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10/23/2023

<u>The Spectrum of Credit Analysis</u>

By Dr. David M. Kohl

Engagement with agriculture producers often shifts to conversations about the ability to obtain credit and what debt levels are appropriate. In recent months, these discussions have focused on more restrictive credit and the need for additional collateral, which in many cases is land. For many agricultural lenders, the focus is on the five C's of credit in the analysis, which include character, cash flow, conditions, collateral, and capital. Candid discussions with producers often center on why some lenders will put more weight on the collateral portion of the spectrum versus the other C's of credit.

Lenders are in the risk assessment business and they want to be assured of loan repayment of both principal and interest. Since repayment occurs over an extended period of time through many economic cycles, assets are pledged for security in case of repayment issues to mitigate the risk. Farmland, which is over 80 percent of the U.S. farm balance sheet, is the asset of choice for collateral because farmland has either remained level or appreciated in value about 80 percent of the time. Other collateral, such as livestock, can die or disappear if it is a stressful or unethical situation. Machinery, equipment, and grain inventory can also quickly disappear and tend to fluctuate more in value than land.

Collateral lending

What are the conditions or situations that will prompt the lender to focus on the “five C’s” of credit, that is collateral, collateral, collateral, collateral, and collateral?

When an agricultural lender asks a producer, “What is your cost of production and break-even point?" and the response is “it is in my head,” the lender may focus more attention on collateral. In today's world of extreme economic volatility in prices, costs, and interest rates, the margin for error is becoming very thin. The cost of production and break-even points are very critical for developing a marketing and risk management program. The use of futures and options and crop and livestock insurance with various outcomes such as best, average, and worst-case economic scenarios can provide the lender some assurance of possible profit and cash flow situations. A producer that is a “shoot from the hip” type of marketer seeking a homerun in outcomes will generally be successful two out of every ten years, but they often bring too much risk to the table.

Another condition for requiring more collateral is the lack of ownership in the financials and the numbers. Does the producer monitor the financials only once per year for tax reasons? Does the producer execute and monitor the marketing and risk management program which impacts output and input decisions in a volatile market?

Another factor in the collateral decision is whether the lender must develop the balance sheet and cash flow statements for the producer, which demonstrates the producer's level of financial and business IQ. One has to be careful of accountant prepared statements. While they are generally good quality information, sometimes the owners and managers lack ownership of the numbers in the decision-making process which can be a red flag concerning risk.

Another variable for more collateral due to increased risk is concern about the accuracy of the family living costs, the number of individuals living out of the business, and the income generated. Family living costs in excess or beyond the means of the business or individual to generate income often result in an operating loan that needs to be refinanced with more collateral. In these situations, a debt-to-asset ratio exceeding 40 percent can be a recipe for increased loan risk.

Cash flow, profitability, and working capital lending

Moving toward the other C's of credit, the focus is on profit and cash flow with working capital as a primary backup and then collateral. This is often the case for producers renting and leasing a considerable part of their asset base. Young, beginning, and smaller producers as well as individuals involved in value-added entrepreneurial businesses would be a fit for this case as well. Many individuals in this situation have indicated that they wish their lenders would focus more on these characteristics and less on collateral.

Those wanting to identify an appropriate situation when focusing more on cash flow, profitability, and working capital is important, as opposed to collateral, can use the following checklist.

- The producer knows their cost of production and break-even points, but they also know it down to the enterprise or, in some cases, per field, per plot, or per head.

- A case for less collateral can be built for individuals who develop and monitor the cash flow at least quarterly and sometimes on a monthly basis. It is encouraging that approximately half of the young and beginning producers I conduct seminars with have their financials on a spreadsheet that they use in the decision-making process.

- When it comes to marketing and risk management, these producers are methodical and objective in their output and input decision-making. They seek "base hits" in profit windows or loss mitigation and are analogous to the turtle versus the rapid rabbit along the business journey.

- A lender can be more of a cash flow and profit lender if the borrower has modest family living costs and they separate business and personal expenses and budgets.

- In good economic years, these types of producers will build working capital to absorb downturns and pounce on opportunities when the situation arises.

- Pay attention to the people your borrower associates with in formal and informal settings. Do they have a team of advisors and mentors?

- Are there government guarantees and other programs available to mitigate risk in the overall lending process?

Finally, the aforementioned producers are often your loan growth prospects of the future and are positioning themselves to acquire land assets in the next decade or two. Although the debt-to-asset ratio will often be 50 to 75 percent, the management practices, execution, follow through, and the general business IQ are the business and character attributes that would suggest less collateral may be appropriate.

Global Economy

The global economic slowdown is in full force and is being impacted by the unfolding events in a very volatile situation in the Middle East. The connections with power players both economically and politically could create extremes in economic volatility moving into the last quarter of 2023 and into 2024. Globally, approximately 40 percent of refined oil moves through the Strait of Hormuz, located near the conflict. This, along with any weather events, could send supply shocks to oil prices.

China's economy continues to struggle due to a number of factors. Demographics and high unemployment of youth due to the government's technology crackdown are weighing on the economy. China's overall exports are down over 14 percent and down 40 percent to Western nations. These are each long-term issues hampering economic growth in China. Retail sales in China have been down during the autumn festival events as consumers are not spending the $2.4 trillion saved during the COVID-19 lockdowns due to uncertainty in the economy and negative adjustments to housing prices.

Over the next six months, watch for payment issues on the $1.3 trillion of loans granted through the Belt and Road Initiative in 70 countries. Up to 60 percent of these loans are in late payment status, resulting in some critical decisions for the future with China. India, Japan, and Southeast Asian economies are growing modestly, but it remains to be seen how they will perform if a global economic slowdown continues.

The Euro sector represents about 20 percent of the world economy. Great Britain registered some growth in recent reports. However, the Euro sector is on the brink of going back into a recession with Germany, the fourth largest economy in the world, in an economic struggle. Weather and the war efforts in Europe and now in the Middle East could wreak havoc on the European economy.

Domestic Economy:

There are major headwinds in the U.S. economy and signposts that bear watching.

- The student debt payments on $100 billion will begin impacting household discretionary spending, specifically for millennials.

- Supply shocks created by OPEC, Russia, and now the Middle East conflict will have a direct impact on oil prices. A key price point is $100 per barrel of oil for an extended period of time.

- Labor strikes in major sectors and industries of the economy could impact manufacturing and technology businesses and their long run sustainability.

- Budget impasses as a result of the erosion of governance at the federal level could persist through the next election cycle and continue to cause uncertainty.

- Fiscal unsustainability, growth of federal spending, and the lack of fiscal discipline are some of the factors that have led to the downgrade of the U.S. economy by rating agencies. A lack of confidence is leading to increasing interest rates on the long end of the yield curve.

- Down payment requirements and the current median price of homes is putting pressure on the housing market. An average of 44 percent of household income is now going toward home mortgage payments, which is an all-time high!

- Many of the leading and lagging economic indicators are blinking red, which will be discussed in further detail.

The Leading Economic Index (LEI) has been blinking red on the signpost all year. The diffusion index, which measures either the positive or negative movements of the ten indicators that make up the LEI, has been under 50. This indicates that at least five out of ten of the variables are performing poorly.

The “red light” threshold for oil prices, which are critical to gasoline and diesel prices, is $100 per barrel for multiple months. Let's see how weather and the wars impact supply and demand, with oil prices currently just under $100.

The Purchasing Manager Index (PMI) has been under 50 all of this year. This indicates a contracting economy. However, the PMI is higher than recessionary levels which would be a metric in the low 40s.

The unemployment rates, both the U-3 rate at 3.8 percent and U-6 rate at 7.0 percent, are in a strong position. Watch for corporate, technology, and service sector layoffs later this year and earlier next year.

Housing starts have taken a sharp decline in recent months. The lack of affordability due to high prices and interest rates along with millennials shifting spending patterns towards consumption is impacting this metric.

The Index of Consumer Sentiment remains in the 60s. While consumer spending on travel and experiences has continued, long-term doubt still persists as consumers begin to run out of saved subsidy funds and build up credit card debt.

Both the core and headline inflation rates continue to decline. However, core inflation is still above the magic number of 2 percent, while headline inflation is just below the ideal number of 4 percent. The Federal Reserve will be on the fence concerning raising interest rates based on these numbers and employment figures. Fiscal spending through the Inflation Reduction Act and other previous programs is resulting in the U.S. economy performing well compared to other economies around the world.

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	104.6			✓
LEI Diffusion Index	30%			✓
Purchasing Manager Index - PMI	49%		✓	
Housing Starts (millions)	1.358		✓	
Factory Capacity Utilization	79.7%		✓	
Unemployment Rate	3.8%	✓		
Core Inflation	4.1%			✓
Headline Inflation	3.7%	✓		
Oil Price ($/barrel)	$97.48		✓	
Yield Curve	--0.88			✓

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