FARMER MAC

DAVE'S GPS

02/26/19

Working with Stressed Agricultural Credits

By Dr. David M. Kohl

The seventh year of the agricultural economic reset is both financially and emotionally stressful for many agriculture producers and lenders. Some producers are in their third restructure or refinance of operating losses on term debt. Contrasted to the 1980s farm crisis, the resilience of farmland values provides options when cash flow and profits are in the red. Other producers have utilized nontraditional sources of credit for operating needs with the strategy of using traditional lenders as a refinance option when negative financial situations occur.

A recent distressed credit workshop provided a vantage point in working with customers who are facing realities of the times. These three panelists, with over a century of combined agriculture lending experience dating back to the 1980s, provided nuggets for individuals that are on the front lines working through problem credits.

Bridge versus pier concept

One of the panelists brought up the “bridge versus pier” concept. Succinctly stated, farmland that has maintained its value in the downturn acts as a good bridge through the down economic cycle. He was quick to state that financial improvement must occur to reduce losses. A producer who continues to employ the strategy of refinancing losses to term debt is analogous to moving out to the end of the pier where it gets narrower and the water becomes deeper. As debt service mounts, the business’ ability to service the debt is reduced. The bottom line is the owner is financially “drowning” as a result of heavy debt service commitments.

In this part of the economic cycle, often preservation of wealth is the priority instead of options for a workout. This is particularly true when farm assets are the only option in a retirement program. This crucial conversation concerning the core equity burn rate, which is often made up primarily of land, must be laid out and discussed.

Communication

Next, the panel discussion shifted toward communication and interaction with customers in stressed credit situations. All three panelists indicated that taking time to develop a call plan before meeting with the customer is imperative.

In this call plan it is very important to outline key points and needs to be focused on in the meeting. Often stressed credit situations can become very emotional, which causes both the lender and producer to lose focus. Five to seven key questions need to be written down on the call plan to ensure goals are accomplished for the meeting.

A written agenda, preferably delivered ahead of time, can be a useful tool in maintaining focus during the meeting. This allows the borrower time to assemble documents that may be useful in the discussion. The goals of the meeting should be included in this communication.

Within 24 hours of completing the meeting, it is critical to develop a call report including the highlights of the meeting. This is very important, especially if a series of meetings occur over a period of time, say over 90 days. In this report, include details about who was in attendance and whether a third party, such as an attorney or facilitator, is involved. Summarize what was agreed upon along with the next action steps for both the borrower and lender. In my experience based upon interaction and facilitation in the 1980s, these call reports and actions can build momentum for the next meeting. The call reports outline what was accomplished and what areas of focus need to occur in the next meeting.

Joint calling

Some lenders may use a strategy of joint calls, which can be very effective especially if there are multiple parties, spouses, and others involved in the meeting. In this situation, it is imperative to develop a call plan and have pre-meeting discussions outlining each lender's role. Often one will ask questions while the other will observe nonverbal communication or body language and take notes. Others find it useful if one individual's role is to develop clarity and transparency of crucial conversations in the current stressed credit situation. It is important to summarize conversations in writing for the file to establish institutional memory.

One panelist indicated that joint calling was very helpful when one of the lenders involved in the stressed credit situation moved to a different position at the bank. This file and the other lender's memory acted as a bridge when the new lender was assigned workout customers.

Dealing with the customer that will not engage

If you have been in lending long enough, you will likely have a situation in which a customer goes silent. They do not return phone calls, text messages, or emails and they avoid interaction. This may require help from someone else, such as an attorney, accountant, or another person with expertise, to bridge the gap and open communication. If one does break the communication barrier, then focus on some positive actions that can be a possible solution. One must be candid in the discussion without overwhelming the borrower with negative points and actions that could be a real detriment to the situation.

One final suggestion is to make sure spouses and all partners are attending the meetings to keep everyone on the same page. This reduces "he said or she said" comments or playing one person against the other.

These are a few summary points that are very critical to being engaged in an environment with stressed credits. Upcoming articles will elaborate further on this topic. As a final recommendation, remember that a borrower's self-worth should not be dictated by their net worth. Separating the "person" from their stressful circumstances can help keep the tone of the communication positive.

Global Economy

The global economy is currently in a synchronized slowdown. Negative growth rates are occurring in Japan, the third largest world economy, and Germany, the fourth largest economy. Germany's economy is very dependent on manufacturing sales to China, specifically automobiles. For the first time in two decades, China has actually observed a slowdown in the growth rate of auto sales.

Political uncertainty is a keyword throughout the global landscape. New or unproven leadership in Mexico, Brazil, and Argentina has created tension and instability of economics and trade relationships. Chancellor Merkel of Germany will be transitioning out of leadership. She has been a stability factor for the European region, which amounts to over 20 percent of the world economy.

A key question for China, the second largest economy in the world, is whether the slowing growth will result in a hard landing. China's GDP growth rate is reported to be approximately 6 percent, which is stellar compared to U.S. standards, but is concerning in Chinese metrics. China experienced growth rates above 10 percent in the early 1990s; in the mid-2000s leading up to the Great Recession, some years the Chinese economy peaked out at nearly 15 percent GDP growth while it was building much of its infrastructure.

The reason for the decline in growth is not the United States' trade barriers. China's government has been cracking down on shadow financing similar to what occurred just before the Great Recession in the U.S. Private companies account for nearly two-thirds of the economy but receive only one third of new monies from traditional banking sources. This resulted in the growth of shadow banking in China. The regulators realize they have a problem and are providing other avenues for credit. China is experiencing a softening of wage growth and rising household debt, which in turn results in the Chinese population developing more conservative spending habits as their economy transitions from a production to a service-based economy.

Domestic Economy

The U.S. Leading Economic Index (LEI) would suggest a slowing economy, but with growth still above recession levels. The LEI and the diffusion index have been flat and slightly declining.

Oil prices have been in a declining mode despite global issues and OPEC cutting oil production. Stability is hinged on the ability of the United States to remain the number one energy producer. Canada is now number four in the world and Mexico is number eight, which provides stability in this important metric.

The PMI, while is still above 50, is declining, which may be the result of trade issues and the global economic slowdown. Speaking of the PMI, this index in China has registered under 50 and certain areas of Europe have also registered under 50, which is a sign of economic slowdown.

Unemployment, a lagging economic indicator, is still strong on both U-3 and U-6 levels, at 3.9 percent for U-3 and 7.6 percent for U-6.

Housing starts are sluggish and new building permits and housing sales suggest a slowdown. Housing represents 10 to 15 percent of the U.S. economy or one in seven people in the workforce, so it bears watching.

While GDP growth is still quite strong despite some of the headwinds, this metric will need to be closely watched. Factory capacity utilization is still quite strong in the important manufacturing sector, but it will be interesting to see how tariffs and trade issues may impact this later into the summer.

Consumer sentiment has been softening, which will be an important metric to observe during the spring quarter. This number is now nearing 90. Below 90 means that the consumer is in a conservative mode. Inflation appears to be quite tame in the 2 percent range, both for core and headline inflation.

Overall, the U.S. economy is one of transition and uncertainty. Data in the next issue should provide a more definitive observation and perspective.

Lender and Business Dashboard Economic Indicator Assessment **02/26/19**

By: Dr. David M. Kohl

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	111.3	✓		
LEI Diffusion Index	70%	✓		
Purchasing Manager Index - PMI	56.6	✓		
Housing Starts (millions)	1.078 (Dec.)		✓	
Factory Capacity Utilization	78.2		✓	
Unemployment Rate	4.0%	✓		
Core Inflation	2.2%		✓	
Headline Inflation	1.6%	✓		
Oil Price ($/barrel)	$60.93		✓	
Yield Curve	0.24		✓	

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