FARMER MAC

# DAVE'S GPS

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## Top Questions from the Road

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Agriculture is in an economic transition that will alter the way business is conducted in the next few years. It is important for industry leaders to ask questions and seek information in order to successfully navigate and guide customers during these uncertain economic times. Agriculture is a knowledge-based industry that requires constant education as well as an openness to learn and change. In this edition, I highlight some of the most common questions I encounter during my time with lenders and producers in the agribusiness industry today.

### Audited statements

*What size should a business be when audited statements are expected?*

This is a great question. More frequently lenders are requesting financial transparency on larger accounts. In agriculture today, 263,000 farms and ranches carry 63 percent of the total farm debt. Actually, the important factor is not necessarily the audit but whether the financial information is used in the business decision-making process. Especially on larger accounts, problems may occur outside the numbers first. Specifically, there may be concerning issues present in a business before any trouble is detected in the financial reports. Utilizing the financial information included in an audit is a tool for verification which can be extremely important.

### Spending issues

*How does a lender guide a customer who does not heed advice to reduce expenses?*

First, ensure personal and business expenses are separated. A personal family living budget is a great tool to quantify, in writing, how much is being spent. Often this is a realization point for many producers which can bring about change. Some lenders require the producer to draw a specified amount from the business earnings and then, live within that total. A tip for lenders is to monitor credit card debt levels. There may be a tendency to utilize credit card debt as the petty cash fund. Other lenders will place a covenant for living withdrawals. If this is the procedure, make sure the covenant is monitored and enforced. Ultimately, the best outcome requires the client's commitment to reduced business and personal expenses in order to maintain a sustainable business.

Tough times

*What advice can you give a new agricultural lender that has not yet experienced the industry in tough economic times?*

First, make sure you align with a good mentor; preferably, one who has experienced a down cycle. Next, maintain a network of positive peers or customers with which you can explore ideas, challenges and issues. Finally, do not take your good customers for granted. There is a tendency to fight fires or spend the majority of your time on problem accounts. Place your solid, stellar customers high on the priority list because they are most likely the ones in position to capitalize on possible opportunities that often occur during tough times. As a side note, avoid conducting business development directly after handling a problem account. Often, problem accounts alter perceptions and business development opportunities may suffer.

The agricultural entrepreneur or urban agriculture

*What is the best way to guide non-traditional agricultural customers towards success?*

There is a definite movement occurring with non-traditional producers entering agriculture. These customers and businesses will come in diverse forms often involved in niche markets such as, local, natural, organic or even farmers' markets operations. The key in working with this customer base is to request a business plan. Be careful that the business plan is not merely developed by a consultant without the owner's active participation. A business plan requires one to think through, in written form, operations, marketing, and financial plans rather than just requesting monies for an idea. These businesses can be very successful, but many fail because of a lack of a systems-type approach to the business. Creativity is good; but it is old-fashioned business basics that make a venture successful.

Poor financials

*How should a lender manage a customer with a poor understanding of financials?*

A regulator recently asked me this question. The great commodity super cycle created complacency in the agriculture industry concerning finance and management. The economic downturn will expose many financial and management issues that were disguised by high commodity prices. My advice to the regulator was to maintain an extremely low debt to asset ratio. In fact, I suggested 25 percent should be the top. Next, if the producer shows no desire for improvement a de-marketing strategy may be a priority for that lender. Remember, 96 percent of customers will not create any issues. However, the other four percent can be challenging and as such, monopolize 50 percent of your time. This is known as the 96-4-50 rule. Sometimes, it is prudent to suggest another lender for your customer or more simply, remove that account from your portfolio.

Long-time producer reticent to change

*How do you work with an older producer that openly displays discontent and lack of trust in the young lender?*

Remember the older generation sometimes has a different method of attempting to establish their negotiation edge. Often, as a young lender, it is best to go into this type of situation prepared to listen rather than talk. Take a genuine interest. Ask about ways the customer was successful in adverse times or methods used to overcome challenges. Some experienced lenders allow the customer to express opinions and frustrations and then, move forward with the relationship. This has proved a successful technique in many cases. A sincere interest in their farm, family and personal life can be a very useful tool. It is not submission but respect and cooperation that can open doors. It is often hard for people to see how much you have to offer until you demonstrate how much you care.

Top Lenders

*What separates the "cut above" lender from the average?*

Foremost, the good lenders and institutions have passion and commitment to the industry. The stellar lender is relationship-based; understanding the industry business with the ability to anticipate needs. The cut above lender and their team also tend to greatly value education. This can take many forms such as, suggested educational venues, financial benchmarking, business and family consulting, or expansion advice. This is especially true for the younger producer who recognizes agriculture as a knowledge-based business and education as the vehicle that can provide the competitive edge.

Lender Management Tip: Problem Loan

- If at all possible, tag-team the problem loan account.
- Document, document, document! Utilize a paper trail for protection of all parties
- Schedule regular review meetings including the spouse or partner. Follow up with minutes and summaries outlining activities, responsibilities and timelines.
- Monitor cash flows through variance analysis.

Global Economics

The global economic slowdown is gaining steam. Half of the BRICS and KIMT nations, (Brazil, Russia, India, China, and South Africa, and South Korea, Indonesia, Mexico, Turkey) are in or near recession. Russia, an economy dependent upon oil revenue is now flexing its military muscle in the Middle East creating uncertainty in oil markets.

China is in the early stages of economic slowdown which will ripple through the Asian region and across the globe. China's real GDP growth rate is ranging between 2 percent and 5 percent. This slows the demand for commodity exports ranging from soybeans to oil and steel, which influences commodity-based nations such as Canada, Australia, South Africa and others. The transition from an infrastructure-building, manufacturing-oriented, exporting economy to a consumption, service-based economy will likely continue. This will cause economic surprises around every corner!

The European region of the world is in an economic malaise. The region is stifled by weakening exports for nations such as Germany, and social program costs, and a high degree of regulation.

In the South and Latin American regions, the economic slowdown is apparent as trade with China has abated; specifically, in the commodities area. October and November federal elections in Argentina and in Canada may be a bellwether of political change. Overall, the global economy is struggling with implications to the economic fortunes in the U.S. flyover states.

Domestic Economics

The U.S. Federal Reserve said it all when they failed to raise interest rates on a very close vote in September. Examining lead and lag indicators reveals direction. The U.S. economy is well into its 70th month of business expansion. The average expansion since 1969 is 84 months with recessions lasting approximately six to seven months.

What are the indicators showing? First, the Leading Economic Index (LEI), a foreteller of the U.S. economy six months forward is not robust and is actually flattening out as compared to earlier in the year. Latest reads on the diffusion index find slightly over 50 percent of the components increasing.

The purchasing manager index, another lead indicator is in slowdown mode slightly above 50. Remember any number below 50 is a sign of a contracting economy. Oil prices are leveling out in the $40 to $50 per barrel range. Military and political tension in oil producing regions along with U.S. production decline of over one-half million barrels of oil per day may result in higher pump prices later this year or early next year.

The unemployment rate stands at 5.1 percent and the U-6 rate is 10 percent. Both are at the lowest level in years. However, major companies are in layoff mode, specifically, in the manufacturing sector. Only time will tell whether these numbers will hold.

As expected, factory utilization is in decline. The increasing inventory buildup is a result of the continued strong dollar and global economic slowdown.

Housing starts, the mainstay of the economy, are flattening out despite low interest rates. Demographics and changing housing patterns of the millennial generation are factors influencing this indicator.

This fall, closely watch consumer sentiment along with GDP growth rate and revisions as an indicator for the holiday season. Additionally, with inflation in a flat mode, the U.S. Federal Reserve may continue its hold on interest rate hikes.

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

| Indicator | Current | Green | Yellow | Red |
|---|---|---|---|---|
| Leading Economic Index - LEI | 123.7 (Aug.) | ✓ | | |
| LEI Diffusion Index | 55% (Aug.) | | ✓ | |
| Purchasing Manager Index - PMI | 50.2 | ✓ | | |
| Housing Starts (millions) | 1.126 (Aug.) | | ✓ | |
| Factory Capacity Utilization | 77.6 (Aug.) | | ✓ | |
| Unemployment Rate | 5.1% | ✓ | | |
| Core Inflation | 1.8 | ✓ | | |
| Headline Inflation | 0.2 | ✓ | | |
| Oil Price ($/barrel) | $43.49 | ✓ | | |
| Yield Curve | 2.16 | ✓ | | |

### 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