FARMER MAC

DAVE'S GPS

12/19/16

<u>The Super Bowl of Agricultural Lending</u>

By Dr. David M. Kohl

Each fall, one of my favorite stops is the American Bankers Association (ABA) National Agricultural Bankers Conference. The year marked the 64th anniversary of the event. Held in Indianapolis, Indiana, this venue was at the backdoor of one of the conference's founding speakers, the late Dr. Earl Butz, Dean Emeritus of Purdue University's School of Agriculture and U.S. Secretary of Agriculture in the 1970s. As it did during Dr. Butz's lifetime, the conference continues to evolve. Entering my fourth decade of speaking at the event, this powerful four-day conference could be entitled, "The Super Bowl of Agricultural Lending." With over 20 pages of notes, I want to highlight some of the great points from this rich environment of information.

The conference actually kicked off on Sunday morning with a hands-on, pre-conference session with USDA Farm Service Agency (FSA). The information presented outlined the various programs and actions designed to assist lenders and producers during this economic downturn. It set a practical and useful tone for the conference.

During the conference, Dale Nordquist of University of Minnesota's Center for Farm Financial Management utilized FINBIN data to illustrate issues impacting the agricultural sector. The average term debt and lease coverage ratio registered in at 79 percent for 2015, which is below the minimum break-even point of 100 percent, for only the second time in the database's 20 years of existence. The third-year of the agricultural downturn now finds producers burning through working capital; specifically for farms in the lower 20 percent of profitability. If the downturn continues, the next line of defense will be core equity reserves, mainly land. Dale also illustrated how a producer generating $1 million in revenue was able to market corn for an additional $0.15 per bushel and soybeans at an increase of $0.77 per bushel, adding approximately $85,000 to net farm income. As a lender, one question to ask your customers is whether they were able to market any of last year's crop in the $4 range, or did they hold out hope for the $6 home run? It is important to accurately judge the level of discipline your customers practice in marketing.

Another interesting perspective from the conference was that the dairy industry is living on the edge. Unlike the downturn of 2009, prices have not bounced back. This is due to a global oversupply of product, the strong U.S. dollar and continued improvement in dairy production and efficiency. Both speakers that addressed this industry issue stated that the U.S. will lose approximately 6 percent of dairy producers each year until 2025. The most vulnerable group is the operations with 200 to 800 cows that built facilities two to three decades ago. These older operations simply cannot compete with the newer, more efficient operations of recent years. However, there is still profit in the dairy industry for those businesses that operate more efficiently at a lower cost through better use of fixed resources. Higher production was cited as an important economic variable; however, according to the speakers, lower feed cost per cow was not quite as important of a variable.

Addressing all agricultural sectors, one speaker made the comment, “Big does not cut it.” While large and growth-oriented producers made considerable money during the economic super cycle, now larger operations must be proactively well-managed, or positioned to lose lots of money. Two different speakers spoke about the future of agriculture and marked this period in the industry as transformative. Yes, agriculture is going through a cyclical downturn similar to the 1980s, but the industry must still be positioned for the future. Tom Day, Vice President of Refrigerated Food from Hormel Foods Corporation, noted four characteristics of a successful industry or business. First, know the global trends in markets. Second, you must produce for multi-cultural demands. Third, be holistic. Fourth, a business must incorporate the on-the-go Millennial generation, both domestically and abroad.

Non-government organizations (NGO) will continue to shape the agriculture industry and how those surrounding it conduct business. For example, any organization must be aware of issues and policies regarding factors such as, biosecurity, antibiotic use, GMO and non-GMO, organic, natural, and animal production. This is no small feat. In fact, even large food organizations and manufacturers are challenged to find ways in which to meet a splintered marketplace in a long-term, profitable manner.

Establishing ethical perimeters, following protocols and more intense monitoring will be critical aspects for the successful farm businesses in the future. One speaker said, “Big ideas often come from the people who have small egos, are good listeners, and understand human behavior.”

Another interesting point from the conference was that communist countries often create economic bubbles. The Russian Wheat Deal of the 1970s illustrates this point well. As a result, land values boomed followed by a bust during the 1980s. More recently, China was among the leading factors that led to the commodity boom of food, fiber and fuel starting in the late 1990s and continuing into 2013. Their strategy of autocratic capitalism was implementing aggressive infrastructure building, which created a rise in income throughout the emerging nations. Will the future of agriculture look like the bust of the 1980s? Only time will tell.

Despite much conversation regarding the outcome of the recent U.S. elections, there was a sense of calm optimism among conference attendees. Informally, many cited regulatory relief, specifically, in banking, business, environment and healthcare reform, as possible positives. Others indicated that a simplification of the tax code and possible tax reductions are also potentially positive outcomes. However, there was much unrest concerning the new Administration's view on international trade including the North American Free Trade Agreement (NAFTA), and immigration. These policies are crucial to agriculture, but also to businesses interconnected with agriculture, including rural businesses.

I heard the timeframe from December 2016 to April 2017 coined as “ground zero” for agricultural lending. The defining terms and process of converting operating loans to term debt will bear significant impact. In large part, events during this time period will determine the impact on land values, land turnover, cash rents, and overall profitability of lending institutions.

This year's conference reminded me of the Eagles' hit song, “New Kid in Town” from their 1976 album. More than 15 percent of the audience was Millennial lenders, regulators and professionals. The generational transition in agriculture is well underway. Those with 30 years of experience and beyond will most likely be out of the lending industry by 2020 to 2025. Other issues highlighted at the conference were lender liability, financial analysis, and problem loans. Better use of professional financial software was also stressed, particularly for the younger agricultural lenders.

Both mentally and physically exhausted, I was exceptionally fulfilled as I rode to the airport. My interaction with bankers, lenders and professionals who consistently desire to better the industry is reassurance that the future of agriculture is bright.

Management Tip:
The 2017 conference will be in Milwaukee, Wisconsin in November. Remember, if you are not attending and learning, your neighbor is. Information, knowledge and networking are your advantages in today's competitive markets.

Global Economics

The global environment is one of political and economic uncertainty. Impeachment proceedings in Brazil and South Korea fuel uncertainties for these prominent world economies. The Italian elections, which followed the BREXIT vote, are both indicators of new directions in the European region. The elections in Germany and France will be equally as interesting and important to follow. The results could impact currency strength, future direction of economics, as well as immigration and political reform in these regions of the world.

Domestic Economics

A fitting description for the current status of the global and domestic economies would be, "At the crossroads, destination unknown." The looming variable is political elections. That includes of course, the recent U.S. elections as well as several, transformative elections taking place around the world.

Will the new administration command control of Congress and prove able to implement major regulatory and tax reform, along with increased infrastructure spending in order to stimulate domestic economic growth? We shall see. Of course, the level of interest rate increases will impact the economy, stock market and other asset values, such as, housing.

The LEI (Leading Economic Index), the LEI Diffusion Index as well as the PMI (Purchasing Managers Index) each indicate a pro-growth economy over the next six months. All factors are in positive ranges with the PMI registering the strongest at 53.2. Another metric to closely observe is the price of copper, which has increased nearly $0.60 per pound this year. This variable often foretells economic growth, interest rates, and of course, inflation.

One major question for 2017 is the number of interest rate increases. How many times will the U.S. Federal Reserve raise rates? Dr. Yellen suggests up to three times. As a predictor of interest rate increases, there are three variables to monitor. Unemployment (U-3) is now 4.6 percent and U-6 is 9.3 percent. If U-3 stays in the 5 percent range and U-6 is constant in the 9.5 to 10 percent range, this could make a very compelling case for an interest rate increase. Another factor to monitor is inflation. Core inflation currently stands at 2.1 percent and headline inflation is at 1.7 percent. Should these metrics increase respectively to 2.5 percent and 3.0 percent (core and headline) this would also support raising interest rates. Finally, the growth of the domestic economy is currently in the 1 to 2 percent annual range. If this rate increases to 3 percent, and combines with other variables, expect short-term interest rates next year to increase at least 75 basis points.

Factory capacity utilization is currently at 75 percent largely due to the decline of automobile production. However, for long-term economic stability, this metric needs to increase by approximately two percentage points. Housing would also require an increase to 1.5 million annually. In both cases, increases may be difficult due to higher interest rates and strength of the U.S. dollar. Much like the strong dollar is a headwind for exports, interest rate increases impede the debt servicing ability of the household.

Overall, the next six months will determine much about the direction of the U.S. economy. For now, it is largely a “wait and see” game.

Lender and Business Dashboard Economic Indicator Assessment **12/19/16**

By: Dr. David M. Kohl

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

Indicator	Current	Green	Yellow	Red
Leading Economic Index - LEI	124.5 (Oct)	✓		
LEI Diffusion Index	60% (Oct)		✓	
Purchasing Manager Index - PMI	53.2	✓		
Housing Starts (millions)	1.090		✓	
Factory Capacity Utilization	75.0		✓	
Unemployment Rate	4.6%	✓		
Core Inflation	2.1%		✓	
Headline Inflation	1.7%	✓		
Oil Price ($/barrel)	$43.87	✓		
Yield Curve	1.88	✓		

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	**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