No BOOM, No BUST

Downward ag adjustment offers bankers opportunity to deepen relationships with farmers

By Matthew Doffing

MANAGING A FARM or an ag bank in 2015 will be analogous to driving on a mountain road where a sign warns: Loose rocks ahead. Bankers and farmers are metaphorically gripping the steering wheel a little tighter, paying closer attention and even slowing down a bit, said Lynn Paulson, senior vice president at Bell State Bank & Trust, Fargo, N.D.

Lynn Paulson

Paulson's expectations are shared by ag bankers throughout the Midwest. They are not expecting the industry to go bust but they anticipate a more difficult 2015 for even the best producers. This is a year to prepare for success even if commodity prices remain low for a long time.

A return to relationships

Ag bankers have been happy to see their customers do well amid record high commodity prices during the last eight years. The boom in ag income, however, has flooded banks in deposits. Farmers' ability to pay in cash has reduced loan demand. And, with rates historically low, farmers asked for fixed low-rate, long-term financing. Over the last few years, farmers have been able to dictate terms; if the banker would not accommodate, the farmer turned to a lender who would.

Now farmers have difficult decisions ahead as they attempt to preserve net income amidst declines in commodity prices. Some, in an effort to avoid paying taxes, have used their reserves to buy equipment. They may have substantial deferred tax liabilities with payments coming due while revenue is depressed. Others have depleted cash reserves by making non-business related expenditures.

In a more challenging economic environment, farmers have a greater need for expertise. This is an opportunity for bankers. Not only will farmers still need loans and be more willing to compromise on terms, many farmers will remain A-rated borrowers. Bankers expect relationships to become important once again to farmers.

Prices down, costs flat

Before the boom of recent years, ag banks were in the business of ag lending. "I had a banker joke with me recently that he was in the business of ag deposit gathering," said Mark Scanlan, senior vice president, agriculture and rural policy at the Independent Community Bankers of America. Farmers will not be nearly as cash flush in 2015, he said.

Mark Scanlan

Bankers already are finding some farmers expect to be squeezed. Commodity prices are down and input costs are holding stubbornly stable, said Dianne Pierce, vice president at the $251 million Dakota Western Bank, Bowman, N.D. The bank's customers are primarily ranchers and wheat producers. "Everyone is buckling up for $6 wheat. We are planning for $2.50 corn. People are feeling like they need to be prepared to bite the bullet," she said. "Operating expense hasn't dropped nearly as much as it should."

Dianne Pierce

Corn and soybean producers also have seen significant reduction in prices. "Corn prices have fallen by around 40 percent in the last year," said agricultural economist Michael Boehlje, Purdue University, West Lafayette, Ind. "Soy prices also have fallen by close to 40 percent."

At the same time, input cost for land rent, seed and chemicals have dropped minimally, and in some areas not at all, Boehlje said. "We expect 2015 to be a time when margins will be very tight," he said. "We aren't expecting margins to improve that much even into 2016."

Boehlje said input costs will adjust eventually but they do not typically decline by more than 10 percent to 15 percent, even when prices decline as much as they have.

Farm Bill programs offer help

The 2014 Farm Bill's Agricultural Risk Coverage programs will help to protect some farm income. In order to obtain the most protection from declining prices, however, farmers need to be proactive, said John Blanchfield, who recently retired as senior vice president, Center for Agricultural and Rural Banking at the American Bankers Association.

The farm bill authorized $956 billion in total spending; about $134 billion is for crop insurance and farm programs, with the vast majority going to nutrition assistance programs. The bill created three ARC programs and a dairy program.

While an ARC program payment is triggered by current-year yield or price, the payment is calculated on historical records. Farmers have a one-time option to update yields and base acreages with the Farm Service Agency for each FSA farm contained within a farmer's total operation. Farmers can update based on planted acreage from 2009 to 2012. "It is really a no brainer to update," Blanchfield said. "The acres and yields used by FSA today are from the 1980s. More than likely both yields and base acreages will be higher today and they are a part of calculating the program payments."

The farm bill's ARC programs are complicated. It will take time and planning for farmers to determine the best option for them. Farmers can enroll in county level coverage (ARC-C), individual farm coverage (ARC-I) or a price-loss

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Dairy is in the limelight for now

Editor's note: Sam Miller is the managing director and group head, agriculture, at BMO Harris Bank. Miller works in Milwaukee. NorthWestern Financial Review *reporter Matthew Doffing spoke with Miller about the dairy industry.*

Sam Miller

Q. The dairy industry has had some very good years. To what do you attribute that?

Dairy producers had one of their best years ever in 2014. Reasons for the great year are two-fold. First, exports increased significantly beginning in late 2013 for many dairy products including whole and skim milk powder, cheese, butter and whey. This increased demand drove milk prices higher in the United States. Second, feed prices declined with cheaper corn and soybean prices. Dairy producer margins expanded as a result. One additional benefit — beef prices have also been high, meaning cull cow and bull calf values have been above average adding to incremental revenue for dairy producers.

Q. What kinds of prices have dairy producers seen? What are the industry's price expectations?

Milk prices were at historic highs in 2014. Milk used to produce cream cheese and hard manufactured cheese, known as Class III to those in the industry, saw a price average of $22.26 per centum (cwt) weight. That beat the prior high of $18.37/cwt in 2011.

Milk prices are expected to decline significantly in 2015 as export demand has dropped and greater milk supplies in both the United States and the world put downward pressure on milk prices. Feed prices and now fuel prices are dropping from 2014 averages so this will help ease some of the pain of lower milk prices.

Q. What risks do you see to a downturn for dairy producers? What is your bank doing to address those risks?

Dairy farmer margins will be under pressure in 2015. Producers have a number of tools available to assist in managing these margins, including:

- Forward contracting milk sales,
- Using hedging and options programs to manage price risk,
- Participating in the Margin Protection Program authorized in last year's Farm Bill,
- Using the LGM-Dairy insurance program,
- Forward-contracting or hedging feed, crop inputs and fuel to manage expenses.

BMO assists producers in analyzing their financial position and providing credit and recommendations to assist in managing price risk. This may include credit facilities to provide capital to meet margin requirements or margin calls, or it may include referrals to qualified marketing advisors or other professionals who can assist in educating dairy producers in understanding and developing price risk management strategies. ■

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coverage program (PLC). After the March 31 deadline passes, farmers cannot change programs until the next farm bill. If a farmer does not select a program, not only would the farmer default into PLC, the farmer would forfeit payment from 2014.

Defaulting into PLC would not be advantageous for most farmers. PLC will only trigger payment when the price of corn drops below $3.70. If corn doesn't go below $3.70, the farmer will have no check coming.

Research from the University of Illinois, Urbana, explains why ARC-C is popular with Midwest farmers. It will pay better so long as corn prices exceed $3.30 per bushel from 2014 through 2018. ARC-C also will pay better for soybeans so long as prices exceed $7.80 per bushel. The same is true for wheat when prices exceed $5.50 per bushel. The futures market is currently offering $3.80 for corn, $10 for soybeans and $5.20 for wheat.

Peter Scheffert

"Our analysis shows that if one were to sign up for the ARC-C program, farmers in Indiana could receive $60 an acre, up to $90 an acre, under a really negative price regime," Boehlje said. "There will probably be no or low payments for soybean base acreage. Farmers in the Dakotas and the Western corn belt may actually receive more."

To avoid any chance of missing a 2014 payment, bankers at Farmers State Bank of Hartland, Freeborn, Minn., are encouraging farmers to sign up quickly, said Peter Scheffert, vice president at the $103 million bank. "Locally, we are worried it is going to be a zoo for people signing up at the last minute at the Farm Service Agency," he said. "Since you can change your program selection as many times as you want before the deadline, I tell farmers to sign up now for the option that looks best. Then, if they need to change they can change it up to the last moment."

No bust in land values

It is unlikely Midwest farmers will see a drastic drop in land values in 2015, said Jackson Takach, economist at Farmer Mac, Washington D.C.

The average loan-to-value ratio for Midwest farmland loans is 53 percent or less, Takach said. "We do not see a lot of loans nationally over 60 percent loan-to-value," he said.

Jackson Takach

Takach said he expects land values in Iowa and Illinois, which track each other closely, to drop by about 5 percent in 2015. The Dakotas could see declines larger than 5 percent depending on the health of the state's energy sector. Minnesota, which didn't have the same inflation in price as Iowa, will adjust only slightly, Takach said. "We should be fine as long as we don't see a lot of people putting land on the market at once," he said.

Paulson said generally a 2 percent decline in farm income will prompt a 1 percent decline in farmland values. Even with large declines in income, land values would have to descend a long way before becoming a problem for farmers and bankers. As of 2012, nearly 80 percent of farmland is debt free, Paulson said.

The overall debt-to-asset ratio for farmers is the lowest since 1954. "But the debt is concentrated," he said. "About 20 percent of farmers, who also account for 80 percent of the output, have 60 percent of the debt."

Farmers remain strong

There is a major correction underway in the grain production sector, Paulson said. "That being said, the industry generally is in a better position to handle the downturn than previous regressions," he said. "Farmers' financials are stronger, lenders are more restrained, sometimes to a fault. Land is in tight hands and, with interest rates relatively low, along with continued strong interest in land ownership by famers and non-farmers alike, we're not subject to a collapse like the 1980s."

Boehlje said his expectation is that farmers who have substantial cash reserves and working capital will not encounter any credit availability challenges. "I think credit availability generally won't change," he said. "I do think bankers will be asking more questions of farmers than they have about their costs, their break-even and about the price they expect for their crops. They will also ask about family living expenditures."

Farmers are not as concerned about 2015 because they have been so profitable, said Nate Kauffman, Omaha branch executive of the Federal Reserve Bank of Kansas City. "They see a tight year ahead but they have a positive outlook," he said. "Leverage, while a problem for some borrowers, is not a problem for most. They do not have so much that they can't handle a shock."

Mike Hein, vice president at the $142 million Liberty Trust & Savings Bank in Durant, Iowa, said farmers already need to borrow more. "There is still quite a bit of corn that hasn't been priced because farmers are hanging on to it for the moment," he said. "It is not going to be a year for panic. It is a time to be proactive on restructuring while we have favorable rates."

Paulson said he expects top producers to do better than break-even this year, even with unfavorable prices and input costs. He and Scheffert categorized farmers: One group has equity, cash reserves, experience and business management skill. "They will get through this no matter what," Scheffert said. The second group will need the government programs and some working capital to live on. "If this low-price atmosphere lasts five years, it will probably get hard for them," he said. The third group struggled even during the last eight years of high commodity prices. "They will be in trouble when prices come down but rent and operating costs don't."

In good times, lending is usually about price. In tougher times, it becomes about relationships, Paulson said. "Despite the short-term downside risks," he said, "there are plenty of positives in ag." ■

New SVP: Lenders will continue to leverage Farmer Mac

Editor's note*: Curt Covington joined Farmer Mac as senior vice president, agricultural finance in January. Covington will lead the company's overall credit administration and underwriting.* NorthWestern Financial Review *reporter Matthew Doffing sat down with Covington to talk about his background and to get his thoughts on agri-finance.*

Q. Tell me about your background; did you grow up on a farm?

I was born and raised in Selma, California, a small farming community in the heart of the San Joaquin Valley. I am the fifth of six siblings and the only one to remain connected to agriculture. Our family farmed walnuts, raisins and wine grapes. My father passed away when I was young and my mother decided to sell the farm so I spent most of my teenage and college years working for other farmers and ranchers in the area. I always knew I wanted to return to agriculture after college but wasn't sure what exactly it was I wanted to do. I suppose what brought me to ag banking were my roots in agriculture. I wanted to contribute in a tangible way to the first and most essential industry in the United States.

Q. You join Farmer Mac after having managed the ag loan portfolio at Bank of the West. Tell me about that. How did Farmer Mac's programs help Bank of the West remain competitive?

Bank of the West, the third largest commercial agricultural bank in the United States, has $6.5 billion in agricultural loan commitments and 27 years of uninterrupted growth in loan volume. Agriculture lending has been a very good business for the bank for many years and Farmer Mac has been an increasingly important partner in sustaining that growth. Farmer Mac's long term fixed rate products, for example, were key to retaining valued client relationships. With increasing market volatility in almost every sector of agriculture, the bank views Farmer Mac's Long Term Standby Purchase Commitment program as a cornerstone product of credit risk mitigation.

Q. Congress recently removed term limits for FSA guaranteed loans. Do you see Farmer Mac's business involving FSA guarantees increasing as a result?

All else equal, removing term limits and expanding the eligible population could increase business in that segment. However, more than the term limit change, business in that segment ultimately depends on whether lenders want to keep those assets on their books or sell them to generate liquidity/manage interest rate risk. Because of the USDA guarantee, these assets typically have a very low risk weight in capital calculations which makes them attractive to retain in portfolio. However, we encourage the sale of the loans via attractive pricing.

Q. Do you expect the harder times ahead for agriculture and for land values will have an effect on how Farmer Mac helps banks compete for lending opportunities?

Declining land value in and of itself should not dramatically change what Farmer Mac can offer banks. The average loan-to-value on purchased loans is around 50 percent, so even a 20 percent reduction of land values would not put the average loan beyond our underwriting standards. That said, at the end of the day, it all comes down to offering competitive rates and an ease of delivery, and that is where Farmer Mac comes in.

Harder times and the potential for declining land values comes with the territory when lending to the farm community. Farmer Mac has been a consistent and pragmatic partner for ag banks for 27 years and during that time has stood by its commitment to serve rural America. From my perspective, if difficult times do come, ag banks will be looking to find ways to mitigate credit risk while at the same time serve their customer's needs. I believe this puts Farmer Mac in a good position to be the solution. ■