examine possible customers that are dangerous from a risk management standpoint, specifically over the next few years.

Betting and Denial

Several producers continue to choose denial and avoid calls from their lender. Others believe adverse weather events in other areas of the country or globally will increase commodity prices. One major issue for lenders is to motivate the producer who was complacent in marketing, finance, and general management as a result of the great commodity super cycle. For some, it is hard to accept how quickly their financial situation eroded. As one Kansas banker stated, "For some of my customers, their working capital is burning up like rocket fuel." Obviously, the size, scope and magnitude of many farm and ranch businesses are important variables that impact burn rate.

Working Capital

Recently, a young, growth-oriented producer served on a panel where he asked, "What's all the fuss about working capital?" He stated that if the need for working capital arises, he will simply sell one or two of the farms or assets to generate the needed liquidity. Well, there is a definitive sense of arrogance with the "balance sheet bully" who may be worth millions of dollars on paper, but fails to account for the fact that assets usually sell at a steep discount from actual value in a down market. Others who choose to sell assets may experience tax issues. The sale of some assets with low basis or cost value could quickly distort a producer's financial position with regardto taxes owed.

Bigness on the Brain

Those agriculture producers who rapidly grew their businesses may experience the "deadly D," or disinterest, when scaling back the operation. Suffering from the syndrome of "bigness on the brain," many of these producers acquired assets without adequate planning for the eventual economic downturn or other financial event. As a lender, be wary of changes in the patterns of a customer's behavior. Confrontational responses and the dismissal of suggestions for improvement are behaviors by which you should be concerned. The main focus must be sustainability, not size or scope of the operation.

Fraudulent Activities

Agricultural lenders need to be on high alert for fraudulent activities. History suggests that embezzlement of cash, cattle, and machinery may quickly become commonplace over the next few years. Watch for agribusinesses in the community that default on loans, possibly exposing your customer to increased financial difficulties. Be thorough and timely on loan documentation, loan agreements and covenants as this economic environment continues to attract unusual activities. Remember to first look outside the numbers for potential problems as ratios and percentages may not show these issues until it is too late.

Rob Peter to Pay Paul

There is no doubt that financial liquidity will be the main difficulty for many agricultural customers over the next few years. Often, producers resort to what is called "split lines of credit." In order to obtain financial liquidity, some producers will increase their lines of credit with various agribusiness firms and utilize this credit to service term debt. I have often heard this called, "robbing Peter to pay Paul." One of the first signs of credit issues is an increase in accounts payable, both in numbers and amounts. Additionally, if the lending institution has loaned money to the agribusiness firms this could create a double jeopardy type of situation; both with the customer and agribusiness increasing the institution's portfolio risk and exposure.

Interconnected Risk

The difference between the 1980s farm crisis and today's environment is the debt concentration among larger agricultural producers. Many of these customers have business relationships with other large customers. Thus, if one operation faces an issue, it will ripple through the others. For example, if a custom operator cannot collect accounts receivable from customers in financial difficulty, the financial issues will continue to multiply and compound. Agricultural lending portfolios must be examined for interconnected relationships, based off of loan concentration.

Corrective Action

In discussions surrounding my speaking engagements and seminars, which customer to finance continues to be a prevalent and relevant topic. Customers that refinance operating money to term debt must develop a written plan to improve the basic business financials. My advice to lenders to make sure this plan is implemented. Failure to do so will often result in an additional refinance request within two to three years. If a producer does not exhibit the willingness and attitude to work side-by-side with the lender for improvement, the loan should be "de-marketed," or in other words, encourage the producer to find another lender.

In summary, a lender needs to monitor financials, but behavior and attitude as well. A customer can display a strong balance sheet and still present dangerous risk and exposure. There is an old saying that it takes five times the amount of time, money, and effort to handle problem accounts as compared to a performing account. Quickly identify problem accounts, require corrective action strategies and closely monitor progress of the account. This process will be critical to the success of any lender or producer.

Management tip:

A good mentor who has experience with dangerous accounts can be extremely valuable in this time period. Increase your networking with other lenders, agribusinesses and in the community in general. Be proactive in connecting the dots and identifying risk to avoid overexposure and dangerous risk in this down economic cycle environment.

Global Economy

With 94 percent of the world's consumers outside the United States, events abroad impact many sectors of the U.S. economy. Overall, global economic growth is anemic at best. The drivers of the robust global economy in the early part of century are now in hibernation.

The slowdown of infrastructure development in emerging nations, specifically China, is a headwind to the manufacturing, energy, as well as the agricultural economies and sectors.

As a result of slowed economic growth worldwide, challenges inside the European economy hinder exports in countries such as Germany. Additionally, the slowdown has resulted in high unemployment rates amongst youth in the European region. Immigration issues within the European sector along with the possible "British exit" from the European Union, also known as "Brexit," are each uncertainties that deter growth and impact currency values.

China continues to struggle with the transition from a manufacturing and export-driven economy to consumption and service-based economy. Exports are down in China and as the world's second largest economy, China's struggles send uncertainty rippling across the globe. Nearly $1 trillion of wealth recently exited China and then was invested in North America and Europe. This reduced the financial reserves in China, although they are still the largest financier of U.S. federal debt.

Maintain a close eye on South America, specifically Brazil and Argentina. The possible impeachment of the Brazilian leader and the global investigation of the data leak known as "Panama Papers" left many global leaders linked to suspicious economic activities.

Recently, I had the opportunity to spend some time with our neighbors to the North in Canada where I found some interesting perspectives. Corn and soybean prices were in the $5.00 and $12.00 ranges respectively as the strong U.S. dollar continues to provide a competitive advantage for Canadian producers. In addition, used farm machinery is selling at a premium compared to prices at U.S. equipment dealers. The most popular question I received during my Canadian tour was how long the U.S. dollar was going to maintain its current strength, as this is critical to the success of many industries in Canada.

Domestic Economy

The U.S. coastal and service-based economies continue to serve as bright spots for the U.S. and globally. The leading economic indicators, the Leading Economic Index (LEI) and the Purchasing Manager Index (PMI) currently present potentially conflicting signals.

The LEI, indicative of the future direction of the U.S. economy, has been relatively stable over the past several months, with a slight increase in February. Maintain a close eye on the diffusion index, which represents the factors that make up the LEI, both positive and negative. In recent months, the diffusion index has registered in under 50 percent, illustrating signs of stress for many key components of the index.

The PMI came in under 50 for four months, which is a sign of a contracting economy. However, it bounced back in March rising above 50. Again, these two lead indicators are giving mixed signals.

Oil prices continue to stay in the $32.00 to low $40.00 per barrel range. Do not be surprised if by the end of the year, oil prices bump up to the $50.00 to $60.00 per barrel range. In fact, some prognostics indicate price may rise to $85.00 per barrel.

The manufacturing sector is a headwind for the U.S. economy. Factory capacity utilization continues to decline. Thus far, the result has been significant layoffs inside key firms; many of which are located in agricultural and rural areas.

Housing starts continue to stay below 1.2 million starts annually; still under the ideal metric of 1.5 million. In general, members of the millennial generation are unable to purchase homes due to student debt, steep regulations and earnings potential. This factor remains a major challenge for the housing industry.

As a key sign of the service-based economy, consumer sentiment has been strong; registering in above 90 for the past six months. The service-based sector continues to carry the U.S. economy and encourage business expansion. Now beyond its 80th month of growth, U.S. business expansion is in one of the longest periods on record. However, the preliminary estimate for April is below 90 which could indicate weakness on the horizon.

When raising interest rates, the Federal Reserve is extremely cautious. While unemployment and inflation suggest a possible rate increase, uncertainties in domestic and global economic growth are significant factors in their decision. Most likely, the U.S. can expect slow and caution changes in interest rates.

Over the next few months, watch the U.S. economic growth, the possible “Brexit,” the direction of inflation, and of course, the U.S. federal elections as pivotal points for the economy.

Lender and Business Dashboard Economic Indicator Assessment **04/19/16**

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	123.2 (Feb.)		✓	
LEI Diffusion Index	45%		✓	
Purchasing Manager Index - PMI	51.8	✓		
Housing Starts (millions)	1.089		✓	
Factory Capacity Utilization	74.8		✓	
Unemployment Rate	5.0%	✓		
Core Inflation	2.2		✓	
Headline Inflation	0.9	✓		
Oil Price ($/barrel)	$34.91	✓		
Yield Curve	1.56	✓		

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